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Southeast Asia

EXPLORING THE TRADE POTENTIAL  
OF THE DFTZ FOR MALAYSIAN SMEs

THAM SIEW YEAN AND  
ANDREW KAM JIA YI

**ISEAS** YUSOF ISHAK  
INSTITUTE

# Trends in Southeast Asia

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# FOREWORD

The economic, political, strategic and cultural dynamism in Southeast Asia has gained added relevance in recent years with the spectacular rise of giant economies in East and South Asia. This has drawn greater attention to the region and to the enhanced role it now plays in international relations and global economics.

The sustained effort made by Southeast Asian nations since 1967 towards a peaceful and gradual integration of their economies has had indubitable success, and perhaps as a consequence of this, most of these countries are undergoing deep political and social changes domestically and are constructing innovative solutions to meet new international challenges. Big Power tensions continue to be played out in the neighbourhood despite the tradition of neutrality exercised by the Association of Southeast Asian Nations (ASEAN).

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# Exploring the Trade Potential of the DFTZ for Malaysian SMEs

By Tham Siew Yean and Andrew Kam Jia Yi

## EXECUTIVE SUMMARY

- Malaysia established the Digital Free Trade Zone (DFTZ) to facilitate the development of e-commerce and the country's small and medium enterprises' (SMEs') exports. The data revealed thus far indicates an increasing number of SMEs coming on board the DFTZ e-commerce platforms.
- The publicly disclosed data focus on the value of exports achieved but do not show whether these are from new or existing exporters or whether they are re-exports. They also do not highlight Malaysia's imports through the zone.
- The overall trend signals that Malaysia is losing its bilateral revealed comparative advantage in exports to China, as well as an increasing use of imports for exporting to China.
- While the DFTZ facilitates both exports and imports, differing standards and customs processes in different export destinations, including China, will require Malaysian SMEs to know and understand the standards and customs processes governing imports in each export destination involved.
- Imports are also encouraged by the *de minimis* rule, which allows duty- and tax-free imports of up to RM800 into Malaysia. Overall, imports can help enhance the competitiveness of Malaysian SMEs, expand choices for Malaysian consumers, as well as facilitate re-exports.
- A clearer understanding of the role of DFTZ in facilitating trade will require more detailed data collection, and a closer investigation of the imports going through the zone, and their uses.





# Exploring the Trade Potential of the DFTZ for Malaysian SMEs

By Tham Siew Yean and Andrew Kam Jia Yi<sup>1</sup>

## INTRODUCTION

In traditional international trade, geographical distance can affect trade negatively with trade declining as the distance between two markets increases. The concept of distance was later extended to cover subjective concepts, such as “cultural distance” as well common history, language, legal systems or even institutional dimensions such as trade agreements between trade partners. E-commerce on the other hand, differs from traditional trade in the distance dimension because the Internet is touted to have made the world flatter by reducing the time and transaction costs associated with distance. This has led to claims on the death of distance<sup>2</sup> in international trade, while others deem that the role of distance has merely been reduced.<sup>3</sup>

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<sup>1</sup> Tham Siew Yean is Senior Fellow at ISEAS – Yusof Ishak Institute, Singapore. Andrew Kam Jia Yi is Associate Professor at the Institute of Malaysian and International Studies (IKMAS), Universiti Kebangsaan Malaysia. The authors would like to thank the participants of a seminar at the Institute of China Studies, University of Malaya, held on 4 October 2018, for kind suggestions for improving an earlier version of our paper. We also thank participants at the Nanyang Technological University’s 2018 Conference on “Singapore as the Nexus of the Maritime Silk Road: Knowledge Exchanges and Capacity Building” held on 7–8 December 2018, Dr Cheong Kee Cheok, Dr Loke Wai Heng, and an anonymous officer for their kind comments for improving the revised version of our paper. Andrew would like to thank Universiti Kebangsaan Malaysia for providing funding for the research via AP-2017-003/1. The usual caveat remains.

<sup>2</sup> F. Cairncross, *The Death of Distance: How the Communications Revolution Will Change Our Lives and Our Work* (London: Orion Business Books, 1997).

<sup>3</sup> T.Y. Kim, R. Dekker and C. Heij, “Cross-Border Electronic Commerce: Distance Effects and Express Delivery in European Union Markets”, *International Journal of Electronic Commerce* 21, no. 2 (2017): 184–218 <<https://doi.org/10.1080/10864415.2016.1234283>>.

Measuring the impact of e-commerce on exports requires a working definition of e-commerce that is quantifiable, and different proxies have been used in different studies and over time. The earlier literature focused mainly on the impact of Internet usage on international trade at the aggregate level. Clarke's cross-country study<sup>4</sup> indicates that enterprises that are connected to the Internet, export more than similar enterprises that are not connected. Similarly, at the aggregate level, Freund and Weinhold<sup>5</sup> found that increases in company's websites in a country help to explain export growth in the following year for the fifty-six developed and developing countries that were pooled together in their study. In another study, ICT infrastructure is found to be relevant for the export performance of developing countries, and its impact on exports seems to be more important as a country becomes wealthier.<sup>6</sup>

At the firm level, the relationship between the Internet and exports may not be so straightforward as it may be conditional. Lu and Julian,<sup>7</sup> in a study covering a sample of 133 Australian firms found that using the Internet can help firms reduce the cost of doing international business besides giving them a competitive advantage over firms without Internet usage. The international experience of a firm is a significant factor in discriminating between high and low export-marketing performance.

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<sup>4</sup> G.R.G. Clarke, "Has the Internet increased exports for firms from low and middle income countries?", World Bank, Washington, D.C., 2005 <[http://siteresources.worldbank.org/INTKNOWLEDGEFORCHANGE/Resources/491519-1199818447826/hastheinternetincreasedexportsforfirmsfromlowandmiddleincomecountries\\_2007.pdf](http://siteresources.worldbank.org/INTKNOWLEDGEFORCHANGE/Resources/491519-1199818447826/hastheinternetincreasedexportsforfirmsfromlowandmiddleincomecountries_2007.pdf)> (accessed 14 November 2018).

<sup>5</sup> C.L. Freund and D. Weinhold, "The effect of the Internet on international trade", *Journal of International Economics* 62, no. 1 (2004): 171–89.

<sup>6</sup> A. Portugal-Perez and J.S. Wilson, "Export Performance and Trade Facilitation Reform: Hard and Soft Infrastructure", *World Development* 40, no. 7 (2012): 1295–307 <<http://dx.doi.org/10.1016/j.worlddev.2011.12.002>>.

