Globalisation and deglobalisation

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Abstract

Malaysia's integration into global value chains has played a crucial role in the recent development of the economy, helping to promote its diversification into higher value added and services-based manufacturing. Globalisation has also enabled technological advances and higher investment. This has led to faster income growth, particularly for capital owners and highly skilled workers. However, Malaysia is also now faced with new issues, such as a heavier reliance on foreign workers and heightened vulnerability from global developments. In particular, Malaysia also faces challenges posed by highly volatile capital flows. Moving forward, the global economy will inevitably become more interconnected. The policy imperative is to develop a labour force that is able to respond quickly to changing global demands, strengthen economic fundamentals to protect economic resilience and continuously implement structural reforms to future-proof the economy.

Keywords: Globalisation, regional integration, global value chain, trade openness, technological advancement, flexible labour market, international policy cooperation, financial integration, trade protectionism.

JEL classification: F60, F62, F63, F66 and F68.

Determinants of international trade and population flows

Since the Great Financial Crisis (GFC), global trade has grown more slowly than the global economy itself. This is due to both cyclical and structural factors. Firstly, persistent economic weakness, particularly subdued investment in the advanced economies, has dampened global trade. Structural factors are also at play, in particular, the diminishing impact of major catalytic factors that were important drivers of the high global trade growth in the 1990s and early 2000s. These include the proliferation of global value chains (GVC), breakthroughs of major trade liberalisations such as the formation of the European Union (EU) and World Trade Organisation (WTO) and the accession of PR China into WTO in 2001. The future of global trade will depend, among other things, on structural shifts such as China's economic transition towards a more consumption-based growth, the rising middle income population in the emerging market economies (EMEs), and new and revised multilateral trade agreements.

In Malaysia, exports grew at a slower pace after the GFC (2011–16: 3.6% compared with 11% in 2003–08). However, more recently, exports have grown at the fastest pace since 2004 (Jan–Sep 2017: 21.3%; 2004: 21.0%). Several factors explain this improvement. First, structural reforms have helped to promote greater diversification in the composition of export products, which has enabled Malaysia to benefit from enlarged intra-regional trade. Second, the diversification into the electrical and electronics (E&E) segment and Malaysia's participation in GVCs have enabled the economy to benefit from the global technology upcycle. Malaysia is the seventh largest global semiconductor exporter, with semiconductor exports totalling USD 35 billion in 2016. Third, the pickup in consumer spending and investment activity in the advanced economies (eg the United States and EU) along with faster expansion in the other EMEs have provided further impetus to Malaysia's exports.

Malaysia's integration into GVCs has been facilitated by its openness to trade, attractive investment environment and strong macroeconomic fundamentals (Malaysia's trade-to-GDP ratio in 2016 was 128% compared with a world average of 88.5%). This has reduced the sensitivity of the exchange rate on exports. External demand remains the most important driver of exports. There are, however, risks. Disruptions along the value chain can affect production and trade by all companies along the value chain. For example, in 2011, the twin disasters of the Tohoku earthquake and floods in Thailand impacted the global electronics production network. Foreign suppliers could not immediately take over the strategic role of some Japanese and Thai suppliers. This resulted in some production disruption in Malaysia's electronics industry during the period (average growth for electronics IPI in March – May 2011: –16.3%; November 2011: –0.4%).

Research has shown that technological advances have a positive impact on trade and economic growth in general through the introduction of new and improved products, opening of new markets and process innovation.[1] In the case of Malaysia, greater technological innovation and its dispersion across borders have helped to

[1] L Márquez-Ramos and I Martínez-Zarzoso, "The effect of technological innovation on international trade: a nonlinear approach", *Economics Discussion Papers*, no 2009-24, Kiel Institute for the World Economy, 2009.

