RCEP IN FOCUS: WHAT DOES IT MEAN FOR MALAYSIA?

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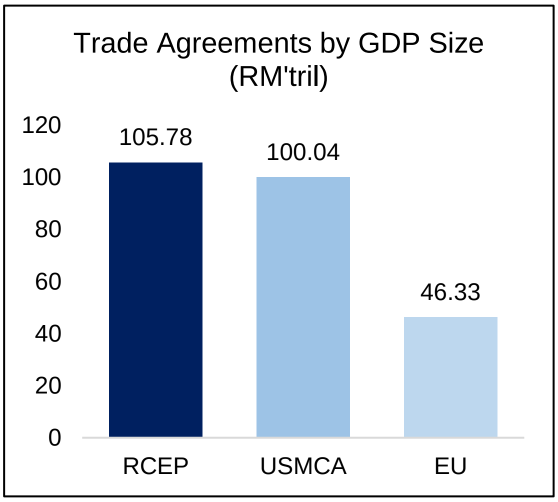
Introduction and Background

The Regional Comprehensive Economic Partnership (RCEP) was signed virtually on the 15th November 2020 during the 37th Association of Southeast Asian Nations (ASEAN) Summit. The partnership comprises 15 member countries, including all 10 ASEAN member states and its existing free trade agreement (FTA) partners including Australia, China, Japan, New Zealand and the Republic of Korea (South Korea).

Altogether, the 15 RCEP member countries have an estimated GDP of US$25.8tril (RM105.7tril), accounting for about 29% of world GDP, 53% of global trade and 30% of the world's population, makes RCEP the largest trading bloc in world history by GDP size – larger than the United States-Mexico-Canada Agreement (USMCA) and more than the GDP size of the European Union (EU)[1] (see below).



Given RCEP's inclusion of less-developed economies in ASEAN, the agreement ensures seamless free trade regulations between the ASEAN trade block and the developed economies of Asia. Essentially, the framework of RCEP streamlines and compiles all the FTAs with ASEAN and its partners while adding an extra layer on top.

The agreement does not immediately change the nature of past FTAs with ASEAN, as it notably excluding issues related to environment, labour rights, government procurement, grants, incentives and subsidies by a government, discipline on export duties and obligations on intellectual property relating to pharmaceuticals. This is in stark contrast to the US-led Trans Pacific Partnership.

This paper will examine the role of RCEP, its key aims and objectives, its impact to the region, particularly in relation to Malaysia, its benefits and costs and ends with a discussion on recommended economic strategies Malaysia should adopt in the face of this new phase of regional economic integration and Asian multilateralism.

Defining RCEP

The RCEP agreement that was finally signed during the 37th ASEAN Summit was the result of 8 years in the making, with 31 rounds of negotiations, 8 ministerial meetings and 4 preceding summits. The monumental agreement brought together 3 important economic blocs of ASEAN, Northeast Asia, Australia and New Zealand[2], forming the largest trading bloc in the world.

The key aim of RCEP is to reduce trading barriers and tariffs, increase the flow of trade in goods and services and encourage inter-member investment, ensuring that all developing countries involved in the low and mid-tier manufacturing sector within the FTA benefit from mass technology transfer and the industrialization of the productive sectors of their economies.[3]

[1] Policy Brief, RCEP: What this means for ASEAN and Malaysia, Institute of Strategic and International Studies (ISIS), 2020
[2] https://www.theedgemarkets.com/article/malaysian-firms-should-strengthen-competitiveness-benefit-rcep-%E2%80%94-mccc-president
[3] https://www.nst.com.my/world/world/2020/11/641276/what-rcep-trade-deal

Meanwhile, its stated key objective is to simplify and combine various ASEAN Plus One FTAs into only one regional trade agreement.[4] It is expected that RCEP will reinforce the importance of regional value chains and improve the user friendliness of the FTAs to primarily benefit small and medium enterprises (SMEs) across all signatories.

Initially, there were 5 ASEAN Plus One FTAs to be amalgamated under RCEP which included the ASEAN-China FTA, ASEAN-Australia-New Zealand FTA, ASEAN-India FTA, ASEAN-Japan FTA and ASEAN-Korea FTA. However, India chose to withdraw from the agreement in November due to industrial concerns that India's markets could be flooded with low-priced manufacturing goods from China as well as low-priced agricultural goods from New Zealand and Australia[5], thus the ASEAN Plus One FTAs involved was reduced to 4.

Though India had opted out of the regional agreement, the 15 participating countries openly expressed hope for the future return of India to the RCEP. In a joint statement by the all the leaders of RCEP on 15 November 2020, it was stated that RCEP will continually remain open for India.[6] India represents a major market for RCEP nations, with India ranking fifth globally in the economic size, surpassing France and the United Kingdom in 2019.[7]

What Does RCEP Cover

There are several distinct elements particularly covered under the RCEP[8]:

1. RCEP aims to significantly decrease or remove tariffs altogether, with the exception of sensitive industries currently under each country's jurisdiction. As a result, the lowering of trade barriers facilitates the movement of trade among participating countries.

2. Participating countries will commit to opening up their service markets to all service providers within RCEP member states. The increase in competition resulting from this liberalization will aim to improve the long-term efficiency of domestic companies providing services in areas such as financial services and telecommunications investment.

3. Increased levels of investments within the RCEP region will be encouraged, regulations eased and enhanced protection of property rights. This is aimed to help enhance the competitiveness and productivity of ho0me - grown Multinational Corporations (MNCs) among member countries in the long run.

4. RCEP attempts to create a level playing field for all Small to Medium Enterprises (SMEs) across both the developed and developing member states. This feature is aimed to enhance SME participation within the RCEP region and enables them to compete on more equal terms, aiming to enhance the region's long-term productivity growth.

5. The RCEP will also attempt to promote a seamless exchange of information and measures to enhance transparency to ensure that businesses and investment activities in the region can be made simpler and easier. Under this feature, the technological capability of companies, especially SMEs are encouraged to venture into new markets where economic and technological cooperation will be provided.

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[4] https://fta.miti.gov.my/index.php/pages/view/60?mid=39

[5] https://economictimes.indiatimes.com/news/economy/foreign-trade/india-decides-to-opt-out-of-rcep-says-key-concerns-not-addressed/articleshow/71896848.cms

[6] https://www.thestar.com.my/aseanplus/aseanplus-news/2020/11/16/no-rethink-of-rcep-as-indian-misgivings-harden-says-official

[7] https://www.investopedia.com/insights/worlds-top-economies/#:~:text=India%20is%20the%20fastest%2Dgrowing,the%20United%20Kingdom%20and%20France.

[8] https://www.thestar.com.my/news/nation/2020/11/16/what-rcep-means-to-malaysia#

What RCEP Does Not Cover

However, it was also noted that some important areas were excluded under the RCEP:

1. The RCEP remains largely silent on many elements of the Investor-State Dispute Settlement (ISDS) Mechanism, which currently there is no legally-binding mechanism to bring governments to court over breaches of obligations under the agreement.

   Note: Current discussions on ISDS have been put on hold which will be finalized within three years after the implementation of the agreement. In comparison to this, the CPTPP had allowed foreign companies to sue governments that have gone against its obligations under the CPTPP.

2. Restrictions on government procurement are currently excluded from the overall RCEP agreement. This is largely due to the strong government-driven sectors in participating member countries which include Malaysia, China, Vietnam and other smaller developing nations in ASEAN.

3. Government grants, subsidies and incentives for local firms are not covered under Chapter 8 of RCEP, which detail the member state's commitment to free and non-discriminatory trade in services. The terms and conditions laid out in Chapter 8 of RCEP cannot be applied to the subsidies and grants provided by governments.

   Note: This exclusion also covers government grants given to the implementation of Bumiputera policies in which Malaysia has the right to offer special privileges in the form of licences and permits to the Bumiputera under "government subsidies".

4. The RCEP contains limited change in the area of intellectual property protection and enforcement. However, in terms of e-commerce, RCEP does provide new provisions which are intended to support SME engagement, consumer protection and the promotion of privacy. Crucially though, the financial services sector is particularly excluded from these measures.

5. The RCEP particularly excludes areas such as environmental protection and the protection of labour union standards. This means that there are no legally binding measures to ensure companies implement environmental protection measures while allowing the erosion of influence from labour unions. This can potentially open the door for companies to challenge governments on their environmental and labour regulations as legitimate "barriers to trade".

6. RCEP also excludes the obligations associated with Pharmaceutical Intellectual Property that may in effect increase the cost of medicines and pharmaceuticals as Japan and South Korea push for rules in intellectual property and investment chapters that could potentially restrict the government's capacity to initiate and execute policies to protect public health and ensure affordable access to medicines.

Summary of RCEP Chapters

Chapter	Title	Description
Chapter 1	Initial Provisions and General Definitions	• This chapter provides the general definitions of terms such as "Agreement" and "juridical person" to improve the clarity of the agreement. The objectives of this agreement including to create a modern, comprehensive, high-quality, and mutually beneficial economic partnership are outlined in this chapter.
Chapter 2	Trade in Goods	• This chapter provides the key elements which rule the implementation of goods-related commitments to ensure that trade liberalisation among RCEP member countries can be improved. • The first section of this chapter is on the general provisions and market access for goods. • The second section is on the provisions on non-tariff measures.
Chapter 3	Rules of Origin (ROO)	• This chapter will be used to decide which goods are applicable under the RCEP Agreement and hence entitled for the preferential tariff treatment. • The first section of this chapter is on the common ROO. • The second section is on the operational certification procedures.
Chapter 4	Customs Procedures and Trade Facilitation (CPTF)	• This chapter seeks to make sure that the application of customs laws and regulations are predictable, consistent, and transparent in the RCEP region. • In addition, it also encourages the efficiency in customs administration procedures and clearance of goods. Since RCEP nations are in varying degrees of readiness to implement certain commitments, countries including Brunei, Cambodia, China, Indonesia, Laos, Malaysia, Myanmar and Viet Nam are given specified time periods for the full implementation of certain provisions as stated in Annex 4A.
Chapter 5	Sanitary and Phytosanitary Measures (SPS)	• This chapter provides the fundamental framework for developing, adopting and applying SPS measures to ensure the safety of lives and health of human, animals and plants. • At the same time, it also details the easing of trade by reducing certain negative effects of SPS measures on trade. The chapter also highlights the significance of transparency, cooperation, capacity-building, and technical consultation to achieve the objectives of this chapter.