<sup>7</sup> V.N. Lu and C.C. Julian, "The internet and export marketing performance: the empirical link in export market ventures", *Asia Pacific Journal of Marketing and Logistics* 19, no. 2 (2007): 127–44.

Firm-level studies focusing specifically on SMEs in developed countries indicate that the eBay platform has opened up export markets to SMEs at lower costs for some EU countries.<sup>8</sup> A study of SMEs in the United Kingdom shows that ICT users are 15 per cent more likely to export, *ceteris paribus*.<sup>9</sup> Hagsten and Kotnik's regression analysis, using firm-level data for a large group of European countries and four different proxies of ICT, found a significant and positive relationship between the ICT capacities and the engagement in exporting activities of SMEs, although the kind of ICT capacity of importance seems to vary across countries.<sup>10</sup>

The literature on the impact of e-commerce at the firm level for *developing countries* is sparse and fragmented and is mostly based on small sample studies at a country level, and the concept of e-commerce used may not be the same from one study to another. For example, using e-mail as the primary business-to-business (B2B) e-commerce application, Humphrey et al.,<sup>11</sup> found that even when some of the expectations about the benefits of better access to information and reduced communication costs are met, very little business with new firms has been generated by using Internet-based B2B e-commerce for the garment and horticultural sectors in Bangladesh, Kenya and South Africa.

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<sup>8</sup> A. Lendle, M. Olarreaga, S. Schropp and P-L. Vezina, "There goes gravity: How eBay reduces trade costs", Centre for Economic Policy Research (CEPR) Discussion Paper No. 9094, London, 2012 <<https://www.ebaymainstreet.com/sites/default/files/How-eBay-Reduces-Trade-Costs.pdf>> (accessed 14 November 2018).

<sup>9</sup> D.A. Higon and N. Driffield, "Exporting and innovation performance: Analysis of the Annual Small Business Survey in the UK", *International Small Business Journal* 29, no. 1 (2011): 4–24.

<sup>10</sup> E. Hagsten and P. Kotnik, "ICT as facilitator of internationalisation in small- and medium-sized firms", *Small Business Economics* 48, no. 2 (2017): 431–46.

<sup>11</sup> R. Humphrey, R. Mansell, D. Pare and H. Schmitz, "The Reality of E-Commerce with Developing Countries", London School of Economics and Political Science, 2003 <[https://eprints.lse.ac.uk/3710/1/The\\_reality\\_of\\_e-commerce\\_with\\_developing\\_countries.pdf](https://eprints.lse.ac.uk/3710/1/The_reality_of_e-commerce_with_developing_countries.pdf)> (accessed 14 November 2018).

Despite the paucity of evidence in developing countries, these countries are keen to utilize e-commerce as a means for internationalizing their SMEs through exports. For Malaysia, the new government elected after the general elections in May 2018 (or GE-14) has continued to uphold the importance of developing a digital economy — an initiative that was promoted by the previous regime. The Digital Free Trade Zone (DFTZ) constitutes a key policy initiative in the raft of policies used to facilitate the digitalization of the Malaysian economy. It is also part of the Digital Silk Road that is envisaged by Jack Ma in his move to align his business expansion plans with the Belt and Road Initiative (BRI) of China. Jack Ma was appointed a special economic advisor to the previous government in November 2016 and the DFTZ was launched later in March 2017, in collaboration with Alibaba.

An important component of this initiative is to utilize e-commerce as an enabler for SMEs to export. The objective of this paper is to explore the development of the DFTZ and its potential to encourage SMEs to exports.

## **DIGITAL FREE TRADE ZONE (DFTZ)**

The DFTZ is a dedicated zone whereby the whole range of services which is needed to ensure the speedy delivery of goods is scheduled to be made available over a staggered timeline. The zone is the first of Jack Ma's Internet-based trading platform or electronic World Trade Platform (e-WTP). Specifically, an eFulfilment<sup>12</sup> hub, a satellite services hub and an eServices Platform, are being developed over two phases with the first phase undertaken by Pos Malaysia at a cost of RM60 million. This budget is used for upgrading and renovating the former Low Cost Carrier Terminal (LCCT) for the facilities of the DFTZ, and it is already operational. The government's budget for 2018, as announced in October 2017, also included an allocation of RM83.5 million for the development of this first phase.

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<sup>12</sup> This encompasses warehousing, and order fulfilment, shipping logistics and last mile delivery in an e-commerce value chain.

The eFulfilment hub aims to develop the Kuala Lumpur International Airport (KLIA) Aeropolis into an aviation, air cargo and logistics hub in Malaysia and ASEAN by providing warehousing, logistics and streamlined customs clearance that can shorten the time taken for exports and imports.<sup>13</sup> This includes the supply of secure warehousing using the latest technology such as temperature-controlled storage, own customs inspection and quarantine area and light industrial units for minor repairs and assembly before shipping of goods.

The satellite services hub aims to be a premier digital hub for global and local Internet-related companies that are geared towards the Southeast Asian market. It will be located at the Kuala Lumpur Internet City (KLIC), which is reportedly a RM5 billion development.<sup>14</sup> According to KLIC's website, Catcha, which is KLIC's master developer, aims to secure 1,000 Internet-related companies and 25,000 tech professionals to take up its 5 million sq. ft. of space over fifteen years.<sup>15</sup>

The eServices Platform is a virtual space development that aims to complement the first two physical developments by providing an integrated system that connects online services by global e-commerce companies to the relevant Malaysian agencies. Government services that are or will be linked to this platform include customs clearance, permits, industry compliance and advice on border trade, while a host of business services such as warehousing and fulfilment, freight-forwarding, last-mile delivery, payments, insurance and web-hosting will also be provided. This is to ensure a seamless journey for exporters and importers in their business online. Integrated trade facilitation measures have managed to reduce cargo clearance time from six to three hours at the KLIA Air-Cargo Terminal 1 (KACT1) thus far.

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<sup>13</sup> See Chapter 1 of "Economic Outlook 2019" <<http://www.treasury.gov.my/pdf/economy/er/1718/chapter1.pdf>> (accessed 14 November 2018).

<sup>14</sup> See <<http://www.theedgemarkets.com/article/tech-kl-internet-city-looking-alternative-site>> (accessed 14 November 2018).

<sup>15</sup> <<http://klinternetcity.com/>> (accessed 14 November 2018).

