

## **The Digital Free Trade Zone – A Path to Inclusive Growth?**

*By Timothy Choy (Analyst, Economics Programme)*

### **Executive Summary**

- The Digital Free Trade Zone (DFTZ) is argued to enhance SME activity through the lowering of cost in business expansion and by creating an innovative ecosystem through competition.
- Immediate beneficiaries of the DFTZ are SMEs that are export-oriented with a strong bias towards goods-centric manufacturing.
- As the DFTZ reduces Non-Tariff Barriers (NTBs) and positions Malaysia as the trade hub for inter- and intra-ASEAN trade, trade volume is expected to increase substantially.
- With the completion of the DFTZ, there will be a new demand for "e-Mediary" employments that will target high-skill domestic labour.
- Details on the DFTZ are still scarce and thorough impact assessments are lacking. This warrants concern as the effects of this huge project may adversely affect the country's socio-economic conditions.

# The Digital Free Trade Zone – A Path to Inclusive Growth?

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## Introduction

The first-ever Digital Free Trade Zone (DFTZ), an e-hub jointly established by China's Alibaba Group and the Malaysia Digital Economy Corporation (MDEC), was recently launched at the Global Transformation Forum by Prime Minister Najib Razak.

Playing its part in the National e-Commerce Strategic Roadmap (NeSR) that aims to double e-commerce growth by 2020, the DFTZ will be rolled out in three phases, the first being the eFulfillment Hub that will function as a centralised customs clearance, warehousing and fulfillment facility for Malaysia and the region. The second phase is the Satellite Services Hub in the Kuala Lumpur Internet City (KLIC), which will act as a premier digital hub to facilitate end-to-end support, networking and knowledge sharing for local and global Internet-related companies targeting Southeast Asia. The third phase is the development of a virtual unified government services platform that further provides convenient services for users.

The DFTZ has so far been welcomed as a game changer for equitable growth by equipping small and medium-sized enterprises (SMEs) to take part in globalisation and providing employment opportunities to young entrepreneurs. At a policy level, the DFTZ can be viewed as a timely catalyst for synergy between two independently occurring national initiatives; the SME Masterplan 2012-2020 and the NeSR.

The first of its kind, the DFTZ is specifically designed to prioritise SMEs. At the moment, 97% of domestic businesses are SMEs. Collectively, however, SMEs only contribute 37% to the national GDP and approximately 30% to total employment. The launching of DFTZ hopes to see an increase in this ratio.

## Scenario Analysis on SMEs

A direct effect of the DFTZ will be an overall reduction in internal production and transaction costs. SMEs that operate a traditional brick-and-mortar business model face a high fixed cost because they require a physical establishment. Scaling up business would mean acquiring another physical establishment and therefore duplicating inventory costs – a business expansion plan that is unfeasible for many SMEs that, by definition, possess limited capital.

Under the DFTZ, the eFulfillment Hub will enable SMEs to outsource warehousing and shipping; essentially eliminating the need to maintain multiple physical storefronts in the event of business expansion. Coupled with centralised customs clearance, this increase in demand for warehousing in the eFulfillment Hub will produce economies of scale and act to

reduce administrative costs associated with delivery (Kuwayama, 2001). The use of e-commerce, on the other hand, will provide greater market access to SMEs.

The ability of SMEs to tap into new markets is usually undermined by the cost of acquiring information – distribution channels, buyer preferences, quality standards, policy changes, as well as legal and bureaucratic procedures. By contrast, e-commerce acts as a one-stop solution by connecting sellers and buyers directly. SMEs are able to acquire production inputs more efficiently by sourcing them directly from sellers who meet their business preference. In this respect, the DFTZ will improve growth prospects for SMEs.

With its emphasis on a fulfillment hub, it can be argued that the DFTZ is a goods-centric free trade zone. However, not all SMEs will be affected by the DFTZ in the same way. In the short-term, SMEs that are manufacturers of export-oriented products will be the primary benefactors of the zone. These SMEs produce intermediate goods that are primarily for the global market and are thus 'vertically integrated' into the global supply chain. By virtue of their business operations, such SMEs will stand to benefit more from the reductions in cost accrued by the free trade zone. Conversely, SMEs that primarily produce import substitutes tend to be aimed at the domestic market.

Leveraging on the DFTZ also requires an SME to possess the ability to design a successful adaptive business strategy; a measure of "e-Readiness" of some sort.<sup>1</sup> The effect of trade liberalisation and deregulation in Argentina on SMEs is a case in point. Yoguel (1998) noted that a third of SMEs in Argentina had a limited probability of survival due to productive and managerial constraints, technology backwardness and the inability to adapt and incorporate new products with new export platforms. *e-Readiness* also stems from an SME's ability to compete with other firms.

