Developments in the Malaysian Economy

HIGHLIGHTS

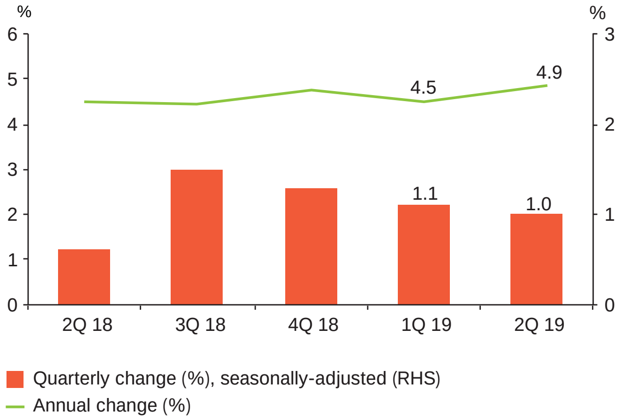
- The Malaysian economy expanded by 4.9% in the second quarter of 2019.
- Headline inflation increased mainly reflecting the lapse in the impact of the Goods and Services Tax (GST) zerorisation, while core inflation remained stable.
- Current account surplus was sizeable at RM14.3 billion.

The Malaysian economy grew at a stronger pace of 4.9% in the second quarter of 2019

GDP registered a higher growth of 4.9% in the second quarter of 2019 (1Q 2019: 4.5%), supported by continued expansion in domestic demand. On a quarter-on-quarter seasonally-adjusted basis, the economy grew by 1.0% (1Q 2019: 1.1%).

Higher growth in 2Q 2019

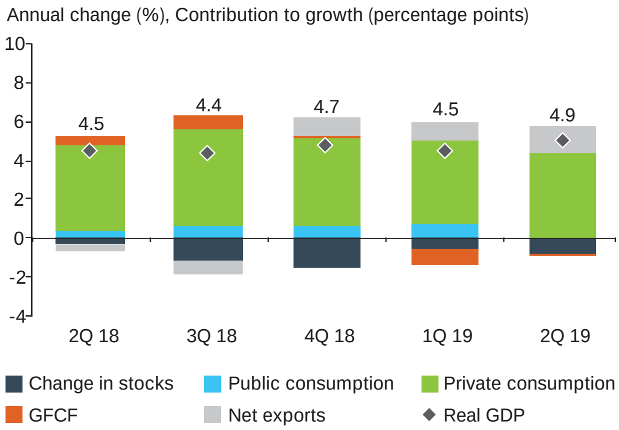
Chart 4: Real GDP Growth



Source: Department of Statistics, Malaysia

Private sector activity remained the key driver of growth

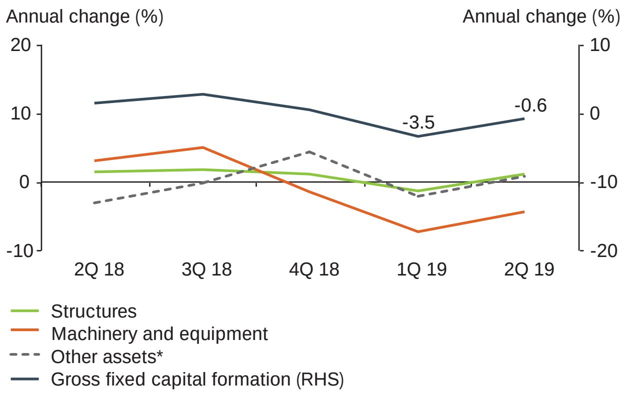
Chart 5: Contribution of Expenditure Components to Real GDP Growth



Source: Department of Statistics, Malaysia

Gross fixed capital formation registered a smaller contraction

Chart 6: GFCF Growth by Type of Assets



*Other assets include mineral exploration, research & development and capitalised planting.

Source: Department of Statistics, Malaysia

Private sector activity remained the key driver of growth

Domestic demand expanded by 4.6% in the second quarter (1Q 2019: 4.4%), supported by firm household spending and slightly higher private investment.

Private consumption expanded by 7.8% (1Q 2019: 7.6%), supported by continued income growth and festive spending during the quarter. Selected Government measures, such as the special Aidilfitri assistance and Bantuan Sara Hidup, also provided some lift to overall household spending.

After a strong growth in the first quarter of 2019 (6.3%), public consumption expanded marginally by 0.3%, due to lower spending on supplies and services.

Growth in gross fixed capital formation (GFCF) registered a smaller contraction of 0.6% (1Q 2019: -3.5%), driven by a slightly higher private investment growth amid a continued decline in public investment. By type of assets, investments in structures turned around to register a positive growth of 1.2% (1Q 2019: -1.3%), reflecting some improvement in the residential property segment. Capital expenditure on machinery and equipment recorded a smaller decline of 4.2% (1Q 2019: -7.4%), following higher spending on information and communications technology (ICT).

Private investment expanded at a faster pace of 1.8% (1Q 2019: 0.4%), supported by increased capital spending in the services and manufacturing sectors. Nonetheless, uncertainty surrounding global trade tensions and prevailing weaknesses in the broad property segment continued to weigh on the investment growth performance.

Public investment registered a smaller contraction of 9.0% (1Q 2019: -13.2%), mainly reflecting higher fixed asset spending by the Federal Government which partially offset the continued weak investment by public corporations.

Expansion across all economic sectors

The services sector expanded by 6.1% in the second quarter of 2019 (1Q 2019: 6.4%). Growth in the wholesale and retail trade subsector was relatively sustained across the wholesale, retail and motor vehicle segments amid firm household spending. The finance and insurance subsector was supported by the fee-based income segment following a major initial public offering in the capital market. Growth in the transport and storage subsector was driven by higher air passenger traffic and port activity in both transhipment and gateway segments. However, growth in the information and communication subsector moderated following slower demand for data communication services.

Growth in the manufacturing sector registered a marginal improvement at 4.3% (1Q 2019: 4.2%) amid better performance in the domestic-oriented industries. Higher production of motor vehicles mainly reflected strong sales during the festive season. Demand for metal-related materials for existing transport and infrastructure projects supported the higher production within the construction-related cluster. Meanwhile, within the export-oriented industries, the production of electronic components continued to be weighed by weaker global demand, with negative spillovers across the global semiconductor value chain.

Growth in the mining sector rebounded to 2.9% (1Q 2019: -2.1%), the first positive growth since the third quarter of 2017. The turnaround was supported mainly by the recovery in natural gas output following the pipeline disruptions in 2018. This had more than offset the continued drag to growth posed by lower oil production amid the planned facility shutdowns in East Malaysia.

