

TRADE THEORIES AND THEIR RELEVANCE TO MALAYSIA'S ECONOMIC DEVELOPMENT

Noor Al-Huda Abdul Karim*, Norimah Rambeli@Ramli,
Norasibah Abdul Jalil, Emilda Hashim and Asmawi Hashim
Universiti Pendidikan Sultan Idris
Main Author*

ABSTRACT

This paper attempts to relate some classical and modern trade theories to Malaysia's economic development. In the mercantilism theory, the world has a fixed amount of wealth only. Some wealth from another country has to be taken through exporting more and importing less if a host country wants to increase its wealth. In Adam Smith's theory of absolute advantage, the consequence of labour division is industrial production improvement in a country. David Ricardo's theory of comparative advantage explains that a country still can gain from trade even though its trading partner is less productive in its production of goods. In the Heckscher-Ohlin (HO) model, linkage of trade patterns with factor proportions is explained. The HO model is extended by the Rybczynski Theorem, Factor Price Equalization Theorem and Stolper-Samuelson Theorem. The relevance of trade theories to Malaysia can be seen from the aspects of industrial, investment, technological and trade development. Malaysia's investment and industrial policies have been established to promote the development of manufacturing and manufacturing-related services. In trade development, bilateral trade policies and export strategies are to enhance the country's exports. Certain measures have also been implemented by Malaysia to secure the access of Malaysian products into overseas markets.

KEYWORDS: TRADE THEORIES, MALAYSIA, ECONOMIC DEVELOPMENT

1. INTRODUCTION

Basically, trade theories explain that countries export their surplus of goods and services and import those that are insufficient in their countries. Scarce local resources must be exploited in a way that the surplus of goods can be produced for trade. Today, the

management of international trade operations are getting complex when it must conform the national agendas of economic growth and development of the trading countries. For developing countries, export-oriented and foreign investment-driven development strategy has been the most promising policy to shift from agriculture to industrialization so that they can achieve long-term modernization.

In the World Trade Report 2014, developing countries has an increasing share in global output from 39 per cent in 2000 to 52 per cent in 2012. The share of G-20 developing economies had much increased in exports from 25 to 36 per cent (Note: Among the G-20 developing members are Argentina, Brazil, China, India, Indonesia, Mexico, Saudi Arabia, South Africa and Turkey). China had increased more than double its share from 7 per cent to 15 per cent and India recorded a modest increase from 4 to 6 per cent over the same interval. The Least Developed Countries (LDCs), however, accounted for only 2 per cent of world exports in 2012, up from 1 per cent in 2000. Global value chains (GVCs) can help developing countries integrate into the global economy by producing only certain components or tasks in their industries at lower costs. Rather than complete final products, the production of higher-value components or tasks within the supply chains can support further economic growth of developing countries. In value-added terms, more than half of developing countries' exports contain GVCs. Their trade share in parts and components has quadrupled over the last 25 years with services constitute more than one-quarter of their exports (WTO, 2014). In the World Trade Report of 2016, the focus on how to increase contribution share of small and medium-sized enterprises (SMEs) products in international trade is emphasized (WTO, 2016)

Developing countries face challenges in ensuring that their trade and investment policies are able sustain the development of their economic sectors because there are interest groups that put pressures to benefit their trade barriers. In this case, the propositions of Heckscher-Ohlin (HO) model may or may not be able to overcome their existing unequal distribution of domestic resources. Therefore, it is not necessary for them to trade according to the comparative advantage model. For trade liberalization, multilateral (WTO) and regional trade agreements have been engaged. But for international trade expansion, unilateral policy reforms and technical change have been used as its major drivers.

