

THE BENEFIT OF FREE TRADE AGREEMENT ON THE INTERFIRM TRADE: THE CASE OF THE JAPAN-MALAYSIA ECONOMIC PARTNERSHIP AGREEMENT

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2 Introduction

As one of the largest foreign direct investors in Malaysia, Japan has always been Malaysia's important economic partner. In turn, Japan is also an important destination of Malaysia's export products such as commodities, petrochemical, electronic and electrical products. In addition to trade relations, Japan and Malaysia have also enhanced their policy, social and cultural ties, since the introduction of the 'Look East Policy' initiative in 1982 by the then Malaysian Prime Minister Dr. Mahathir Mohamed..

The 'Look East Policy' mainly involves sending Malaysians to study and be trained in Japan, as an alternative to sending Malaysians studying and receiving training in western countries namely the United States and the United Kingdom. The Look East Policy was also used to change Malaysia's work culture and, at the same time, to further strengthen economic linkages by the signing Japan Malaysia Economic Partnership Agreement (JMEPA) on the 13th July 2006. The main purpose of the JMEPA is to scrap tariffs in all industrial goods and most forestry, agricultural and fisheries products within ten years from the date of the agreement.

The purpose of this article is to discuss the impact of the JMEPA on the intra-firm trade of Japanese companies who invest and have operations both in Malaysia and Japan. It will be examined to what extent such firms are drawing any benefits from the existence of JMEPA. The paper is divided into the following parts: Part II describes the economic relationship between Japan and Malaysia, Part III will discuss the JMEPA and Part IV will discuss the implications of JMEPA on the intra-firm trade. Part V will conclude the paper.

2. Japan-Malaysia Economic Relationship

The relationship between Japan and Malaysia has changed a lot since the Second World War. During the Second World War, the territories making up Malaysia then were under Japanese occupation, and history shows that people in Malaysia did not have a good memory of those years. The impact of the Japanese occupation in Malaysia left a lasting impression and often affected bilateral cultural relations..

However this has changed especially since the introduction of the Japanese Fukuda Doctrine in 1977 that proclaimed a transformation of the relationship between Japan and ASEAN member countries, including Malaysia, from unequal partners to equal partners. The Japanese rationale behind this shift was the insight that the development of the ASEAN region is also of crucial importance to Japan's security and economic prosperity. Historically, relations have evolved from a state of war to reconciliation and normalization, as well as from unequal cooperation to cooperation between strategic partners. Mahiwo (2008) observes that Japan's engagement in ASEAN in the last four decades shifted from selective engagement to comprehensive involvement. Mahiwo (2008) suggests that the contemporary relationship between ASEAN member countries such as Malaysia and Japan are subjected to the phenomenon of regionalism and globalisation.

In economic terms, ASEAN needs Japan as the source of investment while Japan needs ASEAN as the source of supply of certain materials to support Japanese economic growth. The pattern of key ASEAN exports to Japan indicates a highly complementary trading relationship. ASEAN is a key supplier of fuels and commodities, with shipments of Liquefied Natural Gas, crude oil, wood and rubber accounting for nearly 24% of total exports in 2003. Intermediate electronic components and machine parts bound for Japanese factories accounted for another 20%, underscoring ASEAN's complementary role in the value chains of Japanese MNCs (Toh, 2007).

From the Japan-Malaysia perspective, according to the figure released by the Malaysian Industrial Development Authority (MIDA) there are more than 1,400 Japanese enterprises operating in Malaysia, and these Japanese companies have provided a broad manufacturing base in Malaysia and significantly contributed to economic growth and further development of this country. In 2006 and 2007, Japan was the No 1 investor to Malaysia. Japanese enterprises continue to be very much committed to upgrading or expanding manufacturing facilities in Malaysia. Since 2000, Japan has always been among the top three investing countries together with the United States and Singapore (see Figure 1).

