As the world economy shifts into a more globalized era, presently every developing nation is harnessing its resources in an effort to take part in a more free trade regime. Globalization promotes the practice of free trade and it is believed to promote a more leveled playing field in the world market, as tariff rates are driven down to near 0%. Globalization in the long run, rewards efficient producers the competitive advantage that ensures its position in the global market. Even with the promise of more wealth and ensuring increased welfare for all, the issue of increased competition domestically in the midst of trade liberalization for both developed and developing nations is widely discussed. With all of the advantages of free trade, however some economists are skeptical about the downside of globalization which include increased episodes of wage inequality especially between the skilled and unskilled workers, not only in different countries but even within the border of a particular economy. These episodes according to past literatures are experienced in both developed and developing nations all around the world such as the United States, the United Kingdom, Mexico, Colombia, Brazil and India. The objective of this study is to determine whether trade reforms have increased or decreased wage inequality between the skilled and unskilled workers from 1989 to 2010 in Malaysia.

The period is selected due to drastic reduction of overall tariff rates due to Malaysia’s commitment as a GATT/WTO and ASEAN member country. The sharp removal of trade barriers provides a perfect setting for an empirical analysis. With available data at individual level and plant level provided by the Department of Statistics of Malaysia, the study also aims to portray which channel is important in determining wages in Malaysia. These channels include education premium, skill premium, industry premium and occupation premium.

The link between trade liberalization and wage inequality is highlighted by the workhorse model of international trade, the Heckscher-Ohlin (1933) model, and its companion, Stolper-Samuelson (1941) theorem. The Heckscher-Ohlin model predicts that under a liberalized trade policy, countries will export goods that use the factor of production intensively which are relatively abundant domestically, and import goods that use the factor of production which are scarce. The Stolper-Samuelson theorem links factor prices to product prices. The theorem states that with trade, wage changes can be affected only by product price changes. The mechanism behind this theory is further explained under the assumption that there are two countries with two factors of production, namely skilled and unskilled labor. As price of a good decrease with trade, this will lead to a reduced return to the factor that it uses intensively and increase the return to the other factor. With changes in trade policies, tariff cuts are implemented, which leads to price changes and finally affecting factor price changes.

The findings suggest that trade reforms have led to decreased wage inequality between the skilled and unskilled workers during the period of 1989 to 2009 in Malaysia. Since these sectors experiencing bigger tariff cuts are those with higher shares of unskilled workers, trade reforms have led to increased wages of the unskilled workers. Surprisingly, I found that the proportion of skilled workers rose drastically in every industry. This means that there is a big shift from a highly unskilled labor force to highly skilled labor force in all sectors of the economy. This shift however can be explained by the hypothesis of skill-biased technological change.

In chapter 6 the I analysed and quantified the effects of skill-biased technical change, both exogenous and trade induced, that occurs through changes in the price of M&E and trade liberalization using data at the plant level in Malaysian manufacturing from 2000 to 2010. The results show that the effects of both exogenous and trade-induced SBTC caused by changes in the price of M&E - on the skill premium are of statistical and economic significance. Changes in the import price of equipment and in tariff rates on M&E can explain about 2% the increase in the skill premium during the period considered. Chapter 7 has empirically explored the possible roles of trade and technology in affecting the skill based employment gap within the Malaysia manufacturing sector from 2000-2010.

A first outcome from the study is that both plants and plants employ more unskilled workers if wages are kept low. Increase of wages for unskilled workers will decrease the demand for unskilled workers in the manufacturing sector in Malaysia. From this relationship it is clear why employment inequality is also affected by the SBTC channel in Malaysia’s manufacturing sector which still exists even after trade liberalization episodes. Therefore the results from this study proves that trade policies and skill-biased technical change play a significant role in influencing wage inequality both at the tradable sector level and at the plant level from 1989-2010. Employment inequality is also negatively impacted by the skill-biased technical change in Malaysia from 2000-2010.