Malaysia has its own strategies and policies to manage international trade so that it can benefit its economic growth and development. At the same time, the country always expects good economic, social and even political relations with other countries. For Malaysia's commitment of trade liberalization, the country has reduced trade barriers by cutting its unilateral tariff and establishing trade agreements. According to the report of 2015 Index of Economic Freedom, Malaysia's average tariff rate is 4.0 percent (The Heritage Foundation, 2015). Japan, People's Republic of China, the European Union (EU), United States and India are among the major countries involved in trade activity with Malaysia. With trade, Malaysia has promoted foreign direct investments in its economic

sectors particularly in manufacturing and services sectors. Through the Malaysian Investment Development Authority (MIDA), guidelines and facilities are established to help foreign investors to start up their business activities in Malaysia.

2. THE CLASSICAL AND MODERN TRADE THEORIES

In Mercantilism, a system of government institutions and policies was designed to restrict international trade. The dominance of the system was in Europe from the 16th to the 18th century. In this theory, the world only contains a fixed amount of wealth in which the source of a country's wealth is gold or money. In order to increase wealth, the country must export more and import less (Wikipedia, 2015). Later, the classical Adam Smith's theory of absolute advantage came with the division of labour to bring about production improvements in a country. Countries' specialization is in the production of only a few goods (Schumacher, 2012). In David Ricardo's theory of comparative advantage, a country can gain from trade even if its trading partner is less productive in producing goods. The main point is how much productive or cost efficient one country compared to another. Countries should do specialization by allocating their scarce resources to produce goods and services for which they have a comparative cost advantage (Economics Online, 2015). The Ricardian theory has been a basic constituent of neoclassical trade theory.

Later, the modern model of Heckscher-Ohlin (HO) provides a clear linkage of trade patterns with factor proportions. The HO model was developed by two Swedish economists, Eli Heckscher and Bertil Ohlin in the early 1900s. A country will export products that use its abundant and low cost of factors of production and import products that use its scarce factors. Countries have comparative advantages in those goods for which the required factors of production are relatively and locally abundant. Goods that require abundant local inputs are cheaper to produce than those goods that require scarce local inputs (Wikipedia, 2015).

Rybczynski Theorem, Factor Price Equalization Theorem and Stolper-Samuelson Theorem have extended the Heckscher-Ohlin (HO) model. In the Rybczynski Theorem, the world is assumed at constant prices. If a country experiences an increase in the supply of one factor, it will produce more of the product intensive in that factor and less of the other. In the Factor Price Equalization Theorem with all the assumptions of the HO model, free international trade will lead to the international equalization of individual factor prices. Let say, Country A is relatively capital-abundant and rent is low but with trade, the increase in demand for capital for producing exports raises rent. The opposite happens in country B. In the Stolper-Samuelson Theorem, free international trade gives a benefit to the abundant factor and harms the scarce factor. It caused the emergence of some groups in society who will oppose international trade and the other groups who have scarce factors will lobby government for trade protection. (Husted and Melvin, Chapter 4, 2010).

The development of trade protection causes limitation of imports or promotion of exports by putting up trade barriers. Protectionism is increasingly put into practice in the trade world. But now, trade liberalization policy is gradually given attention and established in developing countries to support free trade for their economic growth and development.

3. PAST STUDIES ON TRADE AND ECONOMIC DEVELOPMENT

Few papers are further explored to find the relevance of trade to economic development. Kudo and Mieno (2007) examined Myanmar's external sector in its transition to an open economy from the early 1990s to the mid 2000s. The trade volume substantially increased after the open-door policy was implemented. However, the contribution of trade to gross domestic product (GDP) remained very low throughout the period. Myanmar's economic structure had not changed into one that is deeply linked to external trade. The contribution of exports to growth of economic sectors had been intermittent whether through the garment industry or through natural gas development. Likewise, foreign direct investment (FDI) had mostly contributed to the growth of the domestic and energy sectors. Export-oriented manufacturing had not been given more emphasis. Myanmar's external sector had not yet shown signs of fulfilling its potential contribution to economic growth and development.

In a study on trade technology by Busse and Groizard (2008), total volume of trade is not the most appropriate measure for technology diffusion as a source of productivity. Instead, taking 21 OECD (Organization for Economic Cooperation and Development) countries into analysis, endogenous growth models and empirical evidence from their econometric model specifications indicate that imports of research and development (R&D) intensive capital goods capture technology diffusion. Countries adopting less technology through trade have a lower productivity. In the long run, technology diffusion through trade increases income levels via total factor productivity, in turn reducing the income gaps among countries.