Chapter 6	Standards, Technical Regulations, and Conformity Assessment Procedures	• This chapter seeks to improve the implementation of the WTO Agreement on the Technical Barriers to Trade (TBT) Agreement. • It also attempts to encourage the mutual understanding of each RCEP member state's standards, technical regulations, and conformity assessment procedures. Furthermore, it also tries to reinforce the information exchange and cooperation among the RCEP member countries in this area.
Chapter 7	Trade Remedies	• This chapter provides trade remedies or measures that RCEP countries can apply if there is abuse in the international trade in goods. • The first section is related to the application of RCEP safeguard measures. • The second section relates to anti-dumping measures and countervailing duties.
Chapter 8	Trade in Services	• This chapter attempts to improve the services trade among RCEP member countries by eliminating much of the restrictive and discriminatory measures in place. • To achieve that, modern and comprehensive provisions such as rules on market access, national treatment and most-favoured-nation (MFN) status treatments are laid out in this chapter. • It also involves the provisions on the reasonability, objectivity, and impartiality of domestic regulations affecting the trade in services, which is more comprehensive than the provisions in the ASEAN Plus One FTAs. Three areas of services, namely financial services, telecommunication services and professional services, are given additional emphasis in Annexes 8A, 8B and 8C respectively.
Chapter 9	Temporary Movement of Natural Persons (MNP)	• This chapter details the commitments that ease the temporary entry and stay of natural persons taking part in trading goods, providing services and making investments. • It introduces rules for RCEP member countries in giving temporary entry and stays such as an efficient processing of complete applications and reasonable fees charged on granting temporary entry and stays. Improvements in transparency obligations are emphasised in this chapter.
Chapter 10	Investment	• This chapter attempts to produce a favourable investment climate among RCEP member countries. • The provisions in this chapter deal with the 4 pillars of investment, namely protection, liberalisation, promotion, and facilitation. This chapter also provides provisions on the investor aftercare, which is important to retain investors and encourage reinvestment.
Chapter 11	Intellectual Property	• This chapter comes out with a balanced and inclusive approach to safeguard and execute the intellectual property rights among RCEP countries. • It provides the safeguarding of intellectual property rights that is more comprehensive than the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement). In addition, there are also provisions to simplify and align certain procedures in obtaining intellectual property rights.

Chapter 12	Electronic Commerce	• This chapter aims to encourage e-commerce activities among RCEP member countries. • In this chapter, all RCEP members are required to adopt a legal framework which ensures a favourable environment for e-commerce to develop. In addition, data-related issues will be tackled through provisions on location-based computing facilities and cross-border transfers of information by electronic means.
Chapter 13	Competition	• This chapter attempts to encourage competition in markets and improve overall economic efficiency and consumer welfare. • This chapter makes it compulsory for all RCEP countries to implement competition laws and regulations and ensure that there are relevant authorities present to enforce such competition laws and regulations. Consumer protection is also discussed in this chapter to protect consumers against unfair market practices.
Chapter 14	Small and Medium Enterprises (SMEs)	• The chapter recognizes that SMEs are an important feature in driving economic growth, employment and innovation. • The chapter attempts to increase information sharing and cooperation in order to enhance the ability of SMEs to reap the benefits of the RCEP Agreement. The chapter also makes it obligatory for every RCEP member country to have a publicly accessible information platform which provides RCEP-related information and documents useful to SMEs.
Chapter 15	Economic and Technical Cooperation (ECOTECH)	• This chapter is intended to reduce the developmental gaps and maximize mutual benefits among RCEP countries. • To reduce the development gap, an emphasis on ECOTECH will be promoted on activities that provide productive capacity building and technical assistance to developing countries and least-developed countries among RCEP member states. Besides this, activities focusing on enhancing public awareness and business access to information will likewise be given priority.
Chapter 16	Government Procurement	• The chapter is used to encourage the transparency of laws, regulations and procedures related to public procurement and, at the same time, improve the cooperation among RCEP members in engaging public procurement activities. • To achieve the former objective, RCEP members need to make laws and regulations as well as procedures on government procurement available to the general public. To improve cooperation among RCEP, members are encouraged to exchange information, provide technical training and share information with each other.
Chapter 17	General Provisions and Exceptions	• The chapter provides general provisions and exceptions relevant across the RCEP Agreement. • These general provisions cover obligations on transparency concerning each RCEP member country's laws, regulations, procedures and administrative rulings of general applications regarding issues included within the RCEP Agreement.

		This chapter incorporates the general exceptions in Article XX of The General Agreement on Tariffs and Trade (GATT) 1994 and Article XIV of General Agreement on Trade in Services (GATS) into RCEP Agreement.
Chapter 18	Institutional Provisions	• This chapter establishes the institutional arrangement for the RCEP and specifies the frequency of meetings of RCEP Ministers. • The RCEP Joint Committee will be introduced to ensure the timely implementation of RCEP Agreement. In addition, 4 subsidiary bodies of the RCEP Joint Committee, namely, the Committee on Goods, Committee on Services and Investment, Committee on Sustainable Growth and Committee on the Business Environment will be established.
Chapter 19	Dispute Settlement	• This chapter recognizes the importance of effective, efficient, and transparent rules and procedures in resolving the disputes under the RCEP Agreement. • The important features of the RCEP dispute settlement process involves the (1) choice of forum, (2) consultations, (3) good offices, conciliation, or mediation, (4) establishment of a panel and (5) rights for interested third parties. In addition, there are special and differential treatments involving least developed countries which require the complainant to practise due restraint if the issues raised involves least developed countries.
Chapter 20	Final Provisions	• This chapter outlines the relationship between the RCEP Agreement towards other agreements. • The procedures involved in amending the agreements are also detailed. • The accession provision states that the RCEP is open for membership by any State or separate customs territory up to 18 months after the agreement comes into force. It is also explained that in order for the agreement to come into force, at least six ASEAN and 3 non-ASEAN RCEP member countries have to fully ratify the agreement in their domestic countries.

Differences between RCEP and TPP/ CPTPP

According to President Datuk Dr Syed Hussain Syed Husman, RCEP is different from the previous FTAs such as Trans-Pacific Partnership (TPP) now renamed the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP). The two treaties are different in their scope, with the CPTPP being the more ambitious of the two, the table below shows a comparison of RCEP against the TPP/ CPTPP.

Aspect	RCEP	TPP/ CPTPP
Raised in	November 2011	December 2009
Negotiations started in	May 2013	March 2010
Signed on	15 November 2020	8 March 2018
Main goal	Reduce 'noodle bowl effect' by simplifying and combining various ASEAN Plus One FTAs into only one regional trade agreement	TPP: Deal with new and old issues by using an extensive '21st century' preferential trade agreement CPTPP: To continue with TPP after the United States (US) withdrawn from TPP
Membership model	ASEAN+1 model	TPP: All Asia-Pacific countries CPTPP: Any state or separate customs territory
Relation to regional architecture	Affirms ASEAN Centrality Principle	Independent of any existing organisation
Scope and coverage	WTO-consistent and ASEAN+1 PTAs—mainly emphasized on WTO-plus issues	WTO-plus and WTO-extra issues
Major sponsor	ASEAN-led	TPP: US CPTPP: Australia, Canada, New Zealand and Japan
Significant "absent members"	US, India	TPP: China, India, Indonesia, South Korea CPTPP: US, China, India, Indonesia, South Korea
Common members	Australia, Brunei, Japan, Malaysia, New Zealand, Singapore, Vietnam	
Commitment level	Lower level of trade liberalisation	High level of trade liberalisation
Special treatment of developing economies	Provided; consistent with the existing ASEAN+1 PTAs	Minimal (there are some exceptions in terms of different schedules for less developed economies for implementation)
Mode of agreement	All issues negotiated in parallel, although there is a possibility that agreement will not be reached as part of a 'single undertaking'	All issues negotiated under a 'single undertaking'

Source: Adapted from Ayub and Jalil (2018)[9]

The TPP was first introduced by the US under the Obama administration's pivot-to-Asia strategy to create a trading bloc that excluded the economic dominance of China.[10] However, soon after the election of Donald Trump in 2016, the US officially withdrew from the trade agreement in 2017, with the US under the Trump administration supporting a wider network of bilateral trade frameworks instead of pursuing multilateralism, giving the US comparatively more economic weight. However, with the projected election victory of Joe Biden, the US may once again reconsider its position on the CPTPP in the near future.

In an Institute of Strategic and International Studies (ISIS) Policy Brief published in November 2020[11], both the RCEP and CPTPP are mega-regional FTAs mainly involve countries in Asia Pacific. As such, both FTAs have many mutual members, namely Australia, Brunei, Japan, Malaysia, New Zealand, Singapore and Vietnam. The following illustration will provide a clearer picture of the overlapping memberships between the RCEP and CPTPP.