Intuitively, a free trade zone works both ways; integrating domestic SMEs into the international market and vice versa. E-commerce tends to shift negotiation powers away from the sellers to the buyers by reducing the cost of switching. Buyers need not spend time searching for alternative products at physical stores or through catalogues and newspapers. Additionally, buyers are empowered to search for sellers with the lowest price for a specific product or service.

This puts immense pressure on domestic SMEs to innovate and compete on all fronts. As is always the case with increased competition and upgrading, those who are not able to adapt are likely to fall behind. The 2009 closure of Borders Bookstore comes to mind with *the Guardian's* headline flashing "Hailed as a 'sure fire' success, the bookstore chain was killed by Amazon and cut-price supermarkets".<sup>2</sup> It is prudent then to assess the e-Readiness of SMEs and ensure targeted safety nets are in place to offset the fallout possibilities of SMEs that are not yet e-Ready.

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<sup>1</sup> The idea of E-Readiness can be traced back to McConnell International (2000), which rates the degree of E-Readiness of countries in Latin America and East Asia by measuring five attributes.

<sup>2</sup> <https://www.theguardian.com/business/2009/nov/26/borders-closure-stores-amazon>.

At the national level, it can be argued that in the short run, the DFTZ will primarily benefit export-oriented SMEs that trade in physical goods. Given that 58% of SMEs are in the service sector, the immediate effect of the DFTZ will be focused on the manufacturing and agricultural sectors. This will bring a moderate growth to the national economy as both the manufacturing and agricultural sectors will jointly contribute approximately 33% to the SME GDP.<sup>3</sup> However, it is misplaced to only bank on the short-run effects of the DFTZ. In the long run, the DFTZ will need to invigorate the national economy through two channels: Firstly by the growth of SMEs through the lowering of cost needed to expand; and secondly, through value added following the increase in competition and the scale of necessary innovation of SMEs. The DFTZ may thus be precisely the next big policy for upgrading SMEs and the national economy.

## **Trade on Steroids**

Studying the effect of the internet on international trade, Freund and Weinhold (2004) concluded that the internet is a major trade stimulus. They found that an increase of web hosts in a country increases export growth through an internet-related reduction in fixed costs. Following this pattern of logic, the DFTZ can function interchangeably as a trade liberalisation policy. Trade barriers are not just confined to tariffs and quotas. In fact, it is commonly argued that trade cost caused by non-tariff barriers (NTBs) matter significantly more than remaining tariff barriers.

As illustrated above, SMEs currently face huge costs in collecting information across national borders, finding the right supplier, arranging deliveries, and specifying product requirements and quality. From the standpoint of SMEs, these costs can effectively act as an NTB. Coupled with Malaysia's predominantly export-oriented economy, the DFTZ, which will see the aggressive uptake of SMEs in trade activities, can potentially lead to a large increase in trade volume; akin to trade on steroids.

Additionally, the free trade zone is also designed to be an access hub for trade in Southeast Asia. With facilities readily available at the e-Fulfillment Hub and the Satellite Services Hub, foreign startups and SMEs that intend to operate in the region will have a huge incentive to set up shop in the DFTZ. This will further fuel trade volume and potentially invite foreign direct investments.

It should be noted that the DFTZ is only one component of the 'trade facilitating' equation. There must also be reciprocation on the part of trading countries. Too many trade restrictions imposed by partner countries may stymie the zone's ability to encourage trade. To that end, the Malaysian government must still continue to engage actively in negotiations on bilateral, multilateral and regional trade agreements, since these are important negotiating platforms for country specific trade policies.

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<sup>3</sup> Data obtained from Department of Statistics Malaysia, Official Portal.

## **Employment Opportunities in e-Mediaries**

As is the case for SMEs, the DFTZ is likely to impact employment in the form of job creations as well as losses. As noted in the scenario analysis, SMEs planning to embark on e-commerce change management will need to design adaptive strategies. This involves acquiring talent equipped with the necessary skill sets to manage information technology as well as exploit large quantities of information. The collective effect of such a change among SMEs will see an increase in demand for high-skill and technologically savvy labour (OECD, 1999). The integration of higher skills requirement and more complex production methods into business processes will also augment job responsibilities, creating a demand for "e-Mediaries", or specialised expertise that can provide technology-related intermediary services. SMEs in the service sector may benefit from the DFTZ in this way.