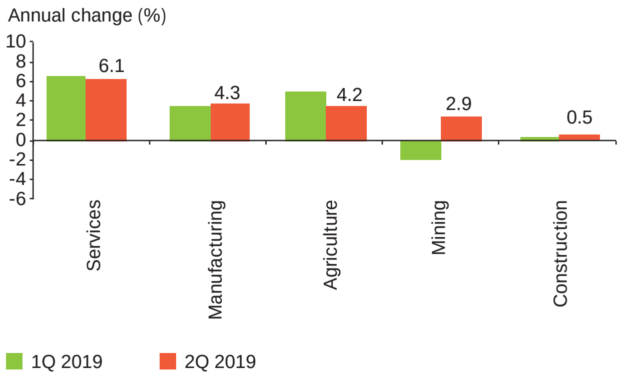
The construction sector registered marginally higher growth at 0.5% (1Q 2019: 0.3%), on account of growth improvements in the residential and special trade subsectors. While the residential subsector registered a smaller contraction, activity remained weak amid the high unsold properties. The higher growth in the special trade subsector was due to end-works activity amid completion of some mixed development projects. The near-completion of a large petrochemical project continued to affect growth in the civil engineering subsector, while the non-residential subsector remained weak amid the oversupply of commercial properties.

In the agriculture sector, growth moderated to 4.2% (1Q 2019: 5.6%) following the decline in fishing and forestry activities as well as the moderation in natural rubber output growth due to the wintering season[2]. This had partially offset the continued recovery in oil palm yields from the adverse weather in 2018.

[2] The wintering season typically occurs between February and May during which the rubber trees shed their leaves and new leaves are formed, affecting both the metabolism of the trees and latex production.

Growth supported by the recovery from commodity supply disruptions and improvements in the manufacturing and construction sectors

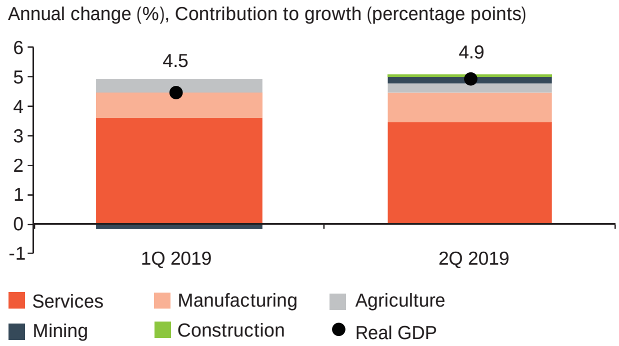
Chart 7: Growth by Sector



Source: Department of Statistics, Malaysia

Services and manufacturing sectors remained the key drivers of growth

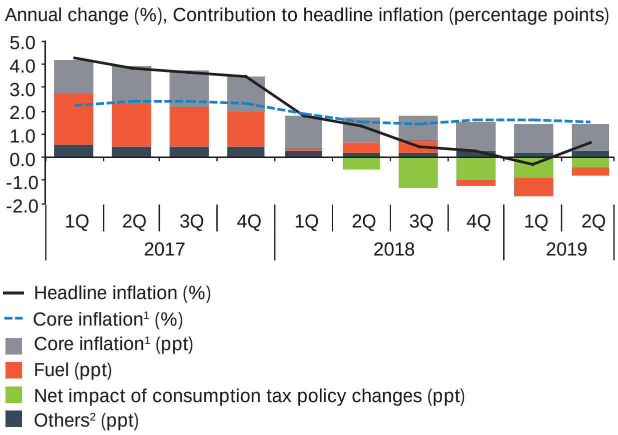
Chart 8: Contributions to Real GDP by Economic Sector



Source: Department of Statistics, Malaysia

The increase in headline inflation reflected the lapse in the impact of the GST zerorisation

Chart 9: Contribution to Headline Inflation by Components



[1] Core inflation is computed by excluding price-volatile and price-administered items. It also excludes the estimated direct impact of consumption tax policy changes

[2] Others include price-volatile items and other price-administered items

Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

Headline inflation increased mainly reflecting the lapse in the impact of the GST zerorisation

Headline inflation, as measured by the annual percentage change in the Consumer Price Index (CPI), averaged higher at 0.6% in 2Q 2019 (1Q 2019: -0.3%).

The increase mainly reflected the lapse in the impact of the GST zerorisation that was implemented in June 2018. This contributed to the rise in headline inflation in June 2019 to 1.5% (May 2019: 0.2%; April 2019: 0.2%).

Fuel inflation recorded a smaller negative largely due to domestic fuel prices averaging higher during the quarter in addition to the base effect (Average RON95 petrol price per litre in 2Q 2019: RM2.08; 1Q 2019: RM2.02).

Core inflation, excluding the impact of consumption tax policy changes, was unchanged at 1.6%. Demand-driven inflationary pressures remained broadly stable and contained, amid the absence of excessive wage pressure and some degree of spare capacity in the capital stock.

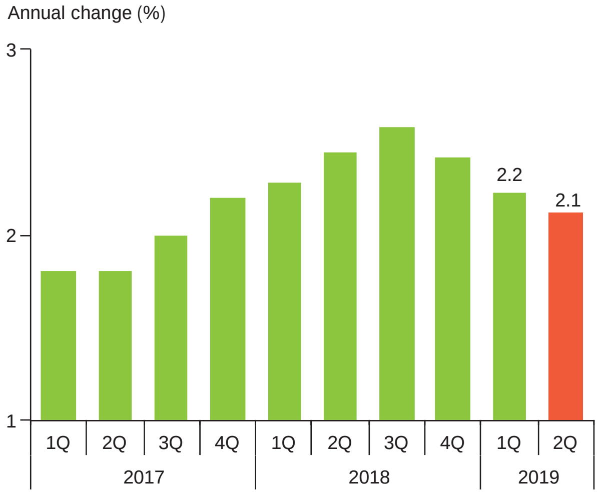
Stable labour market conditions

During the second quarter, labour market conditions were stable. Employment growth was sustained at 2.1% (1Q 2019: 2.2%) while the unemployment rate remained unchanged at 3.3% (1Q 2019: 3.3%) as employment gains kept pace with labour force expansion during the quarter.

Private sector wages grew by 4.2% (1Q 2019: 4.9%), driven by the services sector (4.4%; 1Q 2019: 3.8%) as the wholesale and retail trade subsector saw a pick-up in wage growth (4.1%; 1Q 2019: 3.3%). However, growth in manufacturing wages were lower (3.9%, 1Q 2019: 7.0%), especially in the export-oriented industries, such as the E&E (5.1%; 1Q 2019: 9.7%) and petrochemical clusters (3.1%; 1Q 2019: 6.7%).