advance its overall economic complexity,[2] which increased from 0.70 in 2010 to 0.82 in 2016. This has also led to a rapid shift in Malaysia's export product mix. Within specific E&E products, for example, integrated circuits (which have a higher product complexity of 2.56) have increased their share of Malaysia's total exports from 9.9% in 2010 to 14% in 2016. Correspondingly, Malaysia's exports of computers (with a lower complexity of 1.94) have declined from 4.8% of total exports in 2010 to 4.2% in 2016. In the services sector, new technology has broadened market reach and allow for quicker and more efficient trade facilitation via e-commerce and the digitisation of cross-border activity. Malaysia recently launched a Digital Free Trade Zone, which aims to connect the small and medium enterprises (SMEs) with electronic marketplaces, government agencies and cross-border logistics and payment providers. Advances in information and communications technology (ICT) also promote efficient movement of goods and people through greater use of online applications (eg e-Visa) and marketing tools (eg social media), with a positive impact on trade and tourism. Technological advances may also pose a risk to employment, due to structural changes and increased automation. The challenge is to develop a labour force that can respond quickly to changing industry needs.

Regional and global arrangements have played a key role in facilitating trade and attracting foreign direct investment (FDI). As a result of strengthened regional production, Malaysia is increasingly positioned as a producer and assembler of the intermediate parts and components of manufactured goods, before they are exported for further processing or final consumption. The share of exports to East Asia and the rest of the world[3] has risen from 45.3% in 2001 to 60.2% in 2016. Increased financial integration, particularly in the form of FDI, has contributed to Malaysia's current trade strength by enabling the country to respond quickly to any increase in global demand. However, the increased role of financial centres and the complexity of corporate structures at large multinational companies (MNCs) make it more challenging for policymakers to separate long-term industrial investments from the investment positions of fund vehicles. Investment via international offshore financial centres (IOFCs) is a common international practice for businesses and companies: investable funds are pooled in IOFCs before being redirected to economic sectors in various locations. For example, the share of Malaysia's direct investment abroad (DIA) to IOFCs amounted to 24% of total DIA (2016), which is comparable with other regional economies (eg Thailand: 22% in 2016; Singapore: 15.2% in 2015; Hong Kong SAR: 47% in 2015).[4]

2 Economic complexity captures the diversity and ubiquity of a country's export of goods. It is measured as a standard deviation from the world average. A country can improve its ECI position by producing and exporting more complex and diverse products. This methodology was developed by Ricardo Hausmann et al at the Harvard's Center for International Development. For a more detailed account, please refer to Hausmann, R., et al. (2013), The Atlas of Economic Complexity: Mapping Paths to Prosperity, 2nd ed., Cambridge: MIT Press

3 Other than regional countries, EU member states and advanced economies.

4 Depending on the availability of published data granularity, IOFCs for Malaysia and Singapore include the Cayman Islands, the Isle of Man, Mauritius, the British Virgin Islands and Bermuda; Thailand includes the Cayman Islands, the Isle of Man, Mauritius and the British Virgin Islands; Hong Kong SAR includes the Cayman Islands, the British Virgin Islands and Bermuda. Data is sourced from national authorities.

Macroeconomic and distributional effects of globalisation

Malaysia's natural resources were once a key determinant of its trade performance. However, the country has sought to expand export capacity through greater emphasis on manufactured exports and export-oriented investment. This has been achieved through industrial policies such as the Industrial Master Plans, the Promotion of Investments Act (PIA 1986) and the liberalisation of trade barriers and regulations. Partnerships with foreign investors have also helped to diversify Malaysia's exports.

Consequently, over the years, the economy has steadily evolved, diversifying away from labour-intensive upstream activities towards higher value added and services-based manufacturing activities. As a result, the share of the services sector in the economy has increased, rising from 51.2% in 1990–2000 to 52.9% in 2010–16, while the manufacturing sector has remained as the second largest contributor to the economy (1990–2000: 27.6%; 2010–16: 23.2%). The manufacturing sector in particular, has seen a greater focus on export-oriented industries, such as E&E, and resource-based industries. Industries serving the export markets have developed better capacity and efficiency over the years, with greater linkages with other countries in the region. Industries that relied on low cost and low value added business models were gradually phased out, with some relocating to other countries.