In a study of Nabine (2009) on the impact of Chinese Investment and trade on Nigeria economic growth, the trade relationship between the two countries did not contribute to Nigeria economic growth in short term. But, it could enhance the country's economic growth and development in long term. Nabine's estimation used time-series and panel data from 1990 to 2007 and the statistical methods are the Ordinary Least Squares Method (OLS) and the Granger causality test. Based on the findings, Nigeria should make sure that foreign direct investment (FDI) inflows from China and the bilateral relationship exert the beneficial effects on GDP and exports through advanced technology acquisition and open trade regime. In Daumal and Özyurt (2011), an empirical study was carried out on 26 Brazilian states over the period 1989-2002, exploring the impact of trade openness on their

economic growth. The study used dynamic growth regressions using system GMM estimator found that trade openness is more beneficial to states with a high level of initial per capita income. Trade openness favors more industrialized states, well-endowed in human capital than states that have economic activity mainly agriculture-based economic activity. The policy implications need to consider achievement of balanced territorial economic development in the country.

In Biwott, Moyi and Khainga (2013), trade liberalization policy and outcome measures were used to investigate the effects of trade liberalization and business regulations on economic growth in 16 sub-Saharan Africa (SSA) countries. Using panel data and the Instrumental Variables (IV) and the Generalized Method of Moments (GMM), the results show that less regulated countries benefit more from international trade liberalization than heavily regulated countries. Improved regulatory policies on credit, labour and product markets can contribute to economic growth. In Haq and Luqman (2014), a different empirical analysis was done to estimate dynamic panel growth equations that used a dataset of nine Asian countries over the period 1972–2012. International trade was found to enhance the accumulation of human capital and contribute to economic growth positively. From the past literature, international trade theories highlight their contribution to economic development provided that there are strategies and policies to monitor progress toward the achievement.

4. TRADE AND MALAYSIA'S ECONOMIC DEVELOPMENT

Having reviewed the past trade theories, Malaysia's trade with other countries is to help achieve its national development objectives. Like other open economies, trade is important for Malaysia to increase national income. Economic development can be supported only if the country has money sources to spend for the welfare of people such as the provisions of infrastructure facilities, housing and amenities, job creations, etc. Till present, Malaysia has impressive economic performance through its intensive program of industrialization. In 2006, Malaysia's GDP growth was 5.6 percent in which it was highly dependent on favorable external terms of trade. In 2010, it achieved 7.2 percent. In 2013, it was 4.7 percent. In the year 2015, Malaysia's growth was projected to increase to 5.0-6.0 percent (Bank Negara Malaysia, various issues).

4.1 Trade performance

Trade competitiveness reflects the ability of Malaysia to maintain or expand its share of world exports. In an analysis of the World Bank, the country is suggested to have

immediate policy objectives of a strategy aimed at boosting trade competitiveness (World Bank, 2014). The suggested policy objectives for Malaysia are threefold:

- i. Upgrading Malaysia's participation in Global Value Chains (GVCs) by moving towards knowledge-intensive and high value-added segments;
- ii Increasing linkages between domestic suppliers and other GVC participants; and
- iii. Expanding trade in knowledge-intensive services.

Subject to the fulfillment of these objectives, Malaysia is possible to continue to take advantage of international trade to complete its transition to high-income status.

Table 1 indicates the performance of Malaysia's trade from 2004 to 2014. The total trade value was the highest in 2014 with MYR1, 449.14 billion. In the same year, Malaysia's exports to the EU were 766.13 billion.