A major investment area is electronic products and transportation equipment. On top of such traditional in-

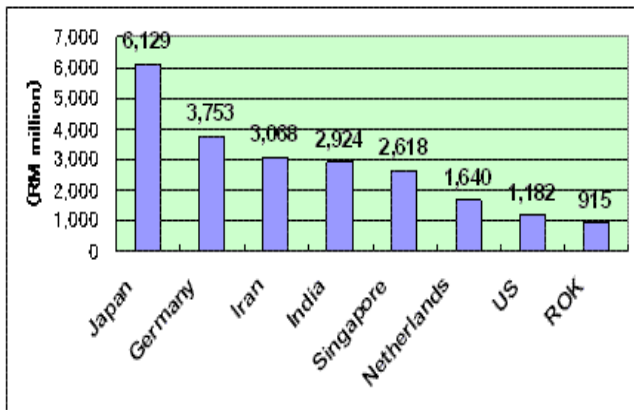
Figure1: Investment to Malaysia

(RM million)							
2000	2001	2002	2003	2004	2005	2006	2007 (10月現在)
①US 13,849	①US 15,788	①US 7,940	①Singapore 6,249	①Singapore 3,020	①Singapore 3,958	①Japan 11,195	①Japan 6,129
②Japan 3,613	②Japan 5,315	②Singapore 5,623	②US 4,765	②Japan 2,558	②US 2,878	②US 3,077	②Germany 3,753
③Germany 3,378	③Singapore 4,462	③Japan 4,146	③Japan 4,685	③US 1,904	③Japan 2,067	③Singapore 3,015	③Iran 3,068
④Hong Kong 1,798	④Netherland 772	④UK 679	④Hong Kong 2,768	④Hong Kong 1,765	④Germany 1,593	④Germany 1,735	④India 2,924
⑤Singapore 1,746	⑤UK 677	⑤Netherland 423	⑤Saudi Arabia 810	⑤Germany 1,136	⑤Hong Kong 1,170	⑤Hong Kong 1,381	⑤Singapore 2,618
⑥UK 836	⑥Germany 384	⑥Germany 411	⑥UK 589	⑥UK 736	⑥UK 942	⑥Canada 1,238	⑥Netherland 1,640

(Source: MIDA)

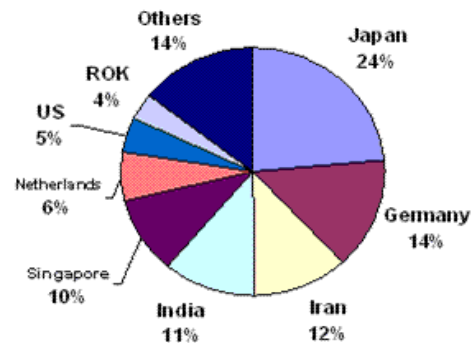
vestment in manufacturing sector, Japanese investment in various services has also been increasing; recent projects include retail sector and logistics, such as AEON and Jusco Supermarket. According to MIDA (Malaysian Industrial Development Authority) Japan’s investment approved in manufacturing sector, has reached 6.1 billion Malaysian Ringgit, or 1.75 billion in US dollar in 2007 (Figure 2). The figure is 39% larger compared to the figure in 2006. Japanese investment projects, approved by MIDA, consists 24% or one-fourth of total manufacturing investment into Malaysia.

Figure2: Approved Investment in Malaysia (January-October 2007)



(Source: MIDA)

Figure3: Share of Approved Manufacturing Investment in Malaysia (January-October 2007)

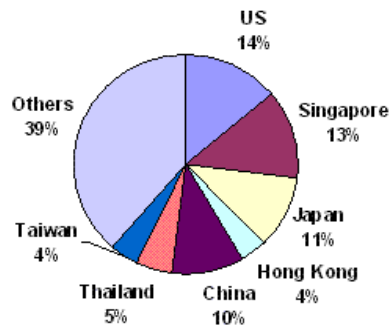


(Source: MIDA)

Regarding bilateral trade between Malaysia and Japan, Japan is the third largest trading partner for Malaysia. Bilateral trade between the two countries makes up 11% of total trade volume of Malaysia (Figure 4).