[9] Recent Trends in Trade and Trade Agreements: Global Value Chains and Mega-Regional Agreements, Aidonna Jan Ayub and Intan Nadia Jalil, 2018

[10] https://news.cgtn.com/news/2020-11-21/If-RCEP-comes-can-CPTPP-be-far-behind-for-China--VBbY7YVGkE/index.html

[11] The Regional Comprehensive Economic Partnership (RCEP): What this means for ASEAN and Malaysia, Juita Mohamad and Calvin Cheng, November 2020

Source: Mohamad and Cheng (2020)

It's clear that the RCEP has exclusively included Asian nations, with the exception of Australia and New Zealand. Compared to the CPTPP, the RCEP strategically involves developing nations such as Laos and Cambodia. In contrast, the CPTPP exclusively comprises upper-middle and high-income nations such as Canada, Mexico, Brunei and Vietnam, with some commentators remarking that the CPTPP behaves more like an exclusive golf club membership than a regional cooperative treaty.

Such reservations exist due to the inability of the least-developed countries in RCEP being less economically capable in committing to CPTPP-level standards on labour, environment and rules on state-owned enterprises. In this regard, RCEP is seen to be less onerous compared to the CPTPP in terms of its scope, depth, and timeline of implementation.

Comparatively, the CPTPP Agreement has altogether 30 chapters that attempt to establish high-level standards on various development areas such as intellectual property, trade in services, committed anti-corruption and non-discriminatory measures. In contrast, the 20 chapters of RCEP provides limited coverage on the aforementioned areas in the CPTPP but places a particular emphasis on the reduction of trade barriers, trade facilitation procedures and the establishment of a "lowest common denominator" standard among RCEP nations.[12]

In short, despite the RCEP being two times larger than the CPTPP, its depth and scope is a quality far behind the provisions of the CPTPP mainly due to the participation of ASEAN's least-developed nations. It can be surmised that RCEP is a wider but shallower pact while the CPTPP is a narrower but deeper longer-term agreement.

However, despite the relatively lower ambition of RCEP, the agreement is still expected to contribute huge economic benefits due to its large coverage of nations. In INSAP's opinion however, as low-developed countries in RCEP such as Cambodia and Laos develop their own economies in the future, the RCEP Agreement should be gradually enhanced in catch up to the depth as proposed by the CPTPP, especially in intellectual property and government procurement restrictions.

China's Grand Strategy and Analysis

At the fifth plenary session of the 19th Central Committee of the Communist Party of China (CPC), China's five-year plan was formalized and discussed. The term "Dual Circulation Strategy (DCS)" was touted as the key aim of the next phase of China's economic development. The ambitious plan has two equally strong components, namely "internal circulation" and "external circulation", referring to China's domestic economic strength and its economic links to the outside world respectively. The plan signals that China wants to reduce the role of international trade in its economic planning and strengthen its domestic economy.

[12] https://news.cgtn.com/news/2020-11-21/If-RCEP-comes-can-CPTPP-be-far-behind-for-China--VBbY7YVGkE/index.html

The worsening US-China relationship had loomed large in the consideration of this strategy, as the United States (US) seems bent on decoupling its economy from China, crippling the latter's economic and technological development. The DCS is thus a long-term initiative designed by Chinese policymakers to enable its technological and economic development without any reliance on the US.

President Xi elaborated that China will now rely mainly on its "internal circulation" or the domestic cycle of production, distribution and consumption for its development, supported by technological innovation and upgrades in the supply-side economy. Further, President Xi announced that the internal circulation will be supported by its external economy, to which no further details were given.

The RCEP will mesh powerfully with China's DCS, which aims to boost self-sufficiency while diversifying economic integration with global markets. With the common rules of origin within RCEP, it will make cross-border trade much more simple and cheaper, allowing Chinese firms to optimize resource allocation between their domestic market and the rest of Asia. RCEP will also anchor high-value added growth areas in China as multinational corporations (MNCs) shift elsewhere in Asia due to the rising cost of production in mainland China and a desire to insulate themselves from the trade friction between China and the US.

The RCEP also coincides well with China's plans to internationalize the Yuan and develop Hainan into the world's largest free-trade port. As China's consumerist middle class -600 million strong- strengthens its purchasing power, through the raising of productive technologies and wages, strengthening the social safety net and expanding economic opportunities in many rural heartlands, the impact on China's projected imports are immense.

Early in November, President Xi had announced that China had projected to import USD22tril in goods over the next decade, it should be noted that this figure represents an import market worth more than the entire 2019 GDP of the USA, demonstrating that China's long-term ambition of internationalizing the Yuan cannot be underestimated especially for RCEP member states who need to be well-poised to tap into this bounty of wealth.

China's role as RCEP's main magnet for imports will aim to offset its status as an export powerhouse and help rebalance its trade dynamics within the pact, a serious concern for many nations who fear exacerbated trade deficits. (India's withdrawal serves as a reminder on the sensitivity of Chinese trade)

Tariff Reduction Measures

Viewed from the standpoint of Malaysia, the RCEP is best understood as a free trade agreement between three manufacturing titans, China, Japan and South Korea and their vast outreach in their ASEAN supply chains. The three nations together generated USD5.3tril of value added in manufacturing in 2019, USD1tril more than the US and EU combined. In addition, the World Bank estimates that the Asia Pacific region can expect to grow their GDP at two to three times the rate in Europe and the US over the next ten years.

There are several rounds of trade commitment measures towards tariff reduction among the two key players, China and Japan. Under RCEP, China commits to eliminate tariffs on 86% of Japanese exports, the tariff elimination rate will significantly increase from the current 8% tariff between Japan and China, two countries without a bilateral FTA[13].

While there is a general commitment to reduce trade tariffs, some tariff reduction measures are more immediate, such as 90% of auto parts shipped to China from Japan will become completely tariff-free, as well as gasoline engine parts and steel products once the agreement takes effect.

Further, 92% of export goods from Japan to South Korea will become duty-free, a tremendous increase from the current 19% of export goods, while about 80% of automotive goods including air bags and electronics will enjoy a gradual full lifting of tariffs.

[13] RCEP to remove tariffs on 86% of Japan's exports to China, Nikkei Asia, 2020

Looking at RCEP as a whole, tariffs on 91.5% of goods exported from Japan and 98.6% of imported goods from Japan will be will be removed. While this exemption rate is still lower than the 99.9% target agreed under the CPTPP, the participation of China, Japan and South Korea makes the agreement significant as the three nations did not have any prior existing FTAs (ibid).

The wide range of tariff cuts come from a concerted effort of compromise from the Chinese-side, with China eager to lead a regional trade pact in which the US and India are not part of, even at the cost of inflicting pain on their own domestic industries.

In addition, China had long been reluctant to sign any free trade agreement that promises data transfers and intellectual property sharing. However, as bilateral tensions with the US reach new and uncertain heights, it has forced China to concede its position to join a trade framework that excludes Washington.

Under the RCEP, all participants are to ensure a free flow of digital information, such as content and data across borders. However, such rules are more relaxed and less onerous than what was included in the TPP/ CPTPP which barred countries from demanding the disclosure of the company's source codes.

INSAP's Political Economy Analysis

In INSAP's view, the DCS is effectively a state-led effort to redirect economic resources towards the domestic economy. As China already has a long-established and complete production supply chain with the help of foreign investors, especially from the US, recent tensions with the superpower has forced them to look elsewhere to secure their technological growth.

As the Trump administration racked up tensions with China, it has exposed China's economic vulnerability as it relies heavily on high-tech US products, such as high-end semiconductors, forcing Beijing to both spur domestic innovation in the field while looking elsewhere to secure their high-end domestic supply chain. Intriguingly, both Japan and South Korea have shown a keen interest in RCEP, with both nations being powerhouses in high-tech innovation and design in their own right.

A likely scenario here may entail a China-South Korea-Japan cooperation corridor in technological innovation, as Japanese companies eye a potential market expansion into the Chinese consumer market, offering high-value added manufacturing and services. Meanwhile, South Korea eyes greater market expansion for their automobile and electronics players, namely the two industrial giants, Hyundai and Samsung.

To achieve the best outcome however, both nations require a comprehensive framework on high-level trade and investment rules on investment liberalization and protection, as well as intellectual property (IP) rights protection. Despite detailed rules on IP protection and investment, whether the RCEP is capable of enforcing such market protection at the country-level remains to be seen.

However, what is certain is that as Japan and South Korea expand further into China's massive consumer market, the need for greater production capacity arises. From a microeconomic viewpoint, as the number of entrants into a market increase, they tend to produce more price competition in both the short and medium term. As producers decrease their prices due to market competition and product differentiation, consumer demand for such products increase. Meanwhile, the confluence of these market forces results in market suppliers placing a higher number of orders with their manufacturers, resulting in a productivity kick that reverberates along the entire supply chain.

Additionally, as the Northern Asian region continues its harmonization and economic integration within their shared markets, the benefits to ASEAN will be immense, as China, South Korea and Japan begin reorienting their productive capacity on the high-end, high-tech market, average wages in these countries will start increasing as more high-end skilled workers are needed. Hence, the low-end manufacturing processes to service the North Asian market will begin shifting toward low-cost production bases in ASEAN.

Gradually, through RCEP we are likely to see greater levels of trade diversion from other parts of the world into ASEAN, potentially becoming the main manufacturing hub for Asia while China, South Korea and Japan shift their production processes toward high-tech manufacturing.

RCEP's Impact to GDP and Trade

The main goal of any trade agreement is the mass economic integration between its different states. In international trade theory, when there is a standardization of rules and a reduction in trade barriers, total trade (exports plus imports) will invariably increase as a result of such integration where each nation focuses on its competitive advantage.

It should be noted that the key to success in this trade agreement will be the wholesale reduction in transaction costs, or costs incurred in the transfer of goods and services from one state to another. Therefore, with advancements in international shipping and freight capacity technology, it is entirely possible that trans-maritime shipping will continue to dominate trans-national trade, becoming more affordable as regional companies integrate their supply chains, severely reducing the impact of transaction costs for international trade.

