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## The Impact of Trade Liberalisation on Wage Inequality in Malaysia

By

**Dr Juita Mohamad**

*Senior Analyst, ISIS Malaysia*

**A**s the world economy shifts into a more globalised era, every developing nation is harnessing its resources in an effort to take part in a more free trade regime. Globalisation promotes the practice of free trade and it is believed to promote a more level playing field in the world market, as tariff rates are driven down to near zero percent. In other words, protectionism policy is at the brink of extinction with the rise of trade reforms. Trade reforms, in the long run, will reward efficient producers with the competitive advantage that ensures their position in the global market.

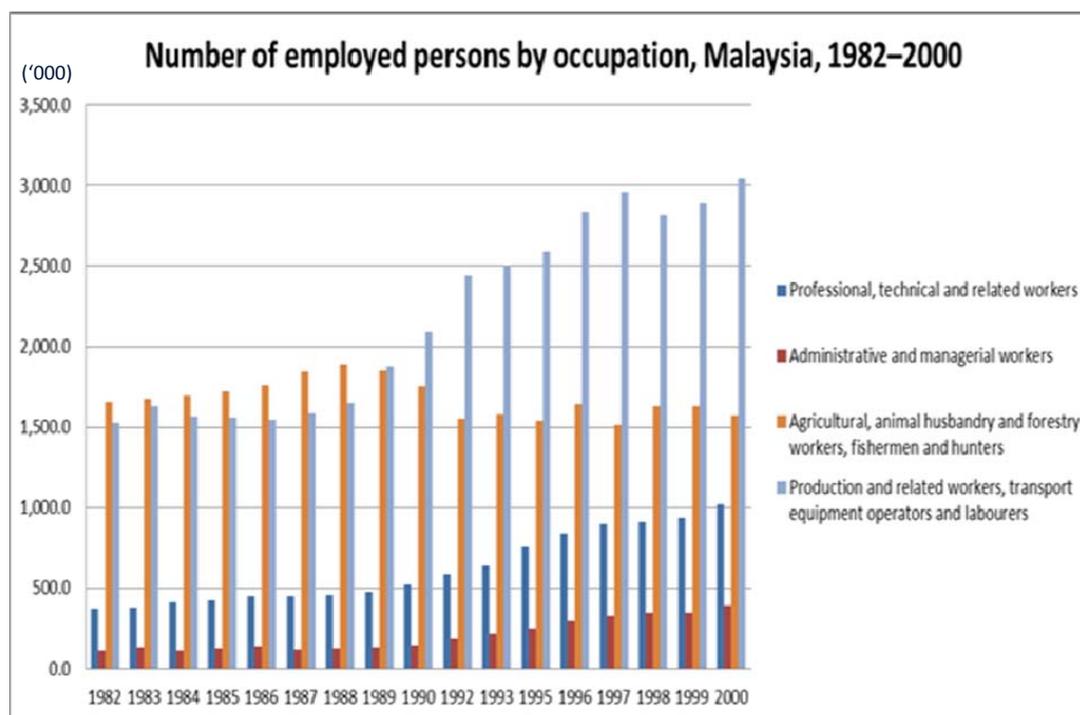
Free trade was promoted by the celebrated Adam Smith in the 18th century who highlighted the idea in his book titled *The Wealth of Nations*. Here was how he put it at that time:

It is the maxim of every prudent master of a family, never to attempt to make at home what it will cost him more to make than to buy. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it from them with some part of the produce of our own industry, employed in a way in which we have some advantage. (Smith 1776)

It is with this notion nations undertake free trade in the many different shapes and forms such as regionalism and bilateral trade pacts. As globalisation brings these nations together through intensified trade activities after trade liberalisation is implemented, households will surely benefit. When intensified trade is carried out, households are able to choose from a wide variety of products in the market at significantly lower prices. These products, which are now available locally, may be manufactured within the country's borders or beyond. Producers then are motivated to increase their productivity and quality of products to compete at a global level.

With all of the advantages of free trade, however, a growing number of economists are sceptical about the short-term problems of globalisation. Labour economists have found a trend in many developed and developing countries where, as trade liberalisation episodes take place, wage inequality between skilled and unskilled workers is observed to be increasing drastically. Due to this coincidental sequencing of events taking place abroad as well as in Malaysia, I have, for the past eight years, been vigorously involved in investigating the impacts of trade liberalisation on wage inequality between skilled and unskilled workers in Malaysia, a small, open economy. Figure 1 highlights the trends of the selected skilled and unskilled occupations held by employees.

**Figure 1: Number of Employed Persons by Occupation**



Source: Department of Statistics Malaysia. Labour Force Survey Online Data, 1982–2010

I am pro-globalisation just like Professor Stiglitz. In his book *Making Globalization Work*, American economist Joseph Stiglitz emphasised that with globalisation, “everyone was supposed to be a winner — those in both developed and the developing world. Globalization was to bring unprecedented prosperity to all” (Stiglitz 2006). Even with all of the advantages of free trade in the long run, there are some groups who are concerned about the downside of globalisation in the short run. Their concerns are real and not without basis. The nature of their concerns served as the focal point of my fascination with this mystery.

In recent years, quite a number of labour economists have found a trend in many developing countries where wage inequality between skilled and unskilled workers was observed to be increasing drastically in the short run as trade reform episodes take place. In the past two decades, the study of wage inequality and trade reforms has had more momentum than it has ever had before. The significant rise in interest on this topic could be explained by the sequencing of incidents of increasing wage inequality, which follows after drastic episodes of trade reform measures in developing countries.

