Rise of Economic Integration in East Asia: The Malaysian Perspective

Introduction
Over this recent decade, intra-regional linkages in East Asia\(^1\) have strengthened significantly, and more recently during the global financial crisis, it has provided crucial support to the region’s robust recovery. Economic integration in East Asia has been led by the vertical integration of production chains as multinational companies (MNC) seek lower-cost manufacturing facilities beyond national boundaries and capitalise on supportive local policy initiatives in foreign countries. In addition to the rising trend in shared production networks, the growing importance of domestic demand in East Asia has also spurred further economic integration in the region. This provides not only additional sources of demand for goods to economies within the region but also vast investment opportunities. As one of the most open economies in East Asia, Malaysia benefits significantly from the rising level of regional economic integration, through both the trade and investment channels.

Trade integration
In the 1980s, more than half of Malaysia’s exports was channelled to the advanced economies\(^2\), while regional demand accounted for only 29.7% of gross exports. Following the intensification of trade integration, East Asia is currently the main export market for Malaysia, accounting for 47.7% of exports in 2010, while the market share of the advanced economies is lower at 30.1% of exports (Chart 1). Of importance, the emergence of East Asia as Malaysia’s top export market illustrates the potential for the region to boost demand for Malaysia’s exports as evidenced by the rebound from the recent global financial crisis. Malaysia’s export growth recovered to 6.6% in the fourth quarter of 2009, supported by the strong export growth to East Asia of 25.1% (Chart 2).

---

1. East Asia refers to PR China, Hong Kong SAR, Chinese Taipei, Korea, Singapore, Thailand, Indonesia and the Philippines.
2. Advanced economies refer to the US, euro area and Japan.
Within the regional production network, Malaysia is positioned as a producer and assembler of the parts and components of manufactured goods. This has provided impetus to the expansion in the exports of manufactured goods, which accounted for 72.1% of gross exports in 2010, compared to only 18.9% in 1980. In tandem with the region’s role as the production and assembly hub for electronic and electrical (E&E) products, semiconductors as well as computer parts and components comprise the bulk of Malaysia’s manufactured exports to the region, accounting for 48.1% of total exports to East Asia (Chart 3). In addition, Malaysia has also seen a significant increase in the exports of commodity-based manufactured goods, particularly chemicals and chemical products (Chart 4). This trend reflects the steady shift in Malaysia’s economic activity from extracting crude commodities to manufacturing downstream products. Since 1990, the exports of commodity-based products have expanded at an annual average rate of 13.3%, supported mainly by firm regional demand. Thus, regional integration not only provides effective diversification of Malaysia’s export destinations, it also creates higher demand for Malaysia’s exports.

Malaysia’s changing export structure has also been complemented by a diversification in import sources. The integration of production networks has led to a discernable trend, where more goods are sourced from the region instead of the traditional markets, particularly Japan. This is reflected by the rise in Malaysia’s imports from the regional countries to 50.2% of total imports in 2010 from 24.3% in 1980 (Chart 5). In contrast, the market share for Japan almost halved to 12.6% over the same period (1980: 22.9%). In addition, 52.6% of Malaysia’s imports of parts and components are from East Asia, compared to 44.8% a decade ago.

Although the bulk of imports continue to be intermediate goods, its share has diminished over the years (Chart 6). This has been matched by an increase in the imports of final goods. In 2010, imports of final goods accounted for 29.9% of gross imports (2000: 21.9%), consisting mainly of motor vehicles, optical and scientific instruments as well as jewellery. It is noteworthy that the imports of final goods are also increasingly being sourced from regional countries, such as PR China, Singapore and Thailand.
Investment integration