Additionally, according to researchers, the implementation of RCEP will be able to reduce the noodle bowl effect[14] (the rise in business and welfare costs as a result of trade diversion) brought about by the differences in procedures and commitments in the various ASEAN Plus One FTAs.[15]. Previously, the differing rules and mechanisms from trade deals between most Asian nations meant that there was no synergy between different FTA's, giving way to overlapping rules and procedures as well as inconsistencies of various elements in safeguarding the national interests of different member states. Therefore, the unification of various trade deals into one mega-regional FTA, ie. RCEP will be instrumental in overturning the noodle bowl effect, thus enhancing regional cooperation in trade.

Lastly, multilateral integration options often provide greater benefits for their participants compared to bilateral options and provides them with useful strategic geopolitical opportunities, such as extended regional influence and increased leverage against bilateral trading pressure[16]. Important economy-wide benefits of multilateral trade agreements for RCEP include more coherent trade rules to facilitate international business operations in the region this includes trade, income and output, as well as productivity and overall welfare gains, spill over effects from reductions in non-tariff barriers and regulatory harmonization (ibid).

Trade Deals Currently in Force Among Original RCEP Nations

	ASEAN	Australia	China	India	Japan	New Zealand	South Korea
ASEAN	N/A	Yes	Yes	Yes	Yes	Yes	Yes
Australia	Yes	N/A	Yes	Yes	Yes	Yes	Yes
China	Yes	Yes	N/A	No	No	Yes	Yes
India	Yes	Yes	No	N/A	Yes	No	Yes
Japan	Yes	Yes	No	Yes	N/A	No	No
New Zealand	Yes	Yes	Yes	No	No	N/A	Yes
South Korea	Yes	Yes	Yes	Yes	No	Yes	N/A

Sources: Governments of Australia, China, India, Japan, New Zealand and South Korea

14 Dealing with the Proliferation of Trade Agreements, Jayant Menon, 2008

15 Malaysia and RCEP Countries: Gain or Pain? Dayang Affizzah Awang Marikan, Mohammad Affendy Arip, Jaber Khan and Hazlin Hamzah, 2020

16 Petri, P.A., Plummer, M.G., Urata, S. & Zhai, F. (October, 2017). Going It Alone in the Asia-Pacific: Regional Trade Agreements Without the United States. PIIE Working Paper 17-10.

Malaysia's Trade with Main RCEP Partners from 2018 to 2020

Year	2018		2019		2020 (up till September)	
Countries	***Exports (RM bil)***	***Imports (RM bil)***	***Exports (RM bil)***	***Imports (RM bil)***	***Exports (RM bil)***	***Imports (RM bil)***
China	139.1	175.4	140.9	175.7	114.5	122.6
Japan	70.4	63.9	66.0	63.6	45.1	43.8
South Korea	34.2	39.3	34.2	38.8	26.4	35.7
ASEAN	**287.1**	**224.6**	**286.5**	**205.0**	**198.0**	**126.7**
Breakdown:						
Singapore	140.2	103.1	137.1	89.5	100.8	54.8
Thailand	57.1	48.6	56.3	44.3	33.2	23.9
Vietnam	34.3	19.5	35.4	19.6	22.4	13.5
Indonesia	31.9	40.5	31.3	38.9	22.9	25.7
Rest of ASEAN	23.6	12.9	26.4	12.7	18.7	8.8

Source: Ministry of International Trade and Industry, Matrade

In analysing the economic impact to Malaysia's trade, it is crucial to have an understanding of the recent trends in Malaysia's international trade. The table above shows the international movement of goods between Malaysia and its main RCEP partners from 2018 to 2020 (it should be noted that both Australia and New Zealand were excluded due to the unavailability of the most recent 2020 trade data). It can be seen that Malaysia's trading relationship with ASEAN is significantly greater than other Asian partners for both exports and imports. It should be noted here that almost 60% of Malaysia's total international trade involve RCEP members and an estimated 56% of Malaysia's exports are with RCEP member states, given that ASEAN's 10 members are regarded as Malaysia's top trading partners.

For the observed 3 years, exports from Malaysia to ASEAN accounted for an average of 28% of Malaysia's total exports while imports from ASEAN countries into Malaysia accounted for more than 20% of total imports. It should be noted that among all ASEAN nations, Singapore accounted for an average of 48% of total trade with ASEAN. It can be seen that the amalgamation of all existing FTAs with ASEAN under the RCEP will serve to increase multilateral trade through Malaysia's supply chain networks to large consumer markets in China, South Korea and Japan.

Trade data makes it clear that at the individual country level, China has been the largest single trading partner in Asia over the past 3 years. The percentage of Malaysia's exports to China over total exports have gradually improved year-on-year (YoY). For reference, this was 13.9% in 2018, increasing to 14.2% in 2019 and subsequently to 16.1% in 2020. Meanwhile, the percentage of Malaysia's imports from China over its total imports remains relatively stable at approximately 20% for the three-year period.

Malaysia and China have long established a 45-year standing bilateral trade relationship with each other[17], explaining the deep trade cooperation in imports and exports figures between the two nations. In signing RCEP, it is expected that China will deepen economic cooperation with Malaysia, improving the economic growth profiles of both nations. As Malaysia is a country highly reliant on foreign trade, RCEP's improved trade openness and reduced trade barriers are likely to assist the country in assessing new product export markets and the sourcing of cheaper raw inputs, improving the competitiveness of both countries on the international level.

What is RCEP's Overall Impact to Malaysia's Trade and GDP?

RCEP's overall impact to Malaysia is unlikely to come from any immediate tariff reduction measures as the ASEAN trade network has already long-committed to reduce trade barriers with RCEP member states. However, in the

[17] https://www.theedgemarkets.com/article/malaysiachina-trade-sets-new-record-2019

case of Malaysia, a look into the Tariff Schedule of Malaysia[18] showed that while most goods were duty-free, there were indeed reasonably high import tariffs on several light manufacturing and mid-tier consumer goods such as refrigerators, microwave ovens and automotive vehicles that were exempt from tariff reduction, no doubt an effort for Malaysia to safeguard their domestic producers from cheaper consumer imports. Aside from this, Malaysia maintains its tariff on various agricultural goods, such as on pineapples, guavas, swine and poultry.

However, most interestingly, the tariff schedule detailed several tariff reductions to the importation of motor vehicles used in the process of agriculture, and larger vehicles for the process of performing specialized services such as concrete mixers, crane lorries, fire-fighting vehicles and the like, from a current base rate of 30% to a final tariff rate of 0% in the 15th year of the agreement. This potentially signals a shift in Malaysia's trading strategy in liberalizing slightly the motor vehicle industry. Despite this however, trade barriers would still remain over the consumer market for motor vehicles.

The more near-term benefits to Malaysia however will likely come in two ways, firstly, the across-the-board elimination of tariffs between China, South Korea and Japan will spur market demand for goods throughout the trans-national supply chain, benefiting Malaysia in the process as Malaysia has positioned itself as a key producer of intermediate goods for their final consumers in China and elsewhere.

Secondly, the harmonization of trade rules surrounding the imports of raw material and intermediate goods used in the production value chain will solidify Malaysia's position as a key player in the mid-stream production market. This allows Malaysia to produce both intermediate and final goods easier and cheaper for all RCEP member economies, without hassle and delay from import customs certifying its origin.

It is worthy to note that all RCEP members had agreed to one basic rule of origin (ROO) of 40% regional value content (RVC) for the preferential trade in all goods. This means that once a product is created to meet the RCEP origination criteria, preferential tariff rules are the same for all 15 members, and can be shipped across the whole RCEP region without any further adjustments and receive any lowered tariff benefit on offer to RCEP firms. For Malaysian exporters, the 40% RVC rule is immeasurably useful, as it ensures that the vast majority of Malaysian exports can travel freely throughout the region at a low cost to both the producer and consumer.

Analysis from Third Party Sources

Despite the purported benefits, the true effect of RCEP on trade and GDP ultimately remains uncertain as much of it remains within the realm of theory. However, several economists and researchers have performed rigorous econometric modelling over the past several years to better define the impact of the trade deal.

According to various research papers, the RCEP is projected to raise Malaysia's overall GDP within the range of 0.7% to 2.9%. It should be noted that most research papers surrounding the RCEP is conservative by definition since many of the potential and actual features of the FTA such as government procurement, endogenous productivity gains and the impact on foreign direct investment (FDI) are excluded from model estimation.

Research Paper #1: Actual and Potential Trade Agreements in the Asia-Pacific: Estimated Effects, Ferrantino et al, The World Bank

A World Bank working paper[19] detailing the estimated effects of the RCEP had used a dynamic computable general equilibrium (CGE) model to study the potential impacts on member countries, compared to a baseline scenario that excludes the effect of any new trade agreement. Therefore, the net effect of tariff and non-tariff reduction intervention under the RCEP scenario on trade will be reflected as deviations from the baseline.