Sustained employment growth

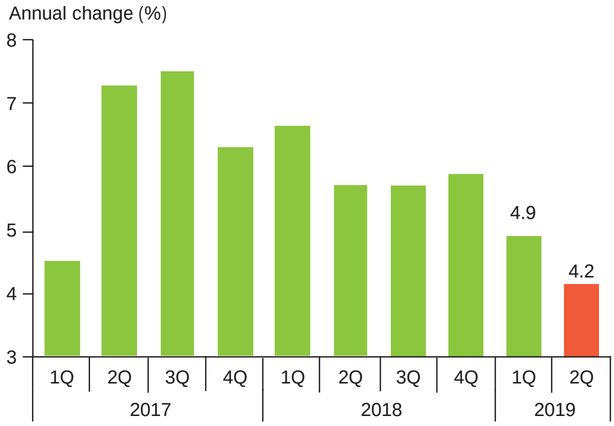
Chart 10: Employment Growth



Source: Department of Statistics, Malaysia

Private sector wages continued to expand, albeit more modestly

Chart 11: Private Sector Wages*



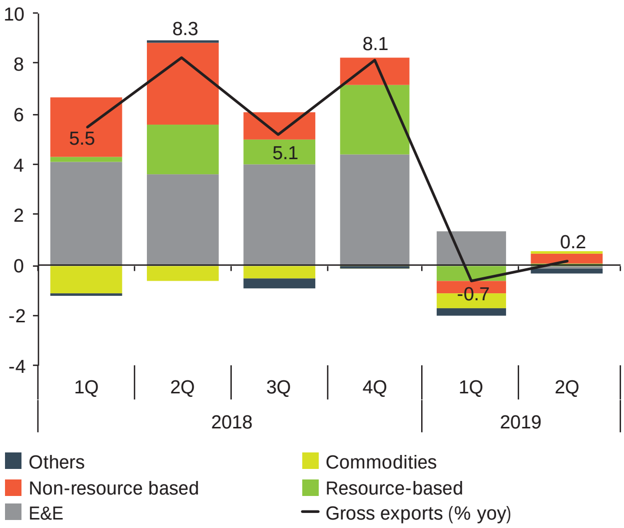
* Private sector wages are derived from the salaries and wages data published in the Monthly Manufacturing Statistics and Quarterly Services Statistics by the Department of Statistics, Malaysia. They cover 62.9% of total employment.

Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

Non-E&E and commodities exports contributed to the recovery in exports

Chart 12: Gross Exports by Products

Annual change (%), Contribution to growth (percentage points)

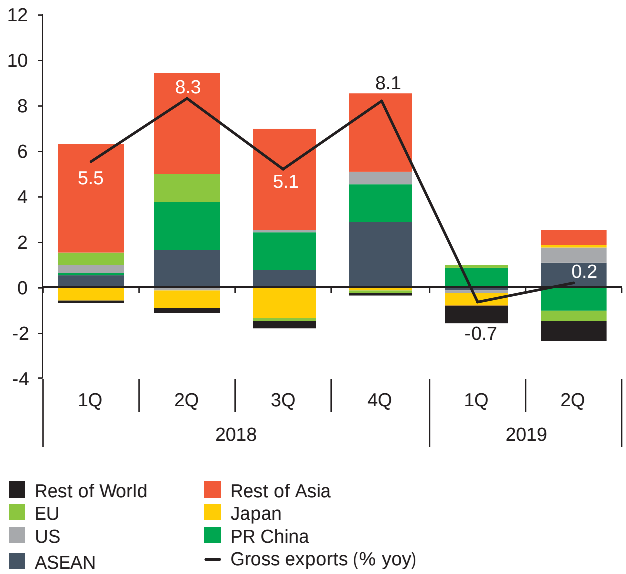


Source: Department of Statistics, Malaysia

Diversified export markets supported export growth

Chart 13: Gross Exports by Markets

Annual change (%), Contribution to growth (percentage points)



Source: Department of Statistics, Malaysia

Slight recovery in exports and smaller decline in imports

In the second quarter of 2019, gross exports turned around to register a positive growth of 0.2% (1Q 2019: -0.7%). This was supported by the rebound in commodities exports amid sustained manufactured exports. The trade surplus[3] remained sizeable, albeit narrower at RM30.1 billion (1Q 2019: RM37.0 billion).

Manufactured export growth was sustained at 0.3% (1Q 2019: 0.3%) as higher non-E&E exports helped offset the contraction in E&E exports. The improvement in non-E&E exports (0.9%; 1Q 2019: -2.5%) was attributed to higher demand for both resource-based and non-resource based exports including iron & steel and chemicals & chemicals products. In contrast, E&E exports declined by 0.4% (1Q 2019: 3.7%) on account of lower demand from PR China due in part to the ongoing trade tensions. Commodities exports rebounded to 0.8% (1Q 2019: -3.7%), supported by LNG and palm oil exports.

Imports recorded a smaller decline of -1.2% (1Q 2019: -2.5%) on account of higher intermediate and consumption imports. Intermediate imports (7.5%; 1Q 2019: 0.0%) were driven by higher crude petroleum imports to cater for refinery activities. Capital imports recorded a smaller contraction due to a lower drag from machinery and equipment investments.

[3] The difference between the goods surplus and trade surplus arises from the exclusion of goods for processing, storage and distribution in the goods accounts as per the 6th Edition of the Balance of Payments and International Investment Position Manual (BPM6) by the IMF.

Current account surplus remained sizeable

The current account surplus of the balance of payment remained sizeable at RM14.3 billion or 3.9% of GNI in the second quarter of 2019 (1Q 2019: RM16.4 billion or 4.7% of GNI). This was due to higher investment income earned by Malaysian firms abroad which partly offset the lower goods surplus.

As the improvement in import growth outpaced export growth, the goods surplus narrowed to RM28.1 billion (1Q 2019: RM33.8 billion).

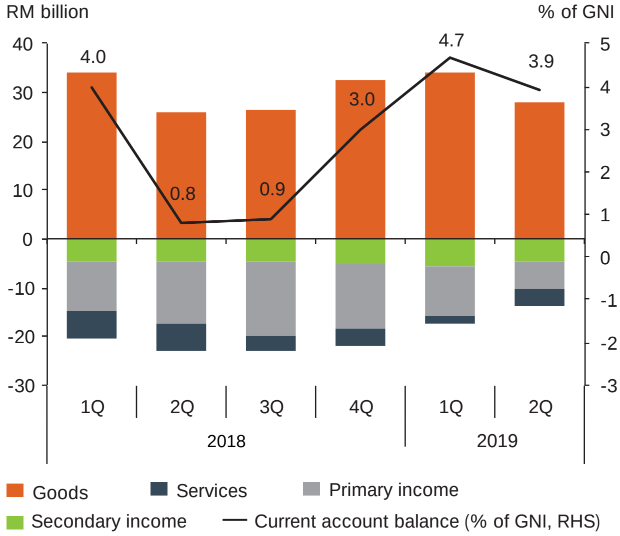
The primary income account registered a smaller deficit of RM5.5 billion (1Q 2019:-RM10.1 billion) due to the increase in investment income earned by Malaysian firms abroad, particularly from direct and portfolio investments. These investments were mainly in the finance and insurance, mining, information and technology sectors. This development more than offset the increase in investment income accrued to foreign direct investors and foreign portfolio investors in publicly-listed firms.