(Total of Export and Import, January-September 2007)

Throughout the last several years, Japan has been the third largest export market for Malaysia and Japan has also been the top import source for Malaysia.

Figure 4: Malaysia's Major Trading Partners

(Source: Department of Statistics, Malaysia)

3. Japan Malaysia Economic Partnership Agreement

The economic relationship between Japan and Malaysia was further strengthened by the signing of the Japan-Malaysia Economic Partnership Agreement (JMEPA) in 2005 that came into force in 2006. The signing of the JMEPA is part of Japan's change of focus from multilateralism to bilateralism. Japan's change in focus to bilateralism is due to several factors such as the slow progress of the multilateral trade negotiations, especially the slow progress of the Doha Development Agenda and other issues such as the multilateral negotiations under the General Agreement on Trade in Services and the slow progress or non acceptance of the Singapore Issues which include investment, competition and government procurement by certain countries. Japan's change in focus is also due to the need to balance the interest of Japanese trade against the greater interest signalled by trading powers such as the US and the European Union (EU) to focus on bilateral trade agreements.

In 1997, in response to Japanese corporate concern regarding discrimination in the Mexican market arising from NAFTA and the EU-Mexico FTA, the Japan External Trade Organization (JETRO) embarked on a joint study with Mexico on the feasibility of a Japan-Mexico FTA which then became Japan's first bilateral trade agreement. Furthermore, in 1999, JETRO-IDE (Institute of Developing Economies) decided to start a joint study with the Korean Institute of International Economic Policy (KIEP) on a Japan-South Korea FTA, and official FTA-related negotiations commenced in 2002. In the meantime, Japan signed an economic partnership agreement with Singapore in January 2002, representing Japan's first departure from multilateralism. Japan's Task Force on Foreign Relations, in its report to Prime Minister Koizumi Jun'ichiro in November 2002, recommends that Japan's economic strategy be defined by a closer partnership with ASEAN, to serve as a counterbalance to the emerging economic presence of China.

In December 2002, Malaysia proposed JMEPA. Negotiations started in January 2004, and in May 2005, both parties agreed in principle on the major elements of JMEPA, including a free trade agreement. Japan and Malaysia signed the JMEPA on 13 December 2005. The scope of JMEPA includes trade in goods and services, investment, customs procedures, movement of natural persons, intellectual property, competition policies, and bilateral cooperation in the fields of agriculture, forestry, fisheries and commodities, education and human resource development, information and communications technology, science and technology, small and medium enterprises, tourism, and environment.

JMEPA includes the ambitious goal of eliminating import tariffs on goods within 10 years. For Japan, the agreed modality for tariff reduction and elimination of tariff lines are categorized into two categories: A - custom duties will be eliminated on the date of entry into force of this agreement, that is July 2006 R - custom duties will be re-negotiated on the occasion of the general review of the JMEPA. For Malaysia, the agreed modality for tariff elimination will follow the following categories: A - custom duties will be eliminated on the date of entry into force of this agreement, that is July 2006 B7 - custom duties will be eliminated in 8 equal annual instalments from the base rate to zero, starting from the date of entry into force of the Agreement.

4 JMEPA and the Japanese intra firm trade

Cross-border trade within multinational companies and their affiliates, often referred to as "intra-firm" or sometimes "related party" trade, accounts for a large share of international trade in goods. Intra-firm trade accounts for around one third of goods exports from Japan and one-quarter of all Japanese goods imports (OECD, 2002). Much intra-firm trade between high-income countries is probably of nearly finished goods destined for affiliate companies that are mainly involved in marketing and distribution with little additional manufacturing processing taking place. There are, however, some middle-income countries where intra-firm trade with rich countries accounts for a high share of their bilateral trade. The primary role of the foreign affiliates located in such countries is more likely to be manufacturing to produce goods that are destined for other markets, including the country of the parent company.