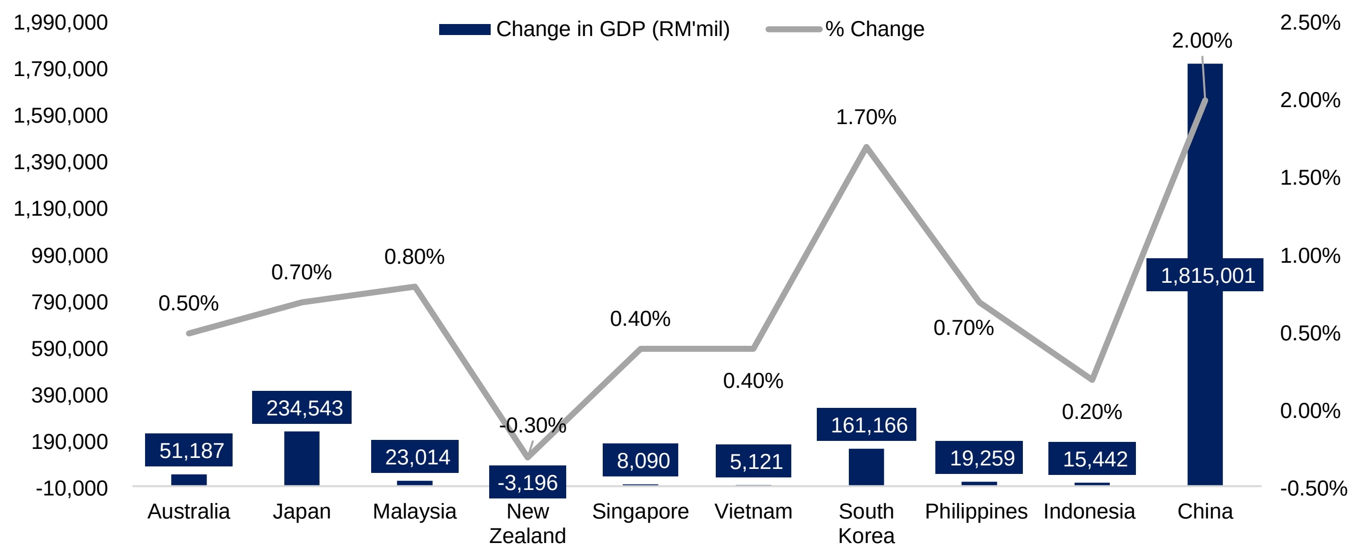
[18] RCEP Schedule of Malaysia Annex I, RCEP
[19] Actual and Potential Trade Agreements in the Asia-Pacific: Estimated Effects, Ferrantino et al, October 2019

Under the RCEP scenario, it follows a real-world trajectory of tariff reduction, with nations like China, Japan and South Korea assuming higher trade barriers in the initial stages and gradually increasing trade openness, reducing both tariff and non-tariff barriers to trade in the long-run.

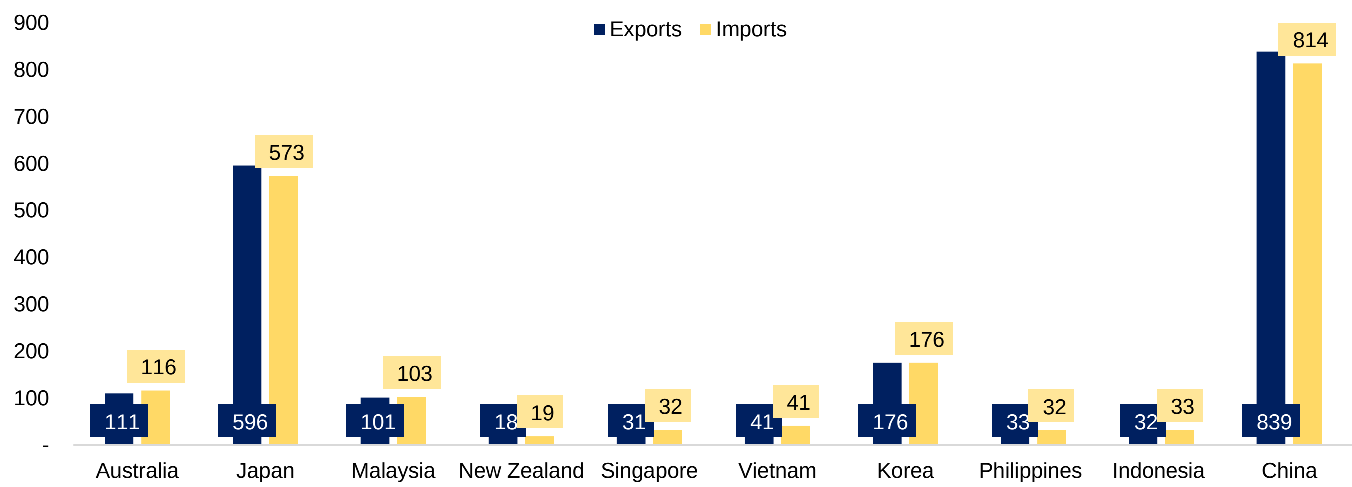
In addition, there is a relative lack of economic integration with RCEP members as opposed to more liberalized economic blocs like the EU and USMCA, therefore the aggregate impact of trade liberalization in RCEP is predicted to be higher compared to other trade deals like the CPTPP. In addition, initial trade barriers for RCEP member states are higher compared to the TPP/CPTPP, mostly due to higher trade barriers in China and South Korea as well as in agriculture for Japan, resulting in a higher level of aggregate gains in RCEP compared to the latter. **(It should be noted however that the following World Bank's estimations were carried out with the assumption that India would have joined the RCEP agreement)**

Total GDP gains from trade across RCEP is projected to be USD654bil (RM2.7tril), or a 1.5% increase from a scenario with no trade deal. The average weighted tariff faced in RCEP markets in China is expected to drop from 2.2% to 0.4% while China's weighted average trade tariff imposed on RCEP members will be reduced from 2.7% to 0.5%. In absolute terms, China, Japan and South Korea is expected to reap the most benefit from the agreement.

Estimated Change in GDP Under RCEP Compared to a No-RCEP Scenario (RM'mil)



Estimated Increases in Exports and Imports Under RCEP Compared to a No-RCEP Scenario (RM'bil)



Note that the estimated impacts above were converted from US Dollar to Ringgit at the average 2019 exchange rate of 1USD=RM4.14

We can observe from the above estimations that Malaysia stands to gain in relation to its exports and total trading strength, however, the percentage share of net export to GDP is set to decrease compared to now as foreign competition gradually offer better productive capacity than local producers, reflecting competitive weaknesses among our domestic producers. Despite the decrease in net exports, Malaysia's GDP is set to increase in absolute terms, at RM23bil or 0.8% higher compared to a no-RCEP scenario.

Sectoral Implications

The World Bank's estimations produced by the model suggest that due to better access to large RCEP markets, the top-most dynamic export growth will be experienced in the following sectors and nations:

- **Food and Beverage** (23.4%), exports will be driven mostly by producers in Korea, Australia, Malaysia, Indonesia and China;
- **Textiles and Clothing** (6.7%), with demand being driven heavily by China and Japan, as the overall consumer market for clothing expands in areas of high population pools.
- **Natural Resource and Mining** (6.2%), with demand driven mainly by China, South Korea and Japan as pressure mounts on manufacturers resulting from the increased production of high-valued electronics, the components of which require vast amounts of rare earth metals.
- **Metals and Metal Products** (5.8%), exports driven mainly by China and Australia as the demand for automobile and machine parts increase the need for metals and its intermediate products.
- **Chemical, Rubber and Plastic Products** (5.5%), with exports driven mainly by China, Japan and Malaysia as the increase in various automobile, electronics and healthcare products require the need for more plastic production.
- **Machinery and Equipment** (4.0%), with exports captured largely by China, followed by Japan and Malaysia as they experience the greatest decline in trade barriers among RCEP member states.

In addition to the above, the RCEP will boost a significant expansion in **Trade and Cross-Border Transportation Services** that is projected to have the largest production increase in absolute terms, a USD235bil (RM973bil) increase compared to the baseline scenario of no trade deal, fuelled mostly by increases in trade opportunities in China and Japan. This is reflected in the significant role that transport services play in the GDPs of these member states (18% in Japan). The author's simulations confirm that the FTA will increase export flows toward its signatory countries, with exports within the RCEP increasing by 11.4% overall.

Under the RCEP, export flows of signatory nations will increase by USD616bil (RM2.6tril) compared to the baseline scenario in 2030. The two economic titans, China and Japan are expected to reorient their exports towards RCEP members the most, as the preferential tariff treatment regime encourage export destination flows.

For instance, Japan is estimated to increase its RCEP share of total exports by 7.8% relative to the baseline no-RCEP scenario. While Malaysia is set to reorient its export flows to RCEP member nations by 0.7% relative to non-RCEP signatories, given Malaysia's large existing share of exports towards RCEP member countries, such as ASEAN and China. However, by major market destinations, increased RCEP member's exports will be directed mostly toward China experiencing an increase in imports of 13.5% from other RCEP members.

Research Paper #2: Malaysia and RCEP Countries: Gain or Pain? Dayang Affizzah Awang Marikan et al, Journal of Asian Scientific Research

The second study examines the impact of RCEP on GDP and exports in Malaysia published in the Journal of Asian Scientific Research.[20] The econometric research paper utilizes a panel data approach of 16 RCEP member

[20] Malaysia and RCEP Countries: Gain or Pain? Dayang Affizzah Awang Marikan, Mohammad Affendy Arip, Jaber Khan and Hazlin Hamzah, 2020

countries (including India) between 1997 to 2018 to determine a potential future growth trajectory in response to RCEP.

In analysing the data, the authors used an augmented gravity model, estimated by using a Dynamic Ordinary Least Squares (DOLS) approach. It is important to note that all the variables were transformed to its natural logarithm, transforming it into a log model. Hence, its interpretation is performed in terms of a percentage change of the variables instead of absolute change. **The estimation model predicted that in the long run, a 1% increase in exports is correlated with a 0.873% increase in the GDP of Malaysia, indicating that exports have a larger than expected impact on GDP.**

However, INSAP notes that the model has several flaws in its calculation methodology which suggests that the predicted result is less reliable than it seems. Firstly, the researcher's estimation had by considering only exports and trade openness when examining the influence of RCEP on GDP omitted other important variables. As exports form only a small component of GDP, it had failed to account for other factors such as domestic consumption, investment and government expenditures in its observation.

Therefore, despite the estimation claiming that a 1% increase in exports is significantly correlated with 0.873% increase in GDP, this may not be an immediate and causal relationship but rather as a result of omitted biases that heavily and positively skews the estimation result. Hence such a result should be taken as a general reference point for overall long-term growth in GDP and not causal relationship between exports and GDP growth in itself.