In the services account, the deficit widened to RM3.4 billion (1Q 2019: -RM1.8 billion). This was attributable to higher net payments to foreign providers for transport and insurance services, in line with higher trade activity during the quarter. The travel account surplus narrowed to RM7.1 billion (1Q 2019: RM7.9 billion) on account of lower tourist per capita spending.

The secondary income account deficit amounted to RM4.9 billion (1Q 2019: -RM5.5 billion), reflecting mainly outward remittances by foreign workers.

Sizeable current account surplus

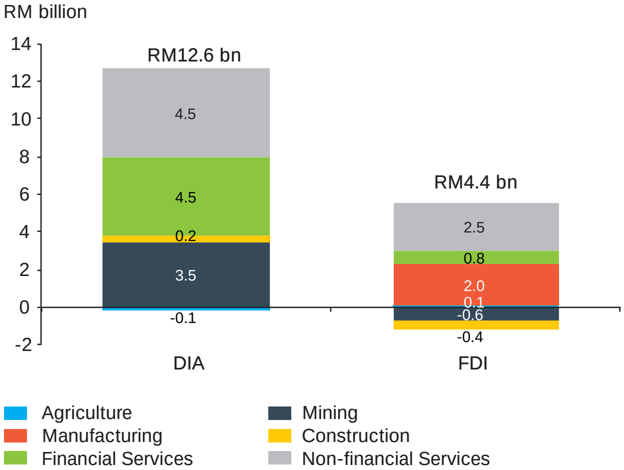
Chart 14: Current Account Balance



Source: Department of Statistics, Malaysia

Higher DIA and more moderate FDI

Chart 15: Net Direct Investment Flows by Sector

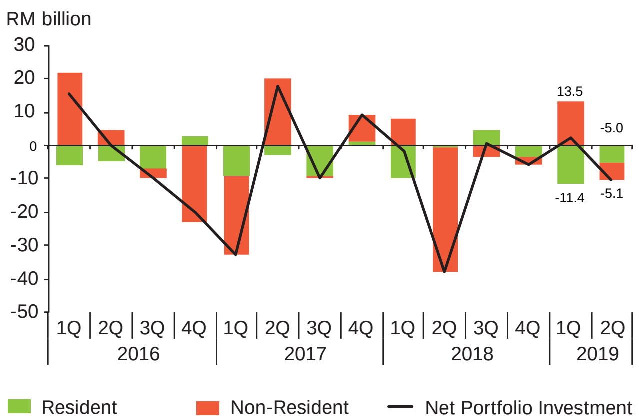


Note: For DIA, positive values refer to net outflows while negative values refer to net inflows

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Net outflows of both resident and non-resident portfolio investments

Chart 16: Portfolio Investments



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Financial account registered a net outflow

The financial account registered a net outflow of RM18.6 billion (1Q 2019: -RM13.8 billion), following outflows in the direct investment and portfolio investment accounts. These outflows have more than offset the marginal net inflow in the other investment account during the quarter.

The direct investment account registered a net outflow of RM8.2 billion (1Q 2019: net inflow of RM16.3 billion). Foreign direct investments (FDI) registered a smaller net inflow of RM4.4 billion (1Q 2019: net inflow of RM21.7 billion). Inflows were channelled mainly into the services and manufacturing sectors. Direct investments abroad (DIA) by Malaysian companies registered a larger net outflow of RM12.6 billion (1Q 2019: net outflow of RM5.5 billion). DIA was channelled mainly into the services sector, particularly the financial services subsector and the accommodation and food services subsector, followed by the mining sector.

The portfolio investment account registered a net outflow of RM10.2 billion (1Q 2019: net inflow of RM2.1 billion), following a reversal of non-resident portfolio investments. Non-resident portfolio investments recorded a net outflow of RM5.1 billion during the quarter (1Q 2019: +RM13.5 billion). Following increased risk aversion and more cautious sentiments, non-resident investors pared down holdings in both the domestic equity and debt markets. At the same time, residents' portfolio investments abroad also recorded a smaller net outflow of RM5.0 billion (1Q 2019: -RM11.4 billion).

The other investment account recorded a marginal net inflow of RM0.3 billion (1Q 2019: -RM31.9 billion). This reflected inter-bank borrowings by the domestic banking system, which were almost entirely offset by interbank placements abroad and a net repayment of loans and trade credits by the private sector. Net errors and omissions amounted to RM2.9 billion, or 0.6% of total trade.

Manageable external debt

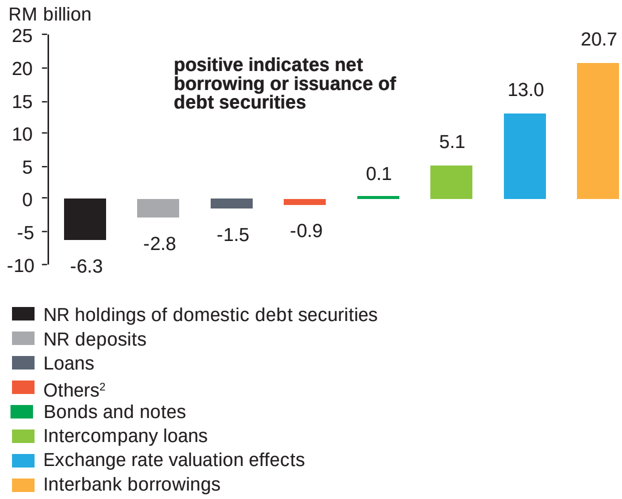
Malaysia's external debt amounted to RM931.1 billion, or 61.3% of GDP as at end-June 2019 (end-March 2019: RM903.7 billion or 59.5% of GDP). The increase reflects mainly the net drawdown of interbank borrowings and intercompany loans. There was also revaluation adjustment from the weaker ringgit against regional and major currencies during the period. These were partially offset by some liquidation of domestic debt securities and withdrawal of deposits by non-residents.