In the second phase, Cainiao Network, the logistic arm of Alibaba, will be partnering with Malaysia Airports Holdings Berhad (MAHB) in a greenfield investment, which will be operational in 2020. Cainiao is reported to hold a 70 per cent stake while the remaining 30 per cent will be held by MAHB. The partnership is expected to invest RM800 million to develop a regional eFulfilment hub at the KLIA Aeropolis.<sup>16</sup> KLIA Aeropolis will build on existing air freight infrastructure to include sea freight via Port Klang and railway cargo to Bukit Kayu Hitam, which will support a regional multimodal transshipment hub. The hub will subsequently be linked to Alibaba's planned e-WTP hubs in other countries.

The Alibaba group has reportedly invested US\$100 million (or about RM400 million) in its various initiatives in the DFTZ, including the purchase of land, infrastructure, and the development of technology and local capabilities.<sup>17</sup> Post GE-14, Ma has categorically stated that he will continue investing in Malaysia, with the approval of the new government.<sup>18</sup>

Alibaba's financial services will also be included eventually as two of Malaysia's financial services providers, Maybank and CIMB Bank Bhd have entered into agreement with Ant Financial Services Group to establish the Alipay mobile wallet in Malaysia. Alibaba Cloud, the cloud-computing arm of Alibaba group, has opened a data centre in Malaysia in October 2017.<sup>19</sup>

The zone therefore aims to provide a complete e-commerce ecosystem which will encompass e-commerce platforms, e-fulfilment, logistics, trade facilitation, payment and finance. This will ease the exit

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<sup>16</sup> <<https://mydftz.com/why-us/aeropolis/>> (accessed 14 November 2018).

<sup>17</sup> See <<http://www.theedgemarkets.com/article/alibabas-investment-malaysia-us100m-and-counting>> (accessed 14 November 2018).

<sup>18</sup> <<https://www.thestar.com.my/news/nation/2018/07/09/alibaba-to-continue-investing-in-msia-tech-giant-assures-its-not-backing-down-on-its-projects-in-the/>> (accessed 14 November 2018).

<sup>19</sup> <<https://www.mdec.my/newsletter/2018/06/Happening1.html>> (accessed 14 November 2018).

and entry of goods into Malaysia by reducing the overall trade costs. The DFTZ is expected to increase the contribution of e-commerce to GDP to RM211 billion by 2020, as stated in the Eleventh Malaysia Plan. It is also expected to double SMEs' exports to RM160 billion (or US\$38 billion) by 2025.

According to Communications and Multimedia Minister Gobind Singh Deo, apart from Alibaba and Lazada.com.my, other platforms such as Amazon.com, eBay, tradeindia.com, as well as local platforms such as Jocom, eRomman, JinBaoMen, DagangHalal.com, AladdinStreet.com.my and BuyMalaysia are also operating in the DFTZ.<sup>20</sup> The joint media release issued by MITI and MDEC in April 2018, revealed that 2,651 SMEs have already come on board the DFTZ since November 2017, with 70 of these generating RM52.1 million in total sales and RM18.1 billion in exports.<sup>21</sup> However, it is unclear whether these exports are generated by new exporters, existing exporters or re-exports.

As at September 2018, about 3,800 SMEs have joined the DFTZ platform.<sup>22</sup> The information does not distinguish SMEs that are new on e-commerce platforms from seasoned SMEs that have used e-commerce channels prior to the establishment of the DFTZ. Critically, there is no data on the sustainability of the SMEs that have been listed on the e-commerce platforms in the DFTZ nor their attrition rate. This is important as some SMEs joined the DFTZ because they were given incentives that subsidized their listing for the first year. The achievements thus far fall short of the reported 8,000 SMEs that are targeted for the year 2018 at the time of writing this paper.<sup>23</sup> In particular,

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<sup>20</sup> <<https://themalaysianreserve.com/2018/07/27/dftz-not-dependent-only-on-alibaba/>> (accessed 14 November 2018).

<sup>21</sup> <[http://www.miti.gov.my/miti/resources/Media%20Release/Media\\_Release\\_-\\_Updates\\_on\\_DFTZ\\_Pilot\\_Project.pdf](http://www.miti.gov.my/miti/resources/Media%20Release/Media_Release_-_Updates_on_DFTZ_Pilot_Project.pdf)> (accessed 14 November 2018).

<sup>22</sup> <<http://www.theedgemarkets.com/article/more-smes-joining-dftz-propping-ecommerce> 02 November 2018> (accessed 14 November 2018).

<sup>23</sup> <<http://www.treasury.gov.my/pdf/economy/er/1718/chapter1.pdf>> (accessed 14 November 2018).



the focus on exports has left out information on imports which can also assist SMEs maintain their cost competitiveness, especially for exporting purposes.

Given the paucity of data reported thus far, we will infer the trade potential of SMEs on board the DFTZ, from the general bilateral trade pattern between Malaysia and China, since exports are also targeted for China, especially via the Alibaba platform. While it is true that exports are not necessarily confined to China, Malaysian SMEs would be competing against Chinese suppliers, especially on Alibaba and Lazada, for sales to China and elsewhere.

## **MALAYSIA-CHINA BILATERAL TRADE PATTERN**

### *Bilateral Trade Trends*

There is no data available to separate total trade between Malaysia and China into e-commerce and traditional trade. Ideally, the bilateral analysis should focus on the types of goods sold through cross-border e-commerce, but that is also not available. Nevertheless, a country's trade data will capture both traditional trade as well as cross-border e-commerce trade since they all have to go through customs, which records the trade data. It is also important to note that the customs facilitation and logistics advantages conferred by the DFTZ as explained in the earlier section, are sector-neutral, as the focus is on improving *processes* for all sectors rather than for specific sectors. It is for all these reasons that we focus our analysis on overall trends.

China has been Malaysia's top trading partner since 2010. It is an especially important trading partner in machinery and transport equipment (SITC 7), even before its accession to the WTO in 2001. Table 1 shows Malaysia's top ten exports (imports) to (from) China since 2010. Although Malaysia exports mostly machinery and transport equipment (SITC 7) to China, there is a declining trend over time. Within the top five exports, there used to be at least one product which is from the SITC 7 category. However, since 2013, machinery and transport equipment are no longer in the top five Malaysian exports to China.