Research Paper #3: Assessing the Economic Effects of the RCEP on ASEAN Member States, Ken Itakura, Nagoya City University

A research paper from the Nagoya City University in Japan likewise examined the impact of RCEP implementation on various economic variables, namely trade (imports and exports), real GDP growth, foreign ownership of capital and the economic welfare of countries with an emphasis given to ASEAN member states.[21]

In this study, RCEP trade policy simulations were conducted using a Dynamic Global Trade Analysis Project (GTAP) model to understand how the liberalization of trading in goods and services, logistical improvements and investment commitments brought about by RCEP can create extended economic benefits to its participating countries.

In this study, 1 baseline scenario and 3 policy scenarios were created. The baseline scenario was set up to represent a hypothetical condition of the world economy if RCEP was not ratified. The function of the baseline scenario is thus to serve as a basis of comparison against the 3 policy scenarios. The 3 policy scenarios meanwhile have different degrees of trade liberalization as summarized in the table below.

Summary of scenarios

Scenario	Description
Baseline scenario	• No RCEP implementation
Policy scenario 1	• Tariff reduction of 50% • Improvement of logistics by 7% • Reduction in services trade barriers by 7%
Policy scenario 2	• Tariff reduction of 75% • Improvement of logistics by 7% • Reduction in services trade barriers by 7%
Policy scenario 3	• Tariff reduction of 75% • Improvement of logistics by 7%

[21] Chapter 1: Assessing the Economic Effects of the Regional Comprehensive Economic Partnership on ASEAN Member States, Ken Itakura, August 2015

	• Reduction in services trade barriers by 7% • Reduction of country-specific risk by 0.05% (as a result of investment commitments)

Source: Itakura (2015)

It can be observed that the degree of trade liberalization increases as the policy scenario moves in rank. Hence, it is expected that the economic impacts will be larger and more pronounced when moving from the first scenario to the last. The simulation results of the paper are presented in the table below:

Simulation Results for Malaysia on Trade and GDP, 2030 (Cumulative Deviation from The Baseline, %)

Economic variables	Policy scenario 1	Policy scenario 2	Policy scenario 3
Real GDP	1.3	1.6	2.9
Export Volume	2.1	2.9	4.7
Import Volume	2.8	3.8	6.5
Investment	3.8	4.9	10.2
Foreign Ownership of Capital	5.1	6.8	16.2
Economic Welfare	0.7	0.6	0.8

Source: Itakura (2015)

The results estimate that in the case of Malaysia, RCEP will have a net positive impact on all economic variables examined regardless of the degree of trade liberalization. It is important to note however that overall impacts become stronger as trade liberalization deepens, evidenced from higher expected changes from policy scenario 1 to 3. Therefore, the estimation results tend to agree with the researcher's original hypothesis that as trade liberalization improves, its overarching economic impacts become larger.

From the estimation table, the most noteworthy deviations from the baseline scenario is the projection that **investment growth will increase by 10.2% and the foreign ownership of capital likewise increases by 16.2%,** under policy scenario 3. The result suggests that Malaysia will indeed attract a heavy level of foreign capital flows and investment as trade barriers decrease and country-specific risks reduce, indicating that Malaysia will remain a key attraction for foreign investors in China and Japan. Positive benefits can translate to more dynamic competition, better quality of production and higher overall productivity growth for either domestic consumption or export.

The downside to this however is the potential erosion of domestic capital ownership in the economy, suggesting that foreign firms will likely come to own a gradually larger share of Malaysia's economy if measures are not implemented to first specialize foreign investors towards key high-end and high-value sectors to enable technology transfers and secondly to encourage domestic investment into high-end technologies.

If such measures are neglected, it could potentially create a situation where foreign players own the most productive and innovative companies in the economy while domestic owners of capital hold on to less competitive ones with reduced profits, allowing for a siphoning of economic profits towards large Multinational Corporations (MNCs), having an adverse impact on Malaysia's economic development.

However, despite the projected benefits and costs, overall economic welfare remains positive compared to a non-RCEP baseline while the impact to real GDP remains positive in each scenario.

Research Paper #4: Comparing the Economic Impacts of the TPP and RCEP, Inkyo Cheong et al, Asian Economic Papers

The research paper in the Asian Economic Papers Journal[22] examines RCEP's impact on the Malaysian economy. The research, conducted in 2013 was to estimate the potential impacts of the two mega-FTAs, namely the TPP

[22] Comparing the Economic Impact of the Trans-Pacific Partnership and the Regional Comprehensive Economic Partnership, Inkyo Cheong and Jose Tongzon, 2013

and RCEP on the nominal GDP of Malaysia. Similar to a previous study, a dynamic GTAP model was performed to conduct a range of policy simulations.

Impacts of the RCEP on GDP by country

Country	(%) change in GDP	Deviations in nominal GDP (million US$)
RCEP regions		
Vietnam	5.87	7,949
Singapore	4.1	11,071
South Korea	2.11	24,551
China	0.88	70,327
New Zealand	0.79	1,426
Malaysia	0.66	2,018
Japan	0.63	37,680
Australia	0.42	6,661
Non-RCEP regions		
US	-0.28	-43,707
Canada	-0.4	-7,218
European Union	-0.54	-90,580
Mexico	-2.01	-24,277
Rest of the World	-0.77	-112,038

Source: Cheong and Tongzon (2013)

According to the estimations above, RCEP in general tends to improve the GDPs of member countries with Malaysia at 0.66%. Meanwhile, non-RCEP nations are expected to experience a negative GDP growth profile as a result of non-RCEP membership. This result is largely consistent with the theory of economic integration, which states that countries who members of a single trading bloc are likely to gain considerable economic advantages while non-member countries are likely to suffer relative losses due to the impact of global trade diversion.

One weakness that the paper presents was that there were no sectoral assessments of the impact of RCEP on the economy. Sectoral assessment is important as it provides information on the economic prospects of the competitive advantages of each nation. This enables policy makers to understand which sectors receives more positive economic benefits as opposed to ones that suffer economic loss upon RCEP's implementation.

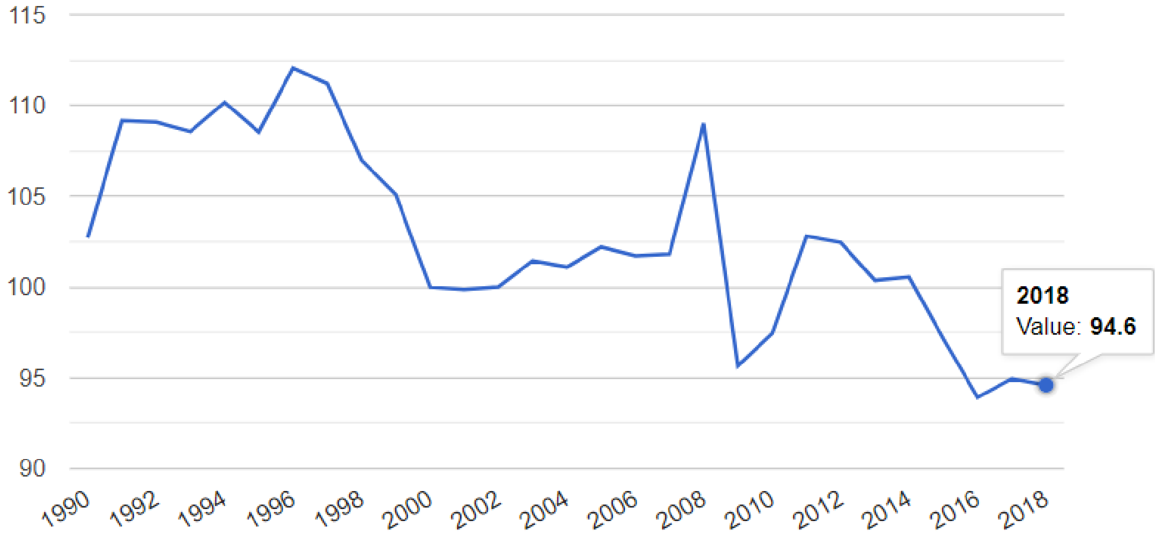
In addition, though the study considered the gradual elimination of tariff barriers, it did not take into consideration the gradual reduction in non-tariff barriers. Non-tariff barrier liberalisation such as import and export quotas are important elements of the RCEP. Hence, the estimation might underestimate the projected impacts of RCEP on GDP if these elements are excluded from the model.

Important Points to Consider

In all the projected scenarios above, there are a few effects that stand out clearly. Chiefly, it was estimated that GDP would grow anywhere from between 0.7% to 2.9% based on projections from the worst to best-case scenario. It should be noted however that such estimations suffer from the uncertainties caused by the economic loss from the recent non-participation of India, potential changes in endogenous factor production methods in the longer-term and the effects of government spending and procurement in the medium term (which can distort true GDP estimations sans government spending). Despite these limitations, **we can safely conclude that overall GDP will likely experience an improvement by joining RCEP compared to non-participation.**

Additionally, it was projected in all research papers that Malaysia is estimated to lose out in regard to its net export position, the only difference being the degree to which Malaysia imports more than it exports in regards to RCEP. This estimation is important to discuss here as this may **signal a weakening of Malaysia's competitive advantages and a deterioration in its long-term terms of trade (ToT)**.

Malaysia's Terms of Trade (1990 – 2018)



Source: TheGlobalEconomy.com

Generally, short-term trade deficits are not by itself harmful to an economy unless the country's ToT worsens over a long period of time, as a worsening ToT signals that the marginal capital accumulation from a nation's exports is lower than its spending on imports. In other words, **a deteriorating ToT indicates that we will need to export relatively more to buy the same number of imports.**

It should be noted however that large short-term fluctuations in a nation's terms of trade are normal, as it reflects short-term fluctuations in the international price of goods. However, a deteriorating ToT over the long term such as Malaysia's gradual deterioration from 1990 to 2018 observed above may signal a nation's inability to climb up the value chain and as in our case, may become further stuck in the middle-income trap amid a decline in our relative competitive advantages compared to other ASEAN nations.