A large part of intra-firm trade is of finished goods with foreign affiliates mainly engaged in marketing and distribution activities. Nevertheless, the increasing importance of foreign direct investment flows, particularly to low- or middle-income countries from the most advanced economies, and the increasing number of supertrading economies, together suggest that the trends in intra-industry and intra-firm trade also partly reflect the increasing im-

portance of the internationalisation of production. Japanese companies are very much involved in outsourcing of parts and components especially in the electronic and automotive sector.

Many East Asian and Southeast Asian developing countries have encouraged multinational affiliates to enter their markets through foreign direct investment (FDI) (ADB 2006). These multinationals are also involved in the production sharing and the rise in production sharing, where different countries contribute towards the production of different components of an end product has become particularly noticeable since the mid-1980s. For example, developing Asia's share of world trade in parts and components rose from 16% in 1992 to 32% in 2003, exceeding the share of the North American Free Trade Agreement (NAFTA) and equaling the share of the EU in 2003 (Athukorala and Yamashita 2005). Despite the significant volume of trade in parts and components within developing Asia, the ultimate destination for most final assembled products remains outside the region, chiefly in the markets of the EU and US. In fact, recent empirical research demonstrates that developing Asia is growing more, not less, dependent on these large markets for final consumption of the outputs of the Asian production networks (ADB 2006).

It can be argued that the free trade agreement has little impact on the decision by firms whether to increase investment (ADB 2006) or to increase the intra-firm trade. In some cases, the margin of preference offered by tariff concessions in a free trade agreement has been too small to compensate firms for the costs of complying with the rules of origin that are necessary to enforce these agreements.. Rules of origin normally is a prominent part of a regional or free trade agreement. Rule of origin is specifically covered in the JMEPA and also the AJCEPA. For example, less than 10% of all intra-ASEAN trade is under the ASEAN Free Trade Area's common effective preferential tariff (CEPT) scheme (*The Economist* 2004). Obtaining an AFTA certificate of origin is apparently difficult in terms of paperwork and costly because it necessitates face-to-face meetings with customs officials, so many ASEAN businesses just chose to pay the MFN tariff (ADB 2006).

However the free trade agreement may have an impact on the intra-firm trade in high-tariff sectors such as automobile as it is worthwhile to obtain the certificate of origin but this is not the case in sectors where tariffs are low or duty drawback is available for imported inputs that are used to produce products for export (e.g., electronics and office equipment) (ADB 2006).

This argument is backed by a study by Kinoshita et al (2004). Kinoshita et al (2004) finds that a free trade agreement had not visible impact in the intra-firm trade and investment decision in the electronic industry and

petrochemical industry among Japanese firms in Malaysia. In the electronic industry there are two layers of productions, finished products and components.

However the free trade agreement has an implication on the automobile industry (Kinoshita et al 2004) where, companies produce specific items in specific countries which are exported to every other country in ASEAN. Japanese automobile-related industry will also use AFTA as they are engaged in the intrafirm trade not only on components but also on finished automobile units. The potential impact of the FTA on the automobile industry is not insignificant. It will have a greater impact on the automobile industry than the electronic or the petro-chemical industry.

One of the most significant outcomes of the JMEPA negotiations is that Malaysia has agreed to eliminate tariffs on knocked-down auto parts for Japanese carmakers in Malaysia, which are basically cars that is later assembled in the importing country, and to completely eliminate tariffs on Japanese finished cars by 2015, starting first with the high-end larger car market segment. Since the domestic car market has long been protected by Malaysia, this can be seen as a positive step in liberalizing this sector. The JMEPA will allow Japanese carmakers direct entry into one of ASEAN's largest car market.

5. Conclusion

In conclusion JMEPA is an important instrument for both Japan and Malaysia to increase both the trade and also the investment between the two countries. It is still too early to predict the effectiveness of the free trade agreement on the flow of trade between the two nations or the usability of the free trade agreement by the exporters in the two countries. However it is predicted that the free trade agreement has little impact on the firms' investment decision as it has little impact on the intra firm trade apart from the automobile industry. Nevertheless one could be worried that the increase in the intra- firm trade would result in the lesser benefit from the FTA like JMEPA as firms may avoid more investment and trading in order to avoid technology spill overs into the local economy.

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