The country's external debt remains manageable, given its currency and maturity profiles, and the presence of large external assets. Close to one-third of external debt is denominated in ringgit (31.7%; end-March 2019: 32.7%), mainly in the form of non-resident holdings of domestic debt securities (61.7% share of ringgit-denominated external debt) and in ringgit deposits (18.0% share) in domestic banking institutions. As such, these liabilities are not subject to valuation changes from the fluctuations in the ringgit exchange rate.

The remaining external debt of RM636.1 billion or 68.3% of total external debt is denominated in foreign currency (FC). As at end-June 2019, offshore borrowings increased to RM580.5 billion or 38.2% of GDP (end-March: RM546.9 billion or 36.0% of GDP). The corporate sector accounted for slightly more than half of FC-denominated external debt and are largely subject to prudential and hedging requirements.

Higher external debt in 2Q 2019

Chart 17: Changes in External Debt
Net change[1]: +RM27.4 billion

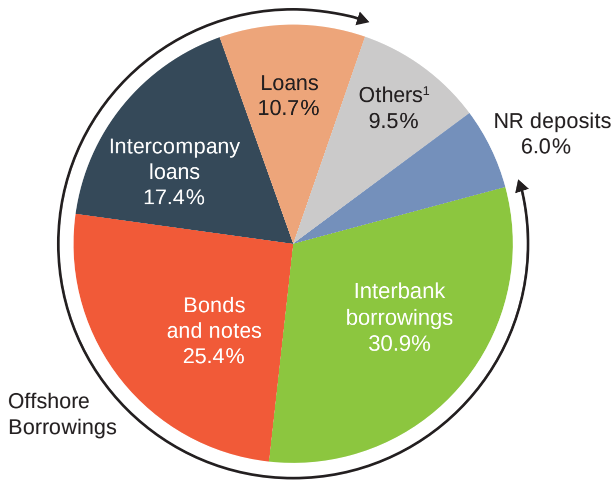


[1] Changes in individual debt instruments exclude exchange rate valuation effects
[2] Comprises trade credits, IMF allocation of SDRs and other debt liabilities
Note: NR refers to non-residents
Figures may not add up due to rounding

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

FC-denominated debt subjected to prudent liquidity management practices and hedging requirements

Chart 18: Breakdown of Foreign Currency-Denominated External Debt (% share)



[1]Includes trade credits and miscellaneous, such as insurance claims yet to be disbursed and interest payables on bonds and notes

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

By instrument, 36.9% (or RM234.9 billion) of FC-denominated external debt are accounted by interbank borrowings and FC deposits in the domestic banking system. 78.3% of the interbank borrowings are in the form of largely stable intragroup borrowings from related offices abroad, including parent banks, regional offices and subsidiaries. This reflects banks' centralised liquidity and funding management practices.

During the quarter, banks' FC-denominated short-term external debt increased by RM20.6 billion driven by higher interbank borrowings. This was largely attributable to parent bank placements with foreign banks' in Malaysia (including banks in Labuan International Banking and Financial Centre (LIBFC)) to facilitate lending and investment activities. Funds received by foreign LIBFC banks were largely invested abroad with non-resident clients, a reflection of LIBFC banks' 'out-out' business activities. For locally-incorporated foreign banks, intragroup funds continue to be primarily used for short-term investments and lending in the domestic interbank market. Domestic banking groups accounted for the remaining increase in interbank borrowings reflecting their central role in managing liquidity and funding needs on a group-wide basis. In line with these developments, banks' total external assets also increased during the quarter by RM22.8 billion.

Overall, banks' funding and liquidity risks continue to be proactively managed via robust internal controls and policies, including internal limits on (i) interbank borrowings; (ii) foreign currency funding and liquidity positions; and (iii) foreign exchange market risk exposures. Foreign-currency risk, measured in terms of the net open position of FC-denominated exposures[4] remained low at 4.9% of banks' total capital.

Long-term bonds and notes issued offshore stood at RM161.7 billion as at end-June 2019, accounting for 25.4% of total FC-denominated external debt. These were mainly by non-financial corporations and channelled primarily to finance asset acquisitions abroad. Intercompany loans, which amount to RM110.5 billion and account for 17.4% of FC-denominated external debt, are typically on flexible and concessionary terms. About 80% of these intercompany loans were obtained by multinational corporations (MNCs) from parent or affiliate companies abroad.

From a maturity perspective, 58.3% of the total external debt is skewed towards medium- to long-term tenure (end-March: 59.2%), suggesting limited rollover risks. Short-term external debt accounted for the remaining 41.7% of external debt. While rollover risks may be inherent, this is well contained. Close to half of the short-term external debt are intragroup borrowings among banks and corporations which are generally stable, while another 11% are accounted by trade credits, largely backed by export earnings. As at 31 July 2019, international reserves stood at USD103.9 billion, sufficient to finance 7.6 months of retained imports, and is 1.1 time the short-term external debt.

Of significance, reserves are not the only means for banks and corporations to meet their external obligations. The progressive liberalisation of foreign exchange administration rules has resulted in significant increase in non-reserves external assets. In particular, banks and corporations held roughly three-quarters of Malaysia's RM1.8 trillion external assets, which can be drawn down to meet their RM728.3 billion external debt obligations. While the flexible exchange rate remains the first line of defence, adequate international reserves and availability of substantial foreign currency external assets by banks and corporations continue to serve as important buffers against potential external shocks.

[4] Refers to the aggregated sum of the net short or long foreign currency positions for all currencies across banks.

1
Box Article

Unresolved Trade Disputes One Year On

Authors: Muhamad Aizuddin, Daryl Yong, Ooi Kiesha, Catharine Kho, Chang Wen Huei

HIGHLIGHTS

- Trade tensions in the past year have broadened in terms of products and countries.
- In addition to impacting global trade and growth, trade tensions have also spurred the reconfiguration of global value chains.
- Latest assessment finds the impact of trade tensions to reduce Malaysia's 2019 export growth by -0.5 to -0.8 ppt.

Over a year since it started, the trade disputes between the US and PR China, as well as with some other economies, remain unresolved and continue to cast its shadow over the global economy. What began as the imposition of tariffs on selected imports, namely steel, aluminium and solar products, have widened to encompass a broader range of goods, with increasingly large spillover effects on global trade and growth. As the disputes escalated, the adverse impact on growth morphed from just the transmission of higher trade costs, to amplification through the Global Value Chain (GVC), increased policy uncertainty for firms in the tradable sector and heightened volatility in financial markets.

This box article is the third in a series of articles[1] on the ongoing global trade dispute, reflecting on the past year of shifting trade tensions, with a focus on: (i) recent trade developments; (ii) emerging trends; and (iii) implications for Malaysia.