As observed in the above research papers, **RCEP is likely to worsen the trade balance of Malaysia**. It is important to note however that having a net import position, does not necessarily indicate a weakening of Malaysia's economy, rather it **depends on the type of trade deficit** experienced by Malaysia. A negative net import scenario occurs when Malaysia's imports are for the direct consumption of consumer goods rather than for the import of capital-intensive and intermediate goods used for the production of other consumption goods, in which case has a positive effect on the domestic economy.

Despite this, it is helpful to assume that suppose the quantity of exports and imports reach parity (a zero trade balance) in the long term, the **indexed price of Malaysia's export basket is likely to be lower relative to the indexed price of its import basket** due to Malaysia's inability to export further up in the value chain where the production of "innovative goods and services" (products that require a high level of innovation) generally have greater levels of "income elasticity of demand" (IED) compared to Malaysia's low and intermediate-levels of manufacturing and service exports where competition is more fierce from other technologically similar ASEAN nations.

When Malaysia's exports have a relatively lower IED compared to a foreign nation's exports, as incomes rise, this will cause consumers to import from the foreign nation relatively more than from Malaysia. In addition, the increasing level of competition from other ASEAN nations such as Thailand, Indonesia and Vietnam in low and intermediate-level manufacturing will make it more **difficult for Malaysia to differentiate their offering of goods and climb the export value chain.**

As the more technically-advanced members of RCEP such as Japan, Korea, China, Australia and New Zealand are already in high-tech and high-end manufacturing, there are opportunities abound for ASEAN in the realm of private sector and MNC investments, providing employment and better productive capacity for lower-income member states. In addition, **the 40% ROO rule will make foreign investment into ASEAN more attractive, as any company from the aforementioned advanced states can source and manufacture their goods anywhere within the ASEAN region**. However, Malaysia would need to set itself apart in order to attract the best and most technologically advanced MNCs in the region.

Such reforms however are difficult, as **Malaysia suffers from a persistent "brain drain" problem,** with the phenomenon expected to be exacerbated by the movement of skilled labour to other RCEP nations who have a greater ability to attract foreign talent. As high-end innovation shifts toward the Northern Asian region, the availability of high-paying innovation jobs will flourish outside Malaysia, encouraging the best and brightest talents in ASEAN to migrate. In addition, the perceived lack of equal opportunities, a lack of meritocracy and growing racial and religious polarization in Malaysia will further exacerbate its brain drain. *<Please see INSAP's Report titled "Strengthening Malaysia's Talent Pool" for a more in-depth analysis>*

In addition to the brain drain phenomena, the ease of importing **cheap foreign labour has made it difficult and, in many cases, have indeed discouraged Malaysian manufacturers from investing in automation, relying on labour-intensive production methods that seriously hamper the long-term productivity growth of Malaysia**. Therefore, it is likely that foreign investment into Malaysia may find it relatively more apt to invest in cheaper labour-intensive production methods for intermediate goods as opposed to high-end technological development, robbing Malaysia of potential technology transfers and innovation-based employment. In the long-run, this will make climbing up higher in the value chain even harder.

By not innovating its production process, Malaysia runs the risk of increased competition from other intermediate level producers like Vietnam, which has been investing heavily into industry innovation over the past few decades. In fact, since the mid 2000's, **Vietnam has been a more attractive location for foreign investors**[23]**, with Japanese manufacturers gradually shifting their operations in electricals and electronics (E&E) from Malaysia to Vietnam**. In addition, countries such as Myanmar, Cambodia and Laos as a result of foreign investment may in fact catch up to Malaysia and the rest of ASEAN in low-end manufacturing, to the further detriment of Malaysia's ToT as **Malaysia increasingly becomes a price-taker in the low-end manufacturing market**.

To reap the best outcomes however, Malaysia needs to **implement serious reforms in its development of human capital and upgrade the automation of its production processes**. As more technologically advanced MNCs move their production bases to Malaysia, technology transfer becomes more ubiquitous, as more Malaysians under these MNCs hone their skills and talents in new technological and productive processes, skilled entrepreneurs (usually after working several years within the MNC) **are encouraged to start their own companies with the financial backing of domestic investors and shareholders, whilst making their own improvements and innovations to the production process**. This is a process known as "creative destruction", a dynamic and continual process of technological disruption through entrepreneurship and new innovative methods of production coined by the famed economist, Joseph Schumpeter.

For this to happen, the necessary government intervention in human capital investment and reforms to the business ecosystem are required in fostering the type of high-end, high-tech and innovative disruptions needed to gradually improve Malaysia's competitive advantage. Such reforms will advance our local business ecosystem to where it needs to be in achieving developed nation status in the future. **In this scenario, Malaysia's overall ToT may not deteriorate but may in fact improve relatively as export prices increase due to its higher technological complexity whilst allowing us to import better quality goods and services, enhancing the living standards for all Malaysians.**

[23] https://www.theedgemarkets.com/article/cover-story-electrical-electronics-moving-value-chain

Where Do We Go from Here? INSAP's Policy Recommendations

There are several steps and recommended initiatives that Malaysia can take as a member state of RCEP, with Asia-Malaysia trade ties reaching highs in 2019, there are many domestic strategies in which Malaysia can act as a catalyst for its future economic growth.

Recommendation 1: Enhancing SME Competitiveness and Upgrading the SME Ecosystem

In order to reap the most benefit from RCEP, the Malaysian government needs to step up its effort in bringing local Malaysian SME exporters up to technological standards with the economic behemoths of China Japan and South Korea. Such a transformation however without the necessary trade protectionist measures and adequate investment in capital goods is an extremely difficult endeavour from an economic perspective.

The Malaysian government should adopt a more export-led strategy to national economic development in the 5 to 7-year term. There are several ways the government can do this, firstly, the government should make a **public declaration of commitment to the export competitiveness of SMEs.** The existence of a clear and strong government commitment of supporting domestic SMEs with potential to export directly or indirectly through MNC linkages will give a positive signal to potential investors.

Additionally, the government should aim to create an **export-friendly business environment for SMEs**, this implies, 1) a simplification of import-export policies and procedures 2) combatting corruption and red-tape that hinder the growth of SME export potential and 3) Creation of an administrative and legal institution such as an anti-monopoly commission to guarantee SMEs a stable legal framework to anti-monopolistic practices.

The government should adopt a policy of **constant improvement of comparative advantage in attracting FDI flows** that purposefully encourage building up knowledge-based local advantages in order to improve advanced and specialized factors of production and to increase linkages with foreign affiliates. In this regard, the government should **target export-oriented MNC partnerships with local SMEs**.

In addition, such investments should be related to the national development objectives of the country, rather than providing indiscriminate assistance to SMEs and FDIs in general. To target risks to unfavourable FDIs, the government should promote continuous dialogue with stakeholders, national entrepreneurs, trade unions, policy makers and civil society and integrate policies to promote SMEs targeted for exports into a national development strategy.

Further, the government should consider **incentives and subsidies in supporting SMEs through both Direct and Indirect means**, as well as implementing measures to **enhance access to financing for exporting SMEs**. Direct fiscal incentives involve the use of channelling government funds directly into the pockets of exporting SMEs, such as providing a cash grant for exporting SMEs *(however, it should be noted that certain direct subsidies to private companies are discouraged within the RCEP framework, thus the government has to exercise a level of caution and discretion when implementing said policies).* While an indirect incentive would be to facilitate and promote the exports of SMEs as part of a public export promotion strategy.

Meanwhile, enhancing SME's access to financing is likewise important, in this effort, the government should **develop a national SME exporter strategy and policy framework with SME Bank and EXIM Bank** to ensure the channelling of adequate funding amounts to exporting SMEs. In addition, the **government can in conjunction with Bank Negara Malaysia (BNM) introduce special liquidity incentives** to commercial banks that provide loans to SMEs such as a special lowering of reserve requirements, access to discount lines of credit, interest rate subsidies and government-backed guarantees.

Recommendation 2: Encourage Greater SME Participation in Foreign Business Partnerships

A chief benefit of RCEP membership is that Malaysian producers will be able to source cheaper raw materials and inputs within ASEAN and have less restrained access to international markets within high-income nations such as Australia, Japan and most importantly, access to a 600 million consumer market in China.

However, it is not necessary that all SMEs would take up the benefits offered by RCEP, partly due to ignorance of foreign trading procedures and a lack of access to main international business circles. Therefore, the government should take the initiative by **establishing a large website database for all relevant contacts, procedures and information for establishing foreign business partnerships within RCEP.**

In addition, the Ministry of International Trade and Industry and Ministry of Finance should consider establishing a **special fund for co-sponsoring special international trade dinners and events** inviting domestic and foreign captains of industry, foreign trade ministers and ambassadors within the RCEP region to enhance trade discussions and connectivity among all member states.

The Malaysian government could additionally consider **providing tax incentives to SMEs in finding suitable business connections for a defined period** after the ratification and finalization of RCEP has been established. The mechanism would offer for after the official adoption of RCEP wherein local SMEs will be allowed to receive a capped tax relief/ benefit when actively seeking linkages with foreign trade partners with the intent of signing long-term trading agreements and large purchase orders.

In addition, the Malaysian government should encourage the use of cross-border e-commerce. Initiatives such as the KLIA Aeropolis DFTZ Park should be enhanced by including a greater number of e-commerce platform players that use the system, currently, Lazada has been the first platform to leverage on the hub, with other companies known to join in the near future. It should be noted that the mega-project under the Electronic World Trade Platform (eWTP) between the Malaysian government and Alibaba has already started commencing operations on the 3rd November 2020[24].