*Table 1: Top 10 Export and Import (% share of total export to China) based on 5-digit SITC rev 3*

Export Ranking	Product/Year 2010		Product/Year 2011		Product/Year 2012		Product/Year 2013		Product/Year 2014		Product/Year 2015		Product/Year 2016		Product/Year 2017	
	%		%		%		%		%		%		%		%	
1	75997	9.94	42229	11.93	42229	9.26	42229	7.04	42229	5.94	33543	5.35	42229	3.35	33543	5.04
2	42229	8.90	23125	6.10	62119	6.03	68212	5.98	33543	3.35	42229	4.09	33543	2.42	23218	3.50
3	23125	4.18	62119	4.34	23125	3.29	62119	4.22	62119	2.95	33525	2.97	23218	2.06	33525	2.83
4	62119	4.12	75997	3.00	43122	2.26	23125	3.09	23125	2.12	23125	1.85	33525	2.03	42229	2.43
5	43122	2.54	43122	2.71	75997	2.19	51124	1.89	68212	2.07	68212	1.59	43122	1.87	77641	2.29
6	77637	1.34	77689	0.82	51124	1.08	43122	1.84	43122	2.00	43122	1.46	23125	1.61	77689	1.85
7	76493	1.01	51124	0.75	77689	1.01	75997	1.30	51124	1.28	68311	1.45	75997	1.27	23125	1.67
8	77689	0.83	42241	0.73	87477	0.69	59899	1.10	77637	1.02	62119	1.30	77689	1.16	75997	1.49
9	57111	0.77	76493	0.69	57111	0.68	77689	1.10	75997	0.88	51124	1.03	68212	1.12	43122	1.48
10	42241	0.69	57111	0.67	68711	0.63	77637	0.98	33525	0.82	77819	0.99	77637	1.10	77637	1.32
Import Ranking	Product/Year 2010		Product/Year 2011		Product/Year 2012		Product/Year 2013		Product/Year 2014		Product/Year 2015		Product/Year 2016		Product/Year 2017	
	%		%		%		%		%		%		%		%	
1	75997	6.79	76493	4.91	76493	3.59	76432	2.98	76432	2.83	76432	2.99	76432	2.71	76432	4.49
2	76493	5.23	75997	4.06	75997	3.22	76493	2.96	75997	2.47	75997	2.55	77689	2.21	77689	2.55
3	76432	2.71	76432	3.03	76432	2.87	75997	2.86	76493	2.31	76493	2.04	75997	2.11	75997	2.47
4	77689	1.25	72849	0.87	77884	2.12	68212	2.54	87193	1.90	77689	1.47	76493	2.10	77688	1.50
5	77259	0.84	77689	0.86	77689	1.43	77884	2.15	77689	1.68	87193	1.27	77688	1.11	89399	1.24
6	77884	0.82	77121	0.79	74133	0.84	77689	2.07	68311	1.32	77688	0.98	67629	1.04	87193	0.99
7	77121	0.81	77259	0.77	87193	0.79	87193	1.33	68421	1.16	68423	0.93	69979	0.81	77121	0.80
8	3611	0.67	89399	0.75	77121	0.77	68423	0.74	69979	1.10	69979	0.91	89399	0.72	72846	0.73
9	5452	0.65	3611	0.73	89399	0.64	77121	0.61	77884	1.02	77637	0.89	71219	0.71	72855	0.66
10	79322	0.62	77884	0.63	77259	0.63	68311	0.59	77637	0.87	77884	0.75	77121	0.71	59861	0.61

Source: UNComtrade.

Taking a broader definition of manufactured goods (that is, comprising SITC 5, 6, 7, 8, less 667 & 68), the share of top ten manufactured goods amounted to 18 per cent of Malaysian total exports to China in 2010. By 2016, the share of these top ten manufactured goods exports had fallen to a mere 5 per cent before improving to 7 per cent in 2017. The top exports from machinery and transport equipment are primarily electrical and electronic parts and components.

In 2016, the top six exports fall in the category of Primary Commodities (SITC 1, 2, 3, 4, 68). Malaysia's top export good to China since 2011 is refined oil and its fractions (SITC 42229). Its share however has also declined from 12 per cent in 2011 to only 2 per cent, although it continues to remain as one of the top export good in 2017. Mineral fuels, lubricants and related materials (SITC 3) products are also becoming increasingly more important as they (i.e., SITC 33543 and 33525) entered the top ten exports list in 2014 and remained in the top five export products, thereafter. Petrol-based products (SITC 33543) became the top export good in 2017.

The top ten imports from China since 2012 are all manufactured goods. The decline in the share of the top ten manufactured imports is less acute compared to exports, falling from 19 per cent to 16 per cent of total imports in 2017.

The decline in the share of exports of manufactured goods warrants some concerns. The Bilateral Revealed Comparative Advantage (BRCA) in Table 2 shows that Malaysia's manufactured goods export to China is at a bilateral disadvantage position or that these products no longer have a comparative advantage in China in 2017, except for SITC 5 and 7. While this holds true for many manufactured goods, further breakdown however shows that Malaysia still has a comparative advantage in electronics and electrical (E&E) products, especially in parts and components exports.

For products such as crude materials, inedible, except fuels (SITC 2), agricultural raw material is the main product that has the highest BRCA. It is the product with the highest export potential in China. Primary commodities which include mineral fuels, lubricants and related materials have increasing BRCA since 2010, implying a strengthening in Malaysia's export share to China as compared to the world. Palm oil used

**Table 2: Bilateral RCA**

<b>Malaysia-China Bilateral RCA<sup>a</sup></b>	<b>2000</b>	<b>2010</b>	<b>2013</b>	<b>2017</b>
SITC 0 - Food and live animals	0.41	0.38	0.49	0.56
SITC 1 - Beverages and tobacco	0.12	0.13	0.10	0.27
SITC 2 - Crude materials, inedible, except fuels	3.38	2.08	2.42	3.42
SITC 3 - Mineral fuels, lubricants and related materials	1.14	0.41	0.48	1.04
SITC 4 - Animal and vegetable oils, fats and waxes	3.24	1.52	1.38	0.83
SITC 5 - Chemicals and related products, n.e.s.	2.39	1.32	1.60	1.51
SITC 6 - Manufactured goods by materials	1.69	0.93	1.45	0.64
SITC 7 - Machinery and transport equipment	0.69	1.21	1.16	1.02
SITC 8 - Miscellaneous manufactured articles	0.35	0.33	0.28	0.43
SITC 9 - Commodities and transactions not classified elsewhere in the SITC	1.08	0.40	0.42	0.25
• Primary commodities	1.81	0.87	0.93	1.16
• All food items	2.17	1.19	1.07	0.72
• Agricultural raw materials	3.36	2.03	2.07	2.89
• Palm Oil	3.62	1.48	1.36	0.63
• Textile fibres, yarn, fabrics and clothing	0.63	0.29	0.37	0.38
• Manufactured goods	0.81	1.07	1.05	0.93
• Electronic Non-PNC	0.27	0.89	0.83	0.78
• PNC, E&E	0.83	1.52	1.46	1.24

Note:

a. Bilateral RCA =  $\frac{\text{Malaysia export } i \text{ product to China/Malaysia total export to China}}{\text{Malaysia export of } i \text{ product to World/Malaysia total export to World}}$

A value above 1 represents that for *i* export, Malaysia has a revealed comparative advantage in Chinese market compared to the rest of the world.