Recent developments reignited trade tensions

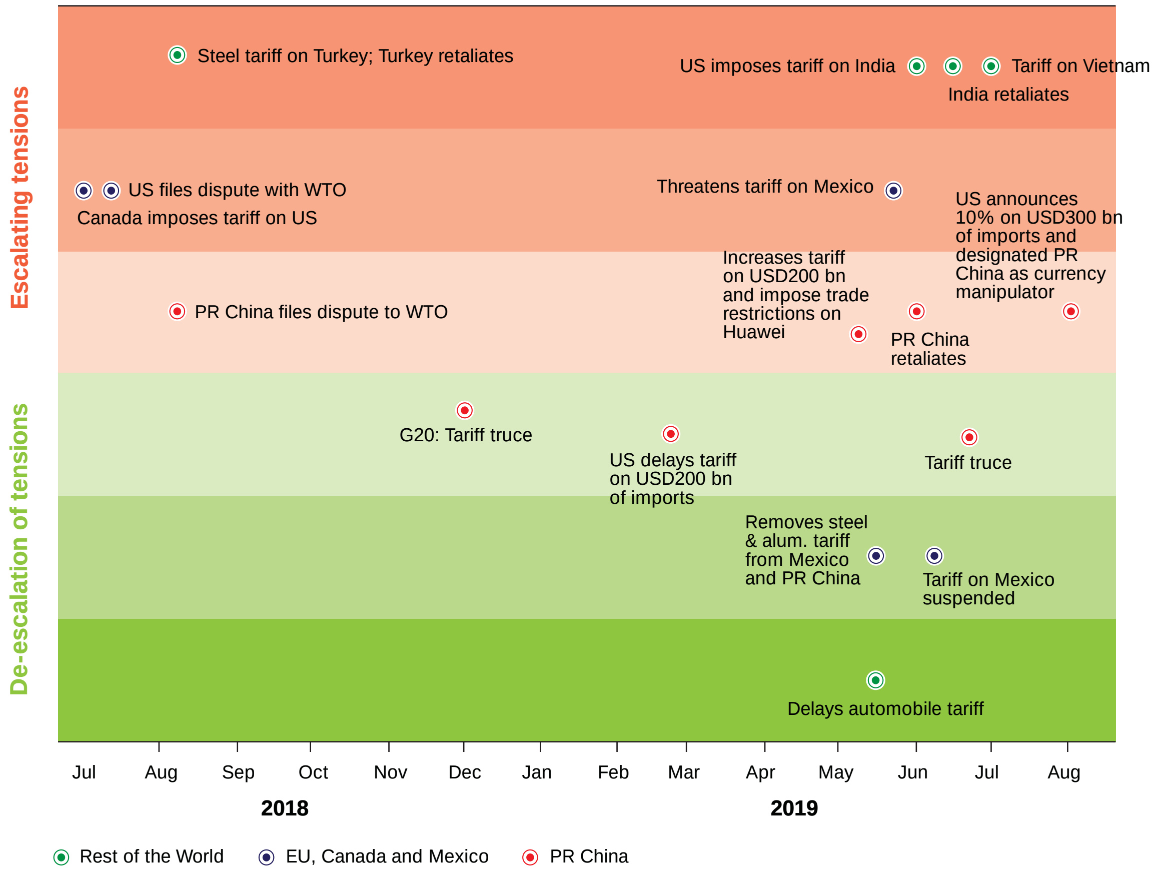
The second quarter of 2019 solidified fears of many since March 2018 that trade tensions were going to persist and propagate to other countries. After the US implemented tariffs of 10% on USD200 bn of imports from PR China in September 2018, tensions eased towards end-2018 as both countries agreed on a truce. This respite was short-lived when the US further raised tariffs from 10% to 25% on USD200 bn of Chinese imports in May 2019, and banned the Chinese telecommunications company, Huawei from purchasing from US companies without government approval. What followed thereafter was a series of developments that vacillated between an intensification and de-escalation of trade tensions, sometimes within the span of a few days. First, the US delayed its decision to implement blanket tariffs on automobile imports. Subsequently, the US threatened and suspended its threat to impose tariffs on Mexico within a week. Thereafter, the US removed India and Turkey as beneficiaries under the Generalised System of Preferences (GSP) programme. The US then agreed on a temporary truce with PR China in June 2019 which also eased restrictions on Huawei. However, this truce was not extended to other countries as the US imposed higher tariffs and circumvention rulings on steel imports from Vietnam in July 2019. Most recently, the US announced tariffs of 10% on all remaining imports from PR China worth USD300 bn to be implemented on 1 September 2019[2].

[1] 1Q 2018 Quarterly Bulletin box article on "Trade Disputes: Implications for Trade and Investments", and 3Q 2018 Quarterly Bulletin box article on "Escalating Trade Tensions and Potential Spillovers to Malaysia".

[2] Since the time of writing, a portion of this tariff on USD300 bn has been postponed to mid-December 2019.

With the lingering risk of potentially sudden US trade actions against other countries, and early signs of a trade conflict between Japan and Korea, the whipsawing developments in the past three months suggest trade policies are likely to remain uncertain (Chart 1).

Chart 1: Summary of Key Developments in the Past Year



Source: National authorities, Newsflows

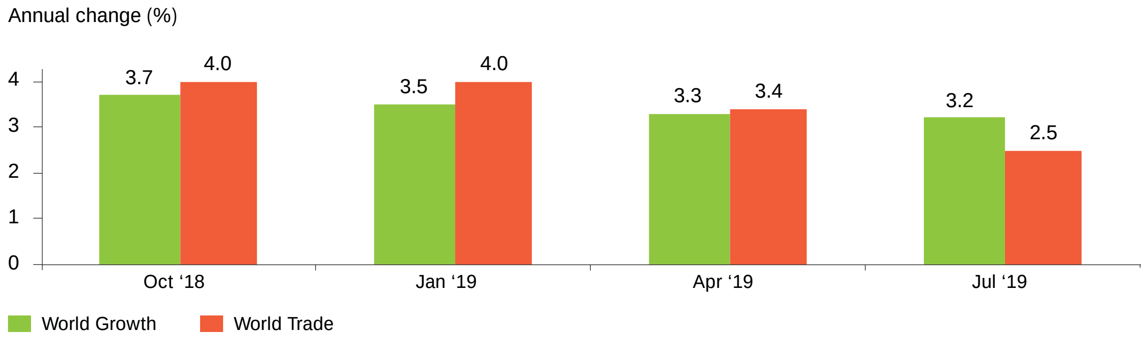
Trade tensions have contributed to a new global landscape

The developments in the past year have shown that the retreat from free trade has evolved from a transient to a potentially longer term threat. The failure of trade negotiations to ease tensions and yield lasting results has triggered a rethink among firms globally about their production strategies and consequently, potential reconfiguration of GVCs. We observe three emerging trends from the prolonged trade disputes:

Trend 1: Protracted trade disputes are weighing on growth and trade prospects

The global economy was already showing signs of moderation amid a cyclical slowdown in trade activity since early 2018 and the trade disputes have only served to exacerbate this downturn (Chart 2). The longer trade disputes remain unresolved, the poorer the outlook for businesses, as firms continue to face uncertainties that materially affect future investment decisions. This is evidenced in monthly Purchasing Managers' Index (PMI) surveys, where companies across the world have cited the ongoing trade disputes as a key concern in making investment decisions, particularly since the escalation of tensions in May 2019.