Table 1: Malaysia's Annual Trade, 2004 -2014

Year	Total Exports (RM billion)	Total Imports (RM billion)	Trade Balance (RM billion)	Total Trade (RM billion)
2004	481.25	399.63	81.62	880.89
2005	536.23	432.87	103.36	969.1
2006	589.24	478.15	111.09	1,067.39
2007	604.3	502.04	102.26	1,106.34
2008	663.01	519.8	143.21	1,182.82
2009	552.52	434.67	117.85	987.19
2010	638.82	528.83	109.99	1,167.65
2011	697.86	573.63	124.24	1,271.49
2012	702.64	606.68	95.96	1,309.32
2013	719.99	648.69	71.3	1,368.69
2014	766.13	683.02	83.11	1,449.14

Source: <http://1-million-dollar-blog.com/malaysia-international-trade-export-import-trade-balance-statistics/>

4.2 Foreign direct investment flows into Malaysia's manufacturing sector

Trade activities have led to remarkable foreign direct investment (FDI) flows into Malaysia's manufacturing sector. The United States had the highest total of FDI in 2012 and 2013. In 2013, it was followed by South Korea.

Table 2: Foreign Investment in Approved Manufacturing Projects by Top Four Countries 2012-2013 (MYR)

Year	Country			
	United States	South Korea	Singapore	Japan
2012	295,779,636	1,636,972,599	2,214,565,561	2,792,900,107
2013	6,320,610,568	5,478,840,221	4,522,314,186	3,591,876,939

Source: MITI (2014)

4.3 The New Economic Model (NEM)

A New Economic Model (NEM) is an economic plan formulated through the National Economic Advisory Council (NEAC) to drive Malaysia's transformation into an advanced nation by 2020. The model to be achieved through an Economic Transformation Programme (ETP) strives for broader goals than just boosting growth and encouraging foreign and domestic investments. It takes a holistic approach that focuses also on the human development, recognizes that while Malaysia has substantially reduced poverty, a hefty 40 percent of its households still earn less than RM1, 500 per month. Income disparity must still be actively addressed and measures are needed to narrow the economic differences prevalent in the states of Sabah and Sarawak as well as in the rural areas of the Peninsula. Openness to the world economy enabled strong economic development and rising per capita income. However, being an open and small economy, Malaysia has faced external shocks, as seen during the past crises that include the prolonged Asian Financial Crisis 1997-1998. Unless production costs and productivity in Malaysia can keep pace with those challenges come from abroad, exports are likely to lose ground with negative effects on national employment and income. Thus, the keys to the model are created as "high income, sustainability and inclusiveness". Its goal is to stimulate economic growth by improving worker productivity across all types of sectors in the country (NEAC, 2009).

Malaysia's exports are still strong but not generating enough high value-added products. Exports are a key focus for Malaysia. The economy is highly dependent on external markets, with an export to- GDP ratio of 1.2 and a trade-to-GDP ratio of 2.2 in 2008. Malaysia's export structure has focused mainly on electrical and electronics (E&E) products and on primary commodities. Many shortcomings faced by Malaysia must be

overcome before the country can transform into an advanced nation by 2020. An advanced nation is not only about the income level. The country's economic structure must be more developed, specialised and technology-driven. Effective institutions must also be in place to ensure good governance. All measures in the model are needed for the country to sustain its export performance in trade (NEAC 2009).

5. CONCLUSION

Malaysia's economic development experience from the past to present is not without a consequence of increased trade activity with various countries. Trade relation between the country and the rest of the world is important to promote foreign direct investment (FDI), which is a complementary to domestic direct investment especially in manufacturing and manufacturing-related services industries. As a result of international trade, there have been increased FDI inflows that further contribute to strengthen Malaysia's economic growth and development. These FDI inflows bring together technology and innovation in production and product development in the country's critical industries. The establishment of bilateral trade policies, export-oriented strategies and the implementation of effective measures have enhanced Malaysia's exports and secured the access of its products into foreign markets. Having studied the past trade theories, attempts to relate their contribution to the economic development of Malaysia's cannot be ignored. The country's abundance of natural resources after being utilized efficiently for production of goods, benefit its overall economy only when trade activity generates large income for the country. Some part of income, in turn, is used to import capital goods that are limited in the country but needed in the production of goods for local and foreign consumption.

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