Another key development in East Asia is the expansion of investment opportunities within the region. Benefiting from the vertical integration of Asia’s production networks, Malaysia has also been receiving a steady rise in foreign direct investment (FDI) inflows. Following the temporary decline in 2009 given the global economic downturn, FDI flows into Malaysia resumed in 2010, amounting to RM27.6 billion. While FDI flows continue to be mainly sourced from the advanced economies, FDI flows from the regional countries have increased in recent years, accounting for almost 30% of total FDI flows to Malaysia in 2009 (2003: 10.1% of total FDI flows). Among the regional countries, Singapore is the main investor in Malaysia (Chart 7), with investments totalling RM46.2 billion as at end-2009 (51.4% of total FDI stock from the region). Similar to the trend of overall FDI flows, investments from the regional countries are also channelled mainly to the manufacturing and the finance and insurance sectors (Chart 8).
Strong economic growth and regional integration in East Asia also intensifies competition in attracting FDIs. In particular, the emergence of lower-cost competitors in the region – notably PR China, Indonesia and Vietnam – has affected Malaysia’s competitive advantage in labour-intensive industries. In this regard, foreign investments received in recent years have shifted towards higher value-added economic activities. Of significance, existing MNCs are spurred to reinvest in new production technology and high quality designs to move up the value chain. In addition, Malaysia has received a sizeable amount of new FDIs in new growth areas, such as renewable energy, aerospace, pharmaceutical and medical equipment. A large share of the new investments have also been channelled into the less capital intensive but high-skilled services sector, such as financial services and shared services operations. Although investments into the services sectors are of smaller value, they generally create a higher multiplier on the domestic economy, thereby contributing to a larger impact on domestic employment and income. In recent years, the Malaysian Government has also undertaken various initiatives to promote FDIs into high value-added sectors, in line with Malaysia’s vision for private sector-driven economic growth. These measures include customising incentives for high-impact investments, introducing administrative reforms, and corporatising the Malaysian Investment Development Authority (MIDA) to facilitate foreign investors’ access to the vast investment opportunities in Malaysia. Going forward, FDI inflows into Malaysia are expected to increase, given the more favourable investment climate as well as the improvement in global economic conditions.

Malaysian companies have also been actively capitalising on the opportunities arising from the deepening regional integration and the expansion in regional economic activity. Net direct investment abroad (DIA) by Malaysian companies has been increasing since 2005, and reached a high of RM50.2 billion in 2008. Of significance, a large share of DIA by Malaysian companies has been channelled to Asia, particularly the ASEAN countries (Chart 9).

The range of activities of DIA by Malaysian companies has also widened in recent years. In the early 1990s, DIA was undertaken mainly by Government-linked companies, particularly in the agriculture and the oil and gas sectors. However, in recent years, DIA has focused on gaining greater access to natural resources and tapping the vast opportunities in the fast growing regional economies. While the oil and gas sector continues to account for the largest share of Malaysia’s investment abroad, there has been a significant rise in investments by the telecommunication and financial and insurance sectors, mainly through mergers.
and acquisitions (Chart 10). The direct investment by Malaysian companies contributes towards creating
growth and employment opportunities in the regional economies while at the same time establishes
stronger relationships between these economies and Malaysia. The expansion of DIA also benefits the
Malaysian economy by developing more competitive and globalised Malaysian companies, as well as
generating higher inflows of profits and dividends into Malaysia. Income accrued to Malaysian companies
investing abroad doubled to RM11.9 billion in 2006, and has continued to increase since, rising to RM18.6
billion in 2010 (Chart 11).

Conclusion
The intensification of regional integration in East Asia has resulted in a broader trading base for Malaysia
in terms of both markets and products. East Asia is currently Malaysia’s main trading partner and a major
consumer of both manufactured products and commodities. Although the advanced economies will
remain an important source of final demand, the East Asian market has become an increasingly important
source of external demand for Malaysia. From the investment perspective, Malaysia has strengthened its
ties with regional countries through various investment ventures. In addition to receiving higher value-
added FDIs that will spur Malaysia’s transition into a high income economy, the increasing overseas
investments by Malaysian firms will also benefit the domestic economy through the development of more
competitive domestic firms. With increasing intra-regional trade and investment, the economic ties within
the region will be further strengthened.