Malaysia poses an interesting case study due to several points highlighted by both domestic and international literature review. Firstly, speculations and suggestions have been made by local Malaysian development economists when they were analysing the income distribution of Malaysians based on ethnicity, location and occupation since the early 1980s. The fact that no clear-cut outcome has been found motivated me to investigate the relationship between trade liberalisation and wage inequality in Malaysia. Secondly, there has been a global trend of increased wage inequality in developing nations. A surge in the number of studies on this topic focusing on both the developed and developing countries such as the United States, the United Kingdom, Colombia, Brazil, India, Mexico, and the Philippines can be observed. Most of the countries under study highlighted the findings that, yes, trade reforms do lead to increased wage

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inequality between skilled and unskilled workers. However, trade reforms have had a positive impact on wage inequality for some countries like Indonesia and India. In their cases, wage inequality between skilled and unskilled workers has been observed to decrease significantly after an episode of trade liberalisation takes place.

Additionally, Malaysia offers an excellent case to study the effects of trade liberalisation for the following reasons linked to its commitments and previous economic shocks. Firstly, the degree of trade reform in Malaysia was very big. Secondly, the trade reforms in Malaysia were exogenous. To overcome the shocks presented by the Asian Financial Crisis of 1997, the government — more than ever — continued to decrease the tariff rates for almost 90 percent of the products, which were not listed on the Sensitive List, through the commitments of the ASEAN Free Trade Area (AFTA). This commitment was done to prepare for

the AFTA Agreement deadline in year 2002, where a more level playing field for trade was to be realised for all the member countries. The reduction of tariff rates and the final tariff rate target were exogenous. Hence, lobbyists were unable to influence the trade reforms. Due to these reasons, the trade reform episode, which was undergone in Malaysia, is believed to be the best case study to explore the effects of trade liberalisation on the issues of wage and employment inequality. Figure 2 highlights the average tariff rate reductions in all industries and the manufacturing industry as well as their magnitude.

According to the assumptions made by the Heckscher-Ohlin theorem and its companion, the Stolper-Samuelson theorem, developing countries should see wage inequality decreasing between the skilled and unskilled workers within their economies as trade reforms enable the

**Figure 2: Drastic Tariff Rate Reductions in All Industries and Manufacturing Industry in Malaysia, 1989–2009**

Year	No. of Industries	Mean (%)	Standard Deviation (%)	Minimum (%)	Maximum (%)
<b>All Industries</b>					
1989	30	13.33	8.84	2.5	31.48
1992	30	12.59	8.83	1.81	30.7
1995	30	10.87	7.09	1.74	25.6
1997	30	7.61	6.51	0	20.87
1999	30	7.61	6.51	0	20.87
2004	30	6.58	6.51	0	25.85
2007	30	4.97	5.01	0	16.79
2009	30	4.35	4.49	0	14.75
<b>Manufacturing Industry</b>					
1989	21	16.96	7.87	5.1	31.48
1992	21	16.18	8.06	4.89	30.7
1995	21	13.84	6.37	4.2	25.6
1997	21	10.04	6.05	1.06	20.87
1999	21	10.04	6.05	1.06	20.87
2004	21	8.98	6.37	0.14	25.85
2007	21	6.83	4.9	0	16.79
2009	21	6.01	4.42	0	14.75

Source: Author's calculation based on figures from World Integrated Trade Solution (WITS) Database

country to export more products produced by the relatively abundant workers in the domestic market. In turn, they will import products from other countries, which are produced by relatively scarce workers. Even with the promise of increased wealth and welfare for all, the widening gap of wage inequality between these groups of workers needs to be addressed in Malaysia.

By employing the National Household Income Survey data and the data on trade policies (tariff rates) from 1989 to 2009, I am happy to report that the findings suggest that trade liberalisation has led to decreased wage inequality between the skilled and unskilled workers in Malaysia when we look at the economy as a whole.

This piece of good news, however, is overshadowed by a looming cloud as I delve deeper into the topic focusing on the manufacturing sector, where data on its workforce is available and abundant. By employing the Annual Manufacturing Survey data from 2000 to 2010, I found that wage inequality has increased significantly among the skilled and unskilled workers in the manufacturing sector through the technology channel. The logic behind this is simple. As tariff rates are driven down to near zero percent, we find that imported technology is now cheaper than before, motivating firms and plants to adopt the usage of highly advanced technologies in their daily operations. Since skilled workers are seen as the closest complimentary factor to technology, unskilled workers lose out when demands for skilled workers are significantly higher in this sector. When demand for skilled workers increases drastically compared to unskilled workers, then the problem of increasing wage inequality is observed.

So, what can we do to deter this short-term problem in the labour market? The solution for this short-term negative spillover is not, however, through eradication or elimination of trade liberalisation episodes. Just like the pieces on a chessboard, we need to strategise and mobilise our pawns to participate and march head-on while at the same time protect the sovereignty

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and interests of our nation by creating a strong defence mechanism.

These mechanisms include strengthening existing social safety nets and increasing capacity building and training efforts by both the public and private sectors. *Bantuan Rakyat 1Malaysia* (BR1M) is an existing but temporary social safety net created to help those in need. This existing framework, however, needs to be reformed so that a more effective and sustainable social safety net can be established to ensure that temporarily displaced workers can seek temporary refuge in between jobs as the labour market readjusts to its new equilibria. When it comes to capacity building, one of the most important areas will be human resource development and skill training. These efforts should not only be initiated by the government or by the private sector separately. These groups can pool their resources into a Public and Private Partnership (PPP) effort that can target more workers more efficiently. If Malaysia is serious about freeing itself from the middle-income trap and elevating its people to a developed-country status, the issues of social safety net and human resource development need to be addressed in a timely fashion.

To withdraw from the short run threat embodied in the opportunity we come to know fondly as “globalisation” is out of the question. This is because it will project the image of weakness, which can have detrimental effects on our nation in the future. To win, we must participate and jump onto the moving wagon.