Palm oil classifications are SITC 4222 and 4224. Refer to Appendix for full item classification.

Source: UNComtrade and classifications follow <[http://unctadstat.unctad.org/EN/Classifications/DimSiteRev3Products\\_DsibSpecialGroupings\\_Hierarchy.pdf](http://unctadstat.unctad.org/EN/Classifications/DimSiteRev3Products_DsibSpecialGroupings_Hierarchy.pdf)>.

to have the highest comparative advantage in the Chinese market, but it has declined to a disadvantaged position since 2015.

### *Exporting with More Imports*

Trade in Value-Added (TIVA) data generally indicates that Malaysia's exports have a relatively high direct and indirect import content (Table 3) due to Malaysia's involvement in the global value chains (GVCs). Malaysia's exports to China in manufactures are also expected to have high foreign content since China is also a part of the GVCs. Table 3 also shows that the domestic value-added (DVA) content is decreasing in manufactures and total exports to China. This implies that Malaysia has captured less domestic value from the products exported to China, over time. But there seems to be some upgrading in the Computer, Electronic

**Table 3: Domestic VA Export as a Share of Malaysia's Gross Export to China (%)**

<b>Year</b>	<b>Food</b>	<b>Manufactures</b>	<b>Computer, Electronic and Optical Equipment</b>	<b>Total Export to China</b>
2000	64.8	42.6	29.8	55.8
2001	65.3	41.6	30.5	53.7
2002	66.5	42.9	31.6	54.1
2003	66.8	40.3	30.0	51.2
2004	63.2	38.4	29.5	49.3
2005	64.8	39.1	29.3	48.4
2006	65.4	37.5	30.4	47.1
2007	67.0	39.1	30.8	48.9
2008	67.6	41.1	32.8	51.3
2009	68.5	43.2	35.8	53.1
2010	63.6	42.7	34.5	51.5
2011	67.4	41.7	33.2	51.2

Source: OECD, TIVA data.

and Optical equipment industry as the DVA in this sector has increased from 2000 to 2011. Nevertheless, the DVA of Malaysia's exports of Computer, Electronic and Optical equipment to China in this industry is still very low, with an average of around 32 per cent. Overall, the DVA content of exports to China has declined from 56 per cent in 2000 to 51 per cent in 2011, indicating an increasing dependence on imports to facilitate Malaysia's exports to China.

The TIVA data also suggests a general trend towards increasing foreign input from China for Malaysia's domestic exports, compared with other source countries like the rest of East Asian countries such as Taiwan, Japan, Korea as well as the United States (Table 4). In 1995, the U.S.'s share in imports for exports was 12 per cent, while China's share was only 2 per cent. By 2011, China's share has increased to 11 per cent, while the share of the United States has dropped to 10.5 per cent.

If we include importing from China for domestic consumption to importing inputs for domestic production and sales as well as for exports, it is not surprising that Malaysia has an overall trade deficit with China, since 2011 (see Figure 1).

### *Case Study: Example of Food and Beverages*

According to MITI, the top ten product categories preferred by Malaysian SMEs on Alibaba are food and beverage, others, beauty and personal care, furniture, health and medical, packaging and printing, apparel, agriculture, rubber and plastics, automobiles and motorcycles (Table 5).<sup>24</sup>

Generally, food products have a relatively higher domestic VA content of exports (DVA) as compared to other manufactures (Table 3). From 2000 to 2011, there is a slight improvement in DVA from 64.8 per cent of gross exports to 67.4 per cent, with the highest registered in 2009

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<sup>24</sup> <[http://www.miti.gov.my/miti/resources/Media%20Release/Fact\\_Sheet\\_DFTZ\\_at\\_Malaysia\\_Digital\\_Economy\\_2018\\_SME\\_Fact\\_Sheet.pdf](http://www.miti.gov.my/miti/resources/Media%20Release/Fact_Sheet_DFTZ_at_Malaysia_Digital_Economy_2018_SME_Fact_Sheet.pdf)> (accessed 20 November 2018).

**Table 4: Foreign Input Providers (% Share in Total Foreign Content of Export)**

<b>Year</b>	<b>China</b>	<b>Taiwan</b>	<b>Japan</b>	<b>Korea</b>	<b>USA</b>
1995	1.9	4.3	24.8	4.4	12.2
1996	2.1	4.0	22.4	6.0	12.8
1997	2.8	4.2	22.1	5.7	14.0
1998	2.5	4.3	21.9	5.6	16.6
1999	2.2	4.4	23.1	5.5	16.7
2000	2.5	4.9	23.7	4.6	17.7
2001	3.1	4.9	20.7	4.4	17.3
2002	4.4	5.1	19.8	5.7	17.0
2003	5.1	4.8	19.1	5.6	16.9
2004	6.3	5.0	18.0	5.3	15.6
2005	7.6	4.9	15.4	5.1	13.8
2006	8.9	4.7	14.2	5.1	13.1
2007	10.0	4.7	13.2	5.1	11.2
2008	10.8	3.7	12.7	4.1	11.2
2009	11.7	3.6	12.7	4.3	12.1
2010	10.5	3.6	12.7	4.5	11.2
2011	11.2	3.7	11.8	3.5	10.5

Source: OECD, calculated from TIVA data.