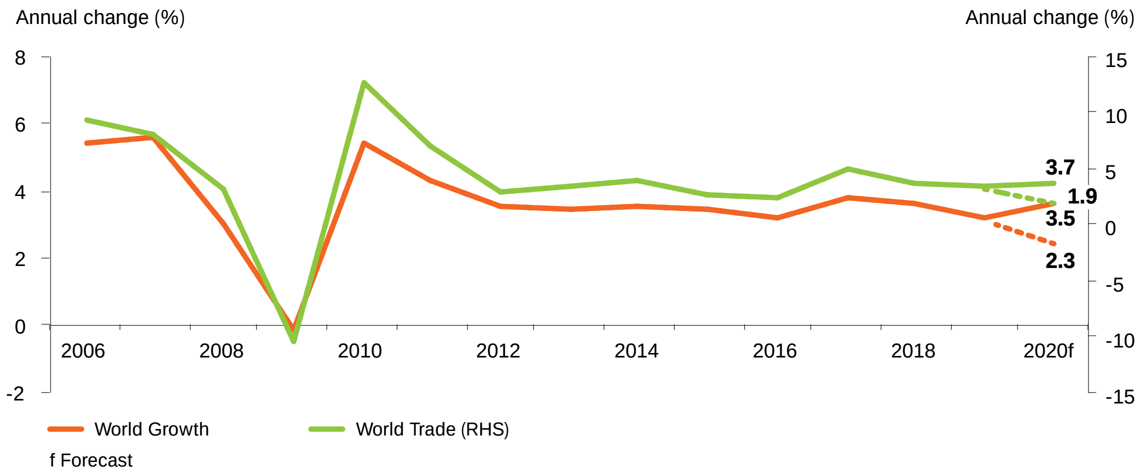
Chart 2: Evolution of IMF World GDP Growth and Trade Forecasts for 2019



Source: IMF World Economic Outlook

While global growth is expected to improve going forward, this is heavily premised on a resolution of existing trade disputes. In the worst-case scenario of an all-out trade dispute in which blanket tariffs are imposed on automobiles and electronics, global growth could potentially fall to its lowest level since the Global Financial Crisis (Chart 3).

Chart 3: Long-Term Global GDP and Trade Growth

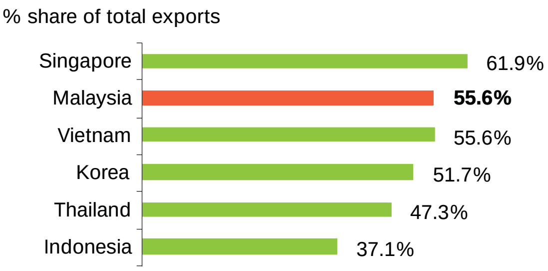


Source: IMF World Economic Outlook, authors' estimation

The inertia against global growth recovery is expected to be prolonged as trade tensions persist. This is more so as trade actions between the US and PR China expanded to encompass technology products and the protection of intellectual property (IP) rights, which would take time to resolve. The continued widening of trade disputes affecting more countries, a larger variety of products and a broader range of strategic sectors, will ultimately be detrimental to global growth and global trade prospects.

For Malaysia, the prolonged trade disputes and the resulting impact on lower global trade has mainly affected Malaysia's trade activity. Not only are Malaysia's exports to affected countries lower (direct channel), exports to countries within the GVC (indirect channel) have also been affected. The latter channel is not negligible, given Malaysia's position as one of the most integrated economies in the GVC, even among regional peers (Chart 4).

Chart 4: GVC Participation Index[3]



Note: Index measures the share of an economy's exports that contain imported inputs and/or are used as inputs for other countries' exports

Source: TiVA OECD, Department of Statistics, Malaysia, Bank Negara Malaysia, authors' estimation

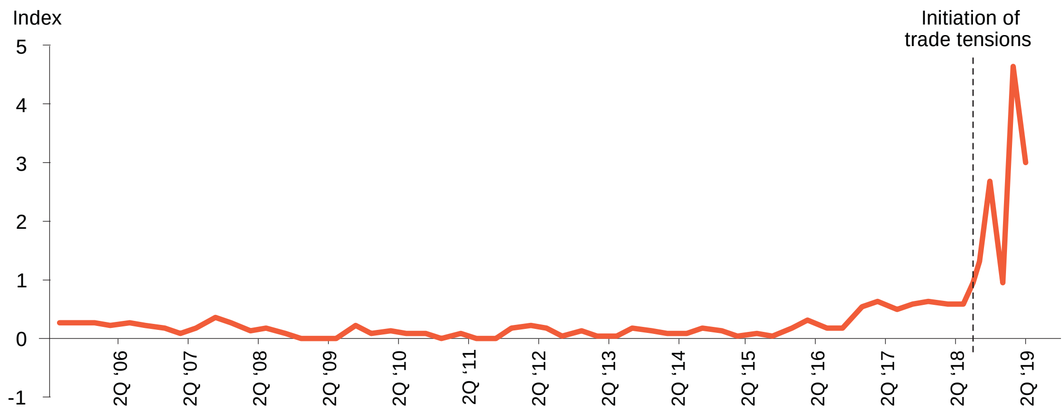
While the direct channel captures demand for Malaysia's exports that are consumed in the final destination country, the indirect channel refers to demand by countries within the GVC for Malaysia's exports which are used as intermediate inputs. Accounting for both direct and indirect channels, the ongoing trade disputes is projected to weigh on Malaysia's 2019 baseline gross export growth by -0.5 to -0.8 ppt, with the GVC channel contributing to about 20 per cent of the decline.

The impact of lower trade activity on growth is also compounded by increased business uncertainty. Should the downside risks[4] from the ongoing trade dispute materialise, this could potentially reduce Malaysia's export growth by up to an additional -0.2 ppt and GDP growth by approximately -0.1 ppt in 2019[5].