To take a concrete example, in recent years, it was discovered that 86.6% of SMEs were not engaged in any sort of promotional activities while only 3% were estimated to use technology in their promotional activities.<sup>4</sup> Potentially speaking, this translates to an increase of 86.6%, or more, in technology-based advertising services such as graphic designing, web-based advertisement applications and sales information data management.

The potential increase in demand for skilled jobs is timely in light of Bank Negara's latest report, which ranked youths with tertiary education as those with the highest unemployment level among their age group. Meanwhile, jobs which rely on traditional forms of doing business; particularly those in low-skill and to some extent, mid-skill range, will be substituted out of the job market.

## **A Word of Caution**

If done right, the DFTZ can usher in a stage of economic growth that is both equitable and sustainable through the creation of jobs and business expansion opportunities for domestic SMEs. As with anything however, the means to an end can easily get distorted from its intended purpose. The recent spat within Felda Global Ventures Holdings Bhd (FGV) is a fitting example. Despite being a means to economically empower the rural poor, FGV today is under the spotlight for shady transactions. In the same way, the DFTZ may potentially sway away from its intended purpose.

Currently, at the initial stage of development, the DFTZ is showing signs of being a "Selangor-KL"-centric national initiative. Despite the focus on going digital, the physical construction of the eFulfillment Hub at the Kuala Lumpur International Airport (KLIA) Aeropolis and the KLIC creates a geographical bias for job creations to be confined within close proximity of these infrastructures. As it is, young working adults are already struggling to handle the high cost of living in both these areas, especially in terms of purchasing a first home.

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<sup>4</sup> Data obtained from Profile of Small and Medium Enterprise (2011), Department of Statistics Malaysia.

The geographical bias of these hubs will also serve to increase the ever widening rural-urban divide. Even now, it is all too common to hear of graduates having to leave their home state due to a lack of job opportunities or low wages.

During its announcement, the DFTZ was branded a free trade zone tailored specifically for SMEs. To date however, there is no concrete manifestation of this idea, and information is scarce. Initial research done by CIMB has identified companies that will benefit directly or indirectly from the DFTZ, many of which are large national and government-linked companies such as Pos Malaysia Bhd, DRB-Hicom Bhd and Malaysia Airports Holdings Bhd (MAHB).

Although it may be practical for these companies to be preliminary beneficiaries, for reasons of expertise and economies of scale, concrete measures should be laid down to ensure that the benefits of the DFTZ will ultimately be channelled to its intended recipients.

## **Concluding Remarks**

It has been argued that the immediate beneficiaries of the DFTZ will be export-oriented SMEs. These companies by virtue of their operations, are already integrated into the global supply chain and thus possess the required capabilities to leverage on the zone.

In the long run, the DFTZ may potentially pave the way for higher economic growth; firstly by shifting the cost structure of SMEs and reducing the cost of business expansion; and secondly, by encouraging competition, which in turn will help create a more innovative and vibrant ecosystem.

From a trade perspective, much of the DFTZ's effects on SMEs may have a reducing effect on NTBs, creating conducive conditions for a significant rise in trade activity. Additionally, being a regional hub, the DFTZ will also help to boost activity from inter- and intra-ASEAN trade. In order to maximise the benefits offered by the DFTZ, SMEs will require a talent pool that is able to fill e-Mediary positions who are likely to be those with a tertiary education. With that, the DFTZ will be a boon to young tertiary graduates who are currently facing high rates of unemployment.

On the flip side, the DFTZ must be buttressed by robust policies so as to avoid transitional difficulties. As competition among SMEs increases, policymakers need to evaluate whether domestic SMEs are truly ready for the DFTZ and its potential impact on the aggregate economy. A trade on steroids may well pose the risk of negatively affecting Malaysia's trade balance and potentially increasing the trade deficit with China. With regards to employment, relevant measures must be implemented to facilitate a smooth transition to high-skilled jobs, so that those in the low- and mid-skilled positions will not be side-lined.

Finally, the DFTZ is showing signs of being a "Selangor-KL"-centric development, a phenomenon which may further aggravate the rural-urban divide and increase socio-economic pressures for young working adults living in these cities.

Moving forward, the DFTZ may very well be the next big policy needed to jumpstart equitable growth in Malaysia. As argued above, it has the potential to create an enabling environment for the SMEs to expand and innovate as well as provide employment opportunities for local graduates. Given the extent of its predicted impact on the economy, a thorough assessment should be carried out on the DFTZ to answer pertinent policy questions that have been laid out in this brief, as well as to ensure appropriate safety nets are put in place for a smooth transition to the digital economy.

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