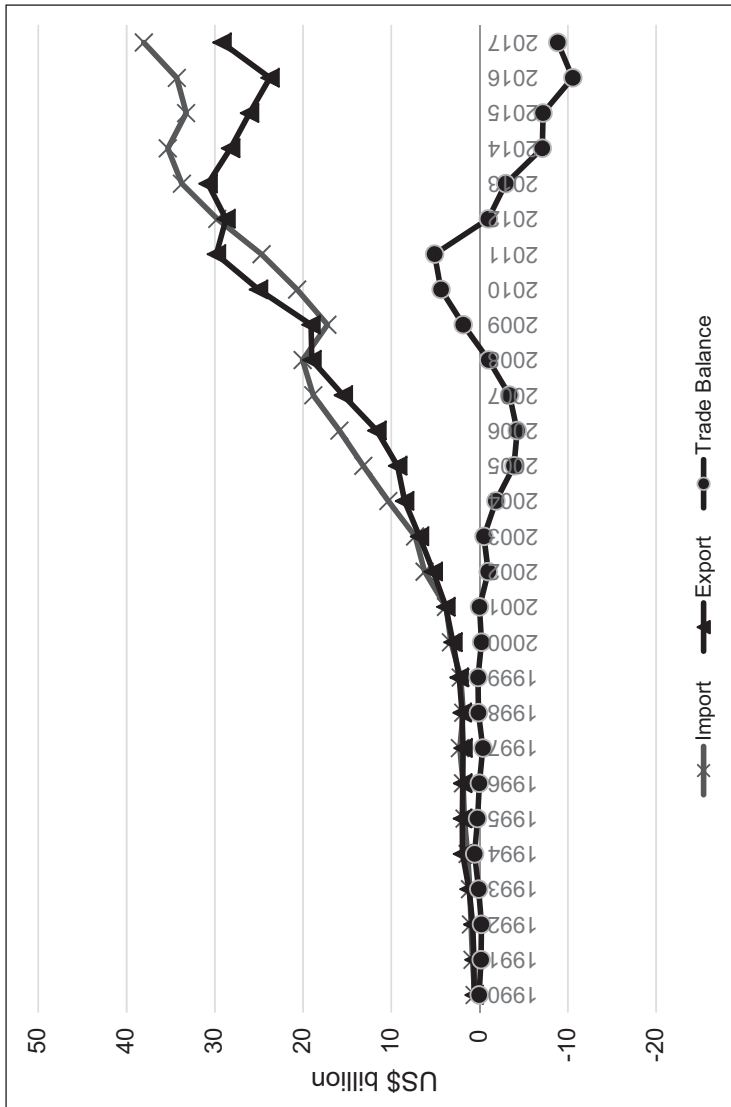
(68.5 per cent). However, Figure 2 shows that this product has declining exports to China but increasing imports. This implies that despite the high DVA content, the trade surplus in this sector is shrinking from 2011 to 2016 with a minor improvement in 2017.

Using classifications under Broad Economic Categories (BEC) by the United Nations International Trade Statistics,<sup>25</sup> we conduct further

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<sup>25</sup> <<https://unstats.un.org/unsd/tradekb/knowledgebase/50089/classification-by-broad-economic-categories-rev4>> (accessed 20 November 2018).

Figure 1: Trade Balance with China (US\$ billion)





**Table 5: Top 10 Categories of Products Preferred by Malaysian SMEs on Alibaba, 2017**

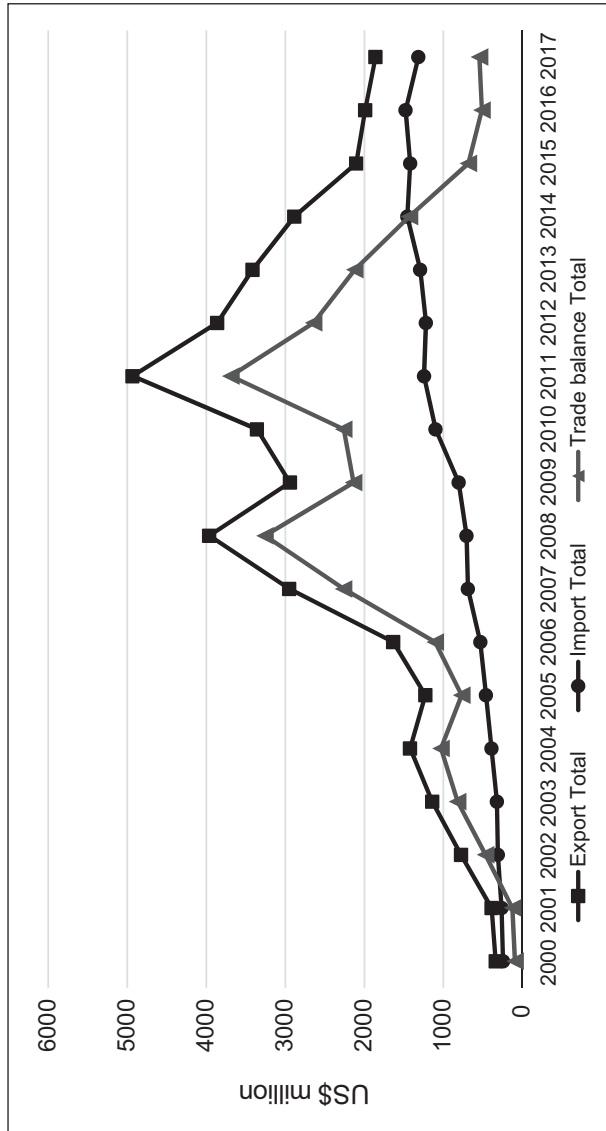
<b>Industry</b>	<b>No. of Companies</b>
Food & Beverage	385
Others	225
Beauty & Personal care	196
Furniture	116
Health & Medical	84
Packaging & Printing	76
Apparel	63
Agriculture	61
Rubber & Plastics	59
Automobiles & Motorcycles	58

*Source:* MITI.