In terms of income, capital owners and highly skilled workers stand to gain the most from globalisation. Capital owners are able to more effectively build and scale operations to take advantage of larger markets. Nonetheless, globalisation has accelerated the inflow of foreign direct investment (FDI), which has provided crucial job opportunities, greater market access and higher wages. On average, foreign MNCs pay 40% higher wages than local firms do.[5] However, a challenge remains in ensuring a steady supply of industry-ready graduates with relevant skills. At the same time, building local capacity to support foreign MNCs is imperative to manage substantial leakage arising from large imports of goods and services, such as machinery and equipment and intermediate inputs.

While greater trade activity has generally benefited the economy with the development of new manufacturing facilities, Malaysia is also now faced with the issue of efficient management of low-skilled foreign workers. Today, they account for 12.1% of Malaysia's documented workforce. This impedes the country's ability to move up the value chain as it discourages firms from automating and adopting technology that will boost productivity. Reliance on foreign workers in Malaysia, particularly in the more labour-intensive sectors of the economy, has led to large remittance outflows. Outward workers' remittances almost doubled from MYR 17 billion in 2008 to MYR 30 billion in 2016 (2.4% of GDP).

Malaysia's inflation dynamics have also been affected as a result of globalisation, through changes in both pricing power and wage-setting behaviour. Increasing global integration has resulted in stronger competition, thus limiting domestic firms' ability to change prices. In addition, greater labour mobility has expanded the pool of available labour for domestic employment, putting downward pressure on labour costs. Together, these factors have contributed to the lower headline inflation

[5] OECD (2008) "Do Multinationals Promote Better Pay and Working Conditions?" OECD Employment Outlook, Paris

experienced since 2000, compared with the levels seen during the 1990s, when inflation was much higher due to rapid economic expansion alongside high employment.

Past efforts towards advancing globalisation have helped economies such as Malaysia's to diversify their sources of growth. Yet tighter integration leads to greater synchronisation with global economic cycles. Inevitably, developments in the advanced economies have a bearing on Malaysia's economic performance. To mitigate external shocks and safeguard the domestic economy, it is vital that trade and financial integration be accompanied with more thoroughgoing industrial reforms, a more resilient banking system, stronger capital buffers, deeper financial markets and comprehensive prudential frameworks.

Key policy issues

The optimal degree of openness depends on a country's economic structure and stage of development. Malaysia has been a consistent proponent of international trade and has benefited through a gradual and phased liberalisation. Recognising the growth potential in the services sector, the government liberalised 46 services subsectors between 2009 and 2012, including telecommunications, healthcare, education and tourism services. Malaysia has also taken steps to raise the capacity and competitiveness of domestic firms via initiatives such as the Services Sector Blueprint and the Logistics and Trade Facilitation Master Plan.

Thus far, Malaysia has signed and implemented six bilateral free trade agreements (FTAs) and six regional FTAs. For instance, under the ASEAN Free Trade Area (AFTA), starting in January 2010, Malaysia with five other ASEAN Member States (Brunei, Indonesia, the Philippines, Singapore and Thailand) became a free trade area for trade in goods. Of significance, the AFTA is conducted in a gradual and phased manner to allow each country to adapt to the trade liberalisation effort. In addition, several categories have also been created (eg the Temporary Exclusion List, Sensitive List and General Exception List) to safeguard the interests of individual countries. The effect of AFTA is reflected in the share of exports to ASEAN in Malaysia's total exports, which rose from 25.4% in 2010 to 29.4% in 2016.

Increased financial integration amid uncertainties surrounding growth and policy normalisation has also resulted in volatile capital flows. For Malaysia, the orderly intermediation of capital flows is supported by measures to develop domestic capital markets, build resilience in the banking system and enhance external buffers. At the same time, prudential requirements have been set to safeguard the domestic economy from systemic risks arising from excessive foreign exchange liabilities. The negative impact from potential outflows is mitigated by the more balanced profile of foreign holders of government bonds and the stabilising support of domestic institutional investors. As at 3Q 2017, most foreign holders of government bonds were long-term strategic investors, such as asset managers, central banks and governments, as well as pension funds, which account for approximately 82.6% of total foreign investors and result in a more stable foreign participation in the ringgit asset markets. In times of outflows, the smoothing effect of mature domestic institutional players continues to enable an orderly intermediation of funds in the capital markets. Malaysia's two main pension funds (EPF and KWAP) had a total of

MYR 855 billion of assets under management in 2016, equivalent to 136% of total non-resident holdings in the domestic debt and equity markets.