The benefits emerging from such a mega-project on SME delivery systems cannot be overstated, as it essentially allows for a globally reachable shipping operation, allowing for SME goods to deliver potentially anywhere around the world in under 72 hours. The Malaysian government **should aim to facilitate the mass uptake of local SME exporters through the DFTZ delivery system** to maximize the export efficiency of local SMEs.

Recommendation 3: Encourage Domestic Investment into Local Innovation-Based Companies

As Malaysia begins to attract greater levels of quality foreign investment through implementing the suggested policies above, this will begin to attract a high degree of technological exchange between local firms and foreign MNCs. As such, a transference of productive capability and technology will start occurring wherein local firms will start developing their local processes similar to the standards set out by the MNC.

Measures from the government should be performed to increase the net benefits of FDI flows such as technology transfers and better production processes. Such measures include the **collection and dissemination of information related to investment opportunities in other RCEP nations** on a monthly or bi-monthly basis to encourage local participation of regional economic opportunities.

In manufacturing and service provision, MNCs and their Malaysian affiliates can do more to drive and guide the competitiveness and upgrading of local SME suppliers and subcontractors. While direct MNC investment into SMEs are rare, Business-to-Business linkages will offer various routes through various transfers of know-how. The government should **encourage social responsibility among MNCs by encouraging the trickle-down effects**

[24] https://www.theedgemarkets.com/article/mahb-alibaba-start-ops-cainiao-aeropolis-ewtp-hub

of their local business activities. The government should incentivize MNCs to act more responsibly toward SMEs, not only offering marginal benefits to their economic, educational, technological and social conditions.

In addition, the government **should offer a greater number of free industrial and trading zones with well developed infrastructure along cargo train lines and international trading ports**. Such free zones should be carefully planned to bring in MNCs into zones with a high level of entertainment services and other amenities catering for both foreign expatriates and local workers in the formulation of manufacturing or innovation clusters. In addition, such clusters should likewise encourage the gradual geographical clustering of SMEs to enhance their ability to grow their competitive advantages through semi-collective organization and specializations among SMEs.

However, as a result of greater levels of foreign capital investment and ownership, local companies could become crowded out by more competitive foreign MNCs, resulting in an economic loss for local companies. Therefore, the Malaysian government should **encourage a greater level of domestic involvement in the expansion of technologically-driven driven companies** while adopting similar or more enhanced production processes of MNCs.

Recommendation 4: Liberalize Government Procurement Contracts and Enhance Domestic SME Participation

As RCEP remains largely silent on the provisions relating to certain areas involving government procurement, the Malaysian government can in fact use these gaps to their own advantage in upgrading the fiscal position of their own domestic SMEs. Due to certain racially-based affirmative action policies in government procurement, open tendering government contracts are a sensitive and taboo subject in Malaysia. However, in the best interests of national development, Malaysia needs to rethink this policy that in reality only serves to benefit a small circle of politically-connected elites at the expense of the general business landscape.

In this regard, the Malaysian government should **consider the gradual liberalization of open tender government procurement contracts awarded to more competitive and innovative domestic firms** rather than through the method of direct negotiation which limits the maximization of social benefits for the public and increases the propensity for corruption and abuse of power[25].

Besides this much-needed change, the government should additionally **consider establishing a mandatory minimum quota of 40%-50% for all government procurement contracts be awarded exclusively to SMEs** who meet certain standards of production quality. This idea is however not new and has been pushed for under the previous PH administration by Deputy Entrepreneur Development Minister Datuk Dr Mohd Hatta who instead called for a minimum SME involvement level of 50%[26]. Despite its simplicity, such a move would dramatically enhance the economic prospects and opportunities afforded to SMEs.

Recommendation 5: Reform Education System towards High-Tech and Science, Technology, Engineering, and Mathematics (STEM) Fields

One of the factors that hampers the skill and access of Malaysia's skilled workforce in high-tech and STEM fields is the teaching of science and mathematics in the Malay language since 2012. This is because once the student learns these subjects in his native language, it becomes difficult for the student to continue their career journey as he would need to continually understand, apply and develop new research ideas conducted internationally. Meanwhile such cutting-edge publications on news and journalistic articles related to science, engineering and technology are overwhelmingly published in the English language internationally.

[25] https://www.freemalaysiatoday.com/category/nation/2020/11/26/drop-direct-negotiation-for-govt-procurement-says-think-tank/

[26] https://themalaysianreserve.com/2019/11/13/putrajaya-to-push-for-minimum-50-smes-involvement-in-govt-procurement/

Therefore, it becomes more pertinent for the government to **speed up and improve the implementation of the Dual Language Programme (DLP)** to all schools in Malaysia. However, an in-depth look found that this programme had contained weaknesses such as a dire shortage of qualified teachers in English and the lack of participation of both primary and secondary schools leading to potential future scientific talent being neglected by the system.

It is suggested that the **government mandate all teachers in Science and Mathematics to attend a DLP training course**. Besides this, the government should require each school to have at least 1 DLP class. In addition, a regularly updated and dynamic diagnostic assessment should be exercised in every school to single out intellectual and academic talents in students who are linguistically competent to become involved with the DLP.

Another reason for the deficiency in skilled workers in high-tech and STEM fields is that for many students, they are simply not interested in such fields. It was estimated that only one out of every three students in the upper secondary and tertiary levels will actively undertake STEM fields.[27] Therefore, the government is advised to **provide greater incentives for the undertaking of STEM subjects among students.**

Some weaknesses likewise point to an insufficient level of funding and the purposeful exclusion of private higher educational institutions in STEM initiatives. Therefore, the government should **increase funding for the overall STEM-initiatives**, and, at the same time, **ensure the inclusion of students in private higher educational institutions** due to their high number of student enrolments.

In addition, the Malaysian government must **ease the recruitment process for domestic firms to hire and keep high skilled talent from foreign nations** that can bring high skilled economic contribution as well as **offering attractive skilled worker programs** such as liberalizing its permanent residency system for workers in the fields of technological research and development. Further, it is advised that the government **encourage the transfer of skills and talent from foreign skilled workers to local workers** through subsidized training programs and packages.

Lastly, another factor leading to the lack of skilled workers is that the Malaysian education system has failed to equip graduates with the skills demanded by private industry, creating an academia-industry skills gap and a high disparity between the skills needed by local firms and the skills possessed by fresh graduates. To address this problem, the government had introduced Industry-Academia Collaboration (IAC) back in 2015.

Nevertheless, the IAC presents some flaws including its narrow scope of industry (i.e., focusing on only a few sectors) and a low number of employers and higher learning institutions involved in this programme. It is suggested that the **scope of the IAC be extended to provide more sector specific coverage**. In addition, employers and higher learning institutions should as well be given **more market incentives in the form of tax relief and more widespread recognition** to encourage collaboration.

<Please see INSAP's report entitled "Strengthening Malaysia's Talent Pool" for a detailed list of recommendations in enhancing Malaysia's skilled workforce and human capital development>

Final Thoughts

In conclusion, the RCEP, made up of ASEAN, Japan, South Korea, New Zealand and Australia is the world's largest free trade zone by GDP. The various ASEAN Plus One FTAs combined into one mega-regional trade agreement is expected to further facilitate trade between ASEAN and its 5 FTA partners, driving economic growth and helping competitive advantages in the region.

It is expected that RCEP will be able to provide sweeping economic benefits to all its participating countries, most notably with China, South Korea and Japan, opening up large consumer markets for all nations. China which had previously relied on high-tech US goods had been heavily impacted due to rising US-China tensions. With RCEP

[27] The future of talent in Malaysia 2035, Chartered Institute of Personnel and Development

however, China will be best suited to source high-end technologies from Japan and South Korea. Meanwhile, Japan and Korea will be able to access Chinese huge consumer market, a win-win situation for all parties.

In addition, the implementation of RCEP will provide further economic benefits as well. First, transaction costs will be severely reduced due to advancements in international shipping and freight capacity technology. Secondly, the amalgamation of several ASEAN Plus One FTAs will heavily mitigate the noodle bowl effect. Thirdly, multilateralism is seen to be better suited to the needs of ASEAN and its trading partners than bilateral trade agreements.

According to several empirical papers described above, RCEP is projected to bring strong economic benefits to Malaysia in terms of GDP and its components such as consumption, investment and exports. The increase in total trade is especially important for Malaysia as it is a country highly reliant on foreign trade.

However, it should be noted that RCEP may have some unintended consequences such as a gradual deterioration in Malaysia's terms of trade if it fails to reform several key aspects of the economy, while potentially increasing the degree of Malaysia's "brain drain" and a reluctance to move into a more capital-intensive method of good production such as in automation and robotics due to the availability of cheap foreign labour. If Malaysia fails to introduce these fundamental reforms, it runs the risk of intensifying the nation's position in the middle-income trap, making it more difficult for Malaysia to climb the global value chain.

In this regard, INSAP has provided several recommendations for reform to ensure that Malaysia can best utilize the advantages of being an RCEP member to promote technology transfers, investment and economic growth. The recommendations detailed within this analysis targeting SMEs are to enhance its natural competitiveness, upgrading the SME ecosystem and encourage greater SME participation in foreign business partnerships while remaining the backbone of the local economy.

Apart from this, the government should likewise promote foreign investment from both MNCs and domestic capital investment in local innovation-based companies. In addition, the government also needs to liberalize the government procurement system to both improve efficiency of the market and accelerate the growth of innovation-based SMEs. Lastly, it is also important for the government to reform the education system in producing a greater amount of highly-skilled talent essential to the technological and economic development of the country.

These suggestions will provide the government with a general direction on how to maximize the advantages from the implementation of RCEP to allow Malaysia upward momentum in the value chain to ascend from the middle-income trap. In short, the top three areas of focus for which the government should consider would be SME growth and participation (the backbone of economy), more incentives and investment into home-grown SMEs and companies in upgrading their production processes, and greater level of investment into Malaysia's human capital.