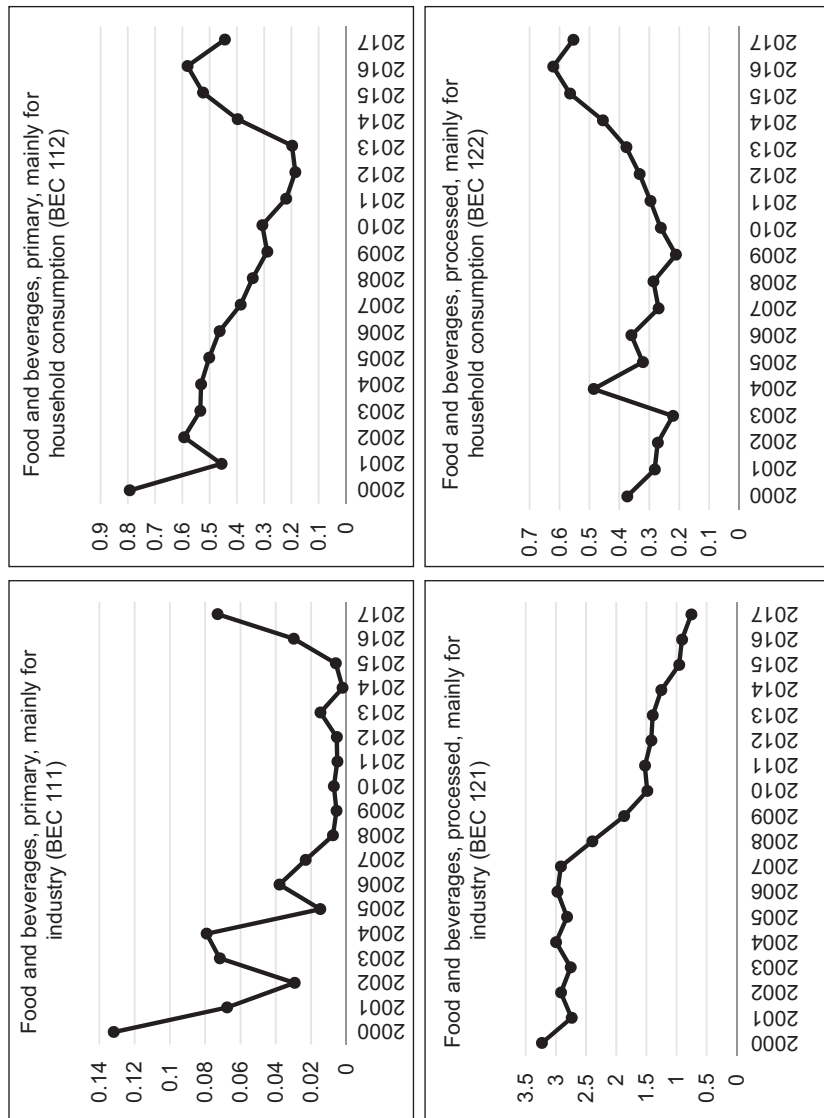
analysis based on the four main sub-product categories under food and beverages to determine if there are any differences in the sub-product groups from the general trend. Figure 3 summarizes the key findings on the bilateral RCA with China for the four main sub-product groups under food and beverages. Overall, the BRCA is less than one for all product groups except for BEC 121 – Food and beverages, processed, mainly for industry, for the period 2000 to 2014. But the BRCA for this product group has fallen to below one from 2014 to 2017 implying that the product group no longer has a bilateral comparative advantage against China’s exports.

The trade trends for food and beverages indicate a trade deficit for all product sub-groups, with the exception again for BEC 121 – Food and beverages, processed, mainly for industry (Figure 4). However, the surplus in this product group for exports to China and the world is shrinking since 2011.

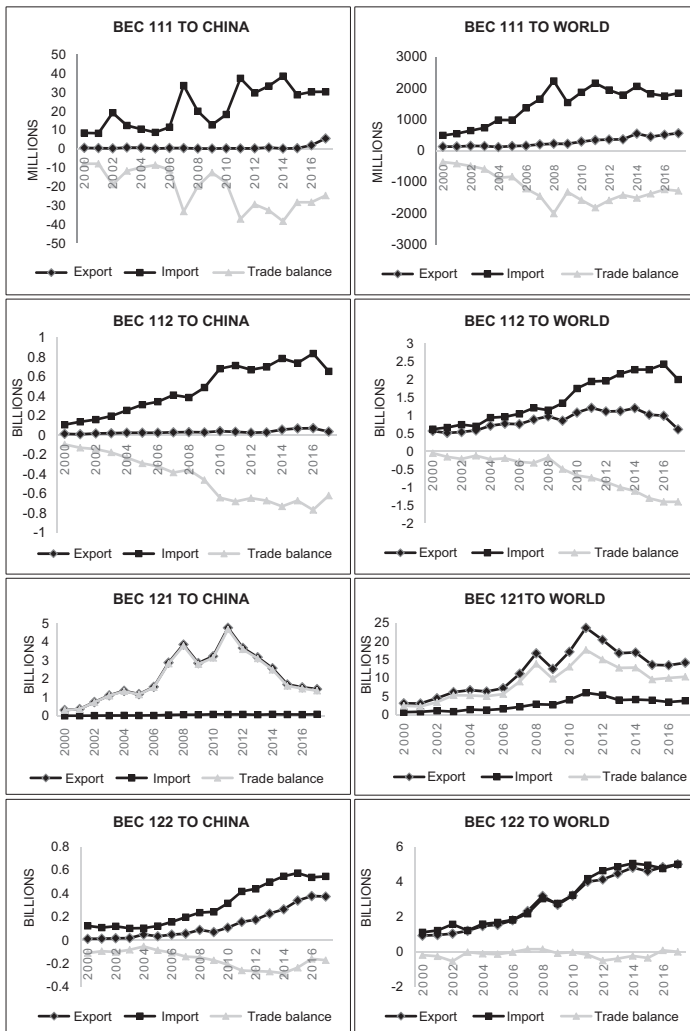
**Figure 2: Food Exports, Imports and Trade Balance with China, 2000–17 (US\$ million)**



**Figure 3. Bilateral RCA (BRCA) Pattern of Food and Beverages to China, 2000–17**



**Figure 4: Trade Pattern of Food and Beverages, 2000–17 to China and to the World**



*Note:* BEC 111 – Food and beverages, primary, mainly for industry; BEC 112 – Food and beverages, primary, mainly for household consumption; BEC 121 – Food and beverages, processed, mainly for industry; BEC 122 – Food and beverages, processed, mainly for household consumption.

## **IMPLICATIONS ON THE TRADE POTENTIAL OF THE DFTZ**

The basic bilateral trade trends with China indicate that Malaysia is losing its comparative advantage in the exports of manufactured goods to China. This is not surprising since Chinese producers face a large domestic market and are able to reap larger economies of scale in production. This translates to a lower cost of production and hence China-made products have a price advantage over Malaysian-made goods. Moreover, the intense domestic competition within China itself implies that China's producers are used to competing with a larger number of producers than Malaysian producers are. Exporting goods to China or the rest of the world on e-commerce platforms competing against suppliers from China will require Malaysian SMEs to invest in branding, marketing and product innovation in order to establish unique value propositions focusing on quality, rather than competing on the basis of price alone.