As an open emerging market economy, in terms of the real and financial sectors, Malaysia is exposed to the vagaries of global economic and financial conditions. As such, an accommodative monetary policy and flexible exchange rate are an important first line of defence, given the limited fiscal policy space. Increased integration with the world has led to challenges in the conduct of monetary policy. For example, financial openness in an environment of rapid movements in global financial flows implies that monetary policy autonomy can only be maintained with the support of a floating exchange rate regime and a high level of reserves. In this way, there is policy scope for both independent monetary policy and managing capital flows, with the impact of capital flows spread between the exchange rate and the foreign exchange reserves. Additionally, monetary policy should only respond to movements and shocks if these events are deemed to materially shift the balance of risks to the outlook for domestic growth and inflation.

The calls for trade protectionism in the advanced economies today threaten to unravel the gains from globalisation. As an open economy, the upsurge in protectionism and insular policies pose a risk to Malaysia. While Malaysia's diversified export market[6] and product mix provide a buffer against these global uncertainties, it is also important for policymakers to remain committed to the integration agenda.

International policy cooperation plays a key role in accelerating greater economic growth, prosperity and wealth. EMEs, particularly in the ASEAN region, have the bargaining power to shape the global trading and financial architecture given the favourable position and demographics of ASEAN countries. ASEAN is home to more than 600 million people and, if considered as a single entity, would represent the sixth largest economy in the world with a combined GDP of USD 2.5 trillion (in 2015). ASEAN is also a major player in the global trading system, with total trade standing at USD 2.3 trillion (in 2015), accounting for the fourth-largest share of total global trade. According to the OECD (2015), the region will sustain an average annual growth of an estimated 5.6% over the next four years and is expected to be the fourth largest trading bloc by 2050. Moreover, in shaping regional financial arrangements, the ASEAN nations together with Japan, Korea and China have achieved significant milestones. These include the enhancement of the regional financial safety net through the Chiang Mai Initiative Multilaterisation (CMIM) as a source of short-term liquidity support to maintain financial stability in the region.

Regional integration complements global integration in increasing global trade and investment by allowing countries to engage in negotiations as blocs rather than as individual countries. For example, the ASEAN Banking Integration Framework (ABIF) complements existing global financial integration frameworks. ASEAN is also involved in integrating itself in the global value chain through free trade agreements such as the Regional Comprehensive and Economic Partnership (RCEP).

Domestic policies can also promote a more globalised economy while protecting the interests of the nation and its people. Malaysia has put in place several measures in this regard, particularly to develop a more flexible labour market to avoid pockets of unemployment and facilitate a more productive use of resources. For example, the

6 Malaysia's export market is now more diversified, with rising exposure to the regional economies in the past decade (exports to regional economies in 2006: 44.4%; 2016: 52.3%). Malaysia's exposure to the United States in terms of export share fell to 10.2% in 2016, from 18.8% in 2006.

government established the 1Malaysia Outplacement Centre (1MOC) in 2016 to help retrenched workers find new jobs. Thus far, the centre has successfully placed 2,400 workers. The recent introduction of the Employment Insurance Scheme (EIS), which offers temporary financial assistance to retrenched workers, also provides for a more comprehensive safety net for employees.

Moving forward

Future technological advances will lead to a more globalised and interconnected world. This will create both opportunities and challenges. As such, it is important for nations to embark on structural reforms to future-proof their economies and people, particularly during the upward phase of the economic cycle. For Malaysia, efforts are ongoing to shift into higher value added industries, as well as to improve soft and hard infrastructure. There is also an urgent need to improve the quality and flexibility of the labour market. This can be done through increasing the platforms for workers to re-skill and upskill, promoting more tech-based courses in universities and inculcating life-long learning practices. It must also be acknowledged that not all segments of society will benefit. Thus, mitigating steps must be put in place to make globalisation safer, to avoid a backlash and unrest.