The DFTZ, while lowering the transaction or trade costs for all sectors, eases these costs for both exports and imports. What exporters need to complement the DFTZ facilities are complementary facilities, including rapid customs clearance and logistics services in the import destinations of Malaysian exports. Malaysian exporters have to abide by the rules and regulations of the importing countries, and this is usually quite stringent in food and health-related products since it affects consumer health the most. Since the import requirements of different importing countries have not yet been integrated into the processes at the DFTZ, it means that Malaysian SMEs have to be able to obtain their own permits from the Malaysian side and the importing side in order to export.<sup>26</sup> On the other hand, Alibaba eases exports from China by providing a range of services such as financial, logistics, and integrated cross-border services including customs clearing, foreign exchange and tax rebating; comprehensive export services (ITC, 2016). These

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<sup>26</sup> <<http://www.theedgemarkets.com/article/dftz-uberise-trade-malaysian-smes>> (accessed 20 November 2018). There are ongoing efforts to establish Mutual Recognition Agreement with the customs in China. If this materializes, it will greatly ease the entry of goods exported by Malaysian SMEs into China.

goods are then facilitated into entering Malaysia via the enhanced trade facilitation measures at the DFTZ. Hence, the Malaysian government has to hasten the process of Mutual Recognition Agreements for standards and customs processes between countries in order to assist the SMEs to export to China and other countries.

Imports have a tax advantage over exports. Budget 2017 has favoured imports by raising the *de minimis* value for imports from RM500 to RM800 (except cigarettes, tobacco and intoxicating liquor) to encourage e-commerce transactions.<sup>27</sup> China's *de minimis* is reported to be US\$8 or approximately RM40.<sup>28</sup> While it is true that China's e-commerce imports are increasing steadily due to tariff reductions from China, these goods tend to be imported from the developed world such as Australia, Germany, the United States, Japan and South Korea, which are also the main export countries to China.<sup>29</sup> Reconsidering the *de minimis* value may help Malaysian SMEs to compete on a more level playing field with importers.

The nature of e-commerce imports needs to be investigated further since it can enable producers to maintain or improve their cost competitiveness, serve consumers' needs for product diversity and competitive pricing as well as to re-export. Table 6 indicates that the share of re-exports to total exports in Malaysia are increasing over time. This can possibly be attributed to the establishment of the DFTZ as well as the emergence of distribution centres by the multinationals in the country.<sup>30</sup>

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<sup>27</sup> This is defined to mean the valuation ceiling for goods, including documents and trade samples, below which no duty or tax is charged and clearance procedures, including data requirements, are minimal. See <<http://tfig.unece.org/contents/de-minimis.htm>> (accessed 24 November 2018).

<sup>28</sup> <[https://global-express.org/assets/files/Customs%20Committee/de-minimis/GEA%20overview%20on%20de%20minimis\\_28%20March%202018.pdf](https://global-express.org/assets/files/Customs%20Committee/de-minimis/GEA%20overview%20on%20de%20minimis_28%20March%202018.pdf)> (accessed 20 November 2018).

<sup>29</sup> <<https://www.usnews.com/news/slideshows/top-5-countries-that-export-to-china?slide=4>> (accessed 20 November 2018).

<sup>30</sup> <<http://www.midf.com.my/images/Downloads/Research/EqStrategy/Others/Strategy-Emergence-of-Cross-Border-Trade-Re-Exports-Trends--Opportunities-MIDF-070618.pdf>> (accessed 20 November 2018).

**Table 6: Exports, Re-exports from Malaysia, 2013–17**

<b>Year</b>	<b>Exports (RM million)</b>	<b>Domestic Exports (RM million)</b>	<b>Re-export (RM million)</b>	<b>Share Re-export/ Total Export (%)</b>
2013	719,992	627,991	92,002	12.8
2014	765,417	665,876	99,540	13.0
2015	777,355	674,171	103,184	13.3
2016	786,964	672,996	113,968	14.5
2017	934,927	792,127	142,800	15.3

*Source:* Department of Statistics.

The availability of warehouses at the DFTZ enables goods flow into the DFTZ to be stored and then re-exported to third countries in the region, based on orders obtained from the e-commerce platforms operating inside and outside the zone. More disaggregated data on imports and their usage, be it for SME producers or SME retailers who import to re-export, with minimal or no value addition to the goods through the DFTZ, will enable Malaysia to formulate a clearer export strategy.

## **CONCLUSION**

The literature on the impact of e-commerce on SMEs exports in developing countries is underdeveloped and does not provide conclusive evidence on the matter. Nevertheless, Malaysia as in the case of other developing countries, has pursued e-commerce in the hope of enhancing the exports of Malaysia's SMEs. Since the establishment of the DFTZ is a key initiative to achieve this goal, its development is complemented with the provision of incentives to export-ready SMEs to list on the e-commerce platforms in the zone.

While the initiative is still relatively new and represents work in progress, the data revealed thus far indicate an increasing number of SMEs coming on board the e-commerce platforms in the DFTZ, though

it falls short of the targeted number as at the time of writing this paper. The number of e-commerce platform providers have also expanded over time to include domestic providers. The data disclosed thus far focus on exports achieved thus far but do not examine whether these are from new or existing exporters or whether they are re-exports.

Analyses at the country level on the bilateral trade trends between Malaysia and China indicate that the former is losing its bilateral revealed comparative advantage in its exports to China, and an increasing use of imports for exporting to China. China's large domestic market provides scalability for its producers and the intensity of domestic competition imply that China's producers have an edge in terms of price competition. While the DFTZ facilitates both exports and imports, differing standards in different export destinations, including China, will require Malaysian SMEs to know and understand the standards governing imports in each export destination. Imports are encouraged by the *de minimis* rule which allows duty- and tax-free imports of up to RM800 per transaction. Overall, imports can help to enhance the competitiveness of Malaysian SMEs, expand choices for Malaysia's consumers, as well as facilitate re-exports. A clearer understanding of the role of DFTZ in facilitating trade will require a closer investigation of the imports going through the zone, and their uses. In conclusion, a more comprehensive analysis of the role of the zone will require more detailed data collection, as basic export numbers alone are inadequate for assessing the success of the zone in terms of its objective, one of which is to facilitate SMEs to export.

## APPENDIX

Product classification based on UNCTAD product groups and composition (SITC Rev. 3). Primary Commodities (SITC 1, 2, 3, 4, 68); All food items (SITC 0, 1, 22, 4); Agricultural raw materials (SITC 2 less 22, 27 and 28); Textile fibres, yarn, fabrics and clothing (SITC 26, 65, 84); Manufactured goods (SITC 5 to 8 less 667 and 68); Electronic Non-PNC – Electronic excluding parts and components (SITC 751, 752, 761, 762, 763, 775); PNC, E&E – Parts and components for electrical and electronic good (SITC 759, 764, 772, 776); Palm Oil/Kernel (SITC 4222, 4224). Mineral fuels, lubricants and related materials are in SITC 3.



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