Trend 2: Volatile financial markets and high investor uncertainty

The rapidly changing trade developments have also induced significant uncertainties, manifesting in deteriorating sentiments and financial market volatility. The extent of the trade-related uncertainty is illustrated by the sentiment-based World Trade Uncertainty Index, which has increased to its highest level in more than two decades (Chart 5). Trade tensions have also heightened financial market volatility, amid the shifting directions of monetary policy among major economies and stretched equity valuations amid slowing economic growth (Chart 6).

Chart 5: World Trade Uncertainty Index



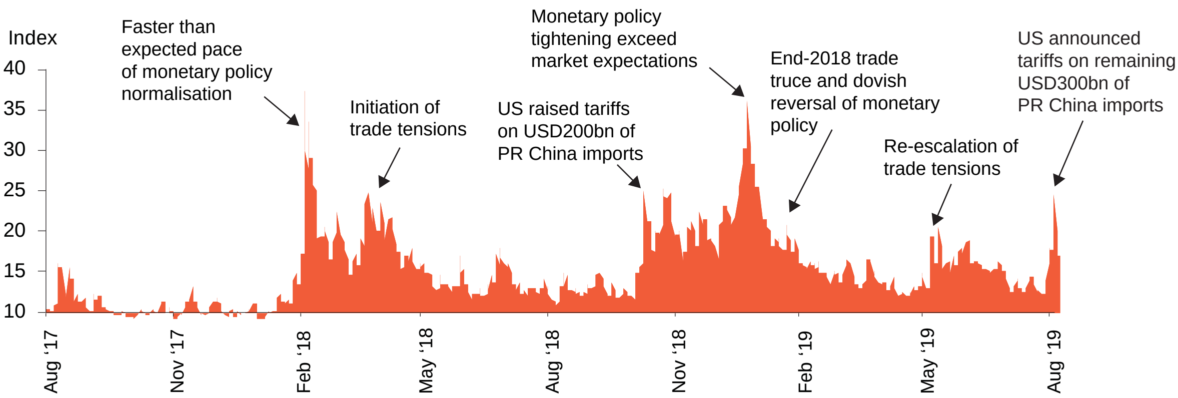
Source: Ahir, Bloom and Furceri, (2018) "The World Uncertainty Index"

[3] GVC participation is estimated as the sum of backward linkage (measures use of imported inputs to produce goods for exports) and forward linkage (measures exports of intermediate goods that are used as inputs for the production of another country's exports) relative to total exports of an economy. The higher the GVC participation index, the more integrated an economy is in the GVC.

[4] The downside risks for 2019 are higher tariffs on all remaining imports from PR China. For 2020, downside risks also include blanket tariffs on automobile and technology imports.

[5] This is an updated estimate since the 3Q 2018 Quarterly Bulletin box article. The lower downside risks in the current assessment for 2019 is due mainly to the shift in the expected implementation of blanket tariffs on automobiles and technology imports from 2019 to 2020. In addition, the impact of the materialisation of downside risks in 2019 is expected to be smaller as the end-year approaches. Nonetheless, the expected prolonged trade tensions could lead to larger downside risks to growth in 2020.

Chart 6: Chicago Board Options Exchange (CBOE) Volatility Index (VIX)



Source: Bloomberg

In early August 2019, following the announcement of 10% tariffs on the remaining imports from PR China, the Chinese renminbi depreciated to its lowest level in more than a decade against the US dollar. Soon after, the US Treasury Department designated PR China as a currency manipulator[6]. In the immediate term, this has generated greater volatility, and could affect the real economy going forward.

The increased financial market volatility following inconclusive trade negotiations and unpredictable global trade policies have dampened domestic business and investor sentiments. In the face of unpredictable coverage and timing of the trade disputes, firms, including in Malaysia, have generally taken a “wait-and-see” approach in capacity expansion. This in part contributed to the recent moderation in private investment.

Trend 3: Reconfiguration of trade and investment networks in the GVCs

The past intensification of GVCs by manufacturers was driven by a race to produce goods at the lowest possible cost. GVCs proliferated significantly with the ascension of PR China into the global market due mainly to its large workforce. Today, any reconfiguration of an established GVC involves the consideration of many factors including but not limited to geographical proximity to consumers and suppliers, financing conditions, profit margins after relocation, investment policies and political stability in the host country. As such, the US-PR China trade disputes will have both short- and long-term implications on trade and investment networks of economies which are integrated in the GVCs.

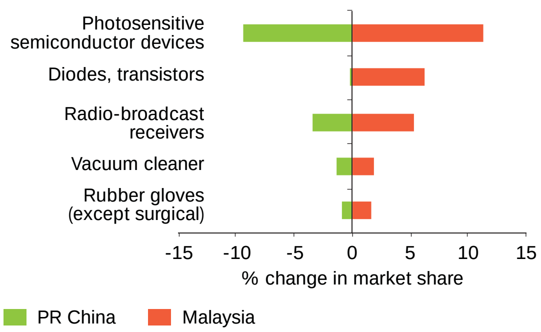
In the short-term, the trade disputes have led to trade diversion, in which firms source for inputs from countries unaffected by the higher tariffs. Since the implementation of tariffs on Chinese imports in the first quarter of 2018, several regional economies, including Vietnam, Chinese Taipei and Korea, have benefitted from trade diversion[7]. In the case of Malaysia, there are preliminary signs of trade diversion arising from higher imports from the US and PR China for certain products[8] (Chart 7 and Chart 8).

[6] The US Treasury Department has three criteria for identifying countries that possibly conduct unfair currency practices. These are (i) significant bilateral trade surplus with the US; (ii) material current account surplus, and (iii) persistent, one-sided intervention in currency markets.

[7] “Exploring US and China trade diversion”, Nomura Global Markets Research (2019).

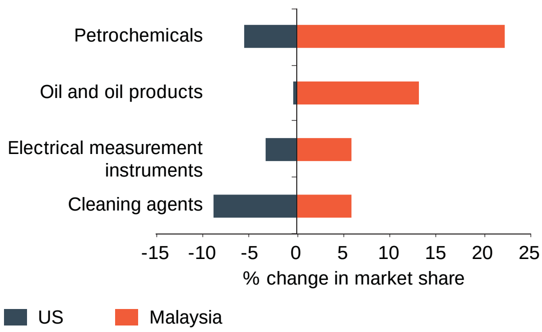
[8] Selected products are tariffed products in which Malaysia has a meaningful presence (Malaysia’s exports account for at least 5% of US’ import) and experienced an increase in share in the US at the expense of PR China between July 2018 and April 2019. The same method applies to PR China’s imports from Malaysia.

Chart 7: Change in share of US imports for selected products (%) (Malaysia and PR China)



Source: Global Trade Atlas

Chart 8: Change in share of PR China imports for selected products (%) (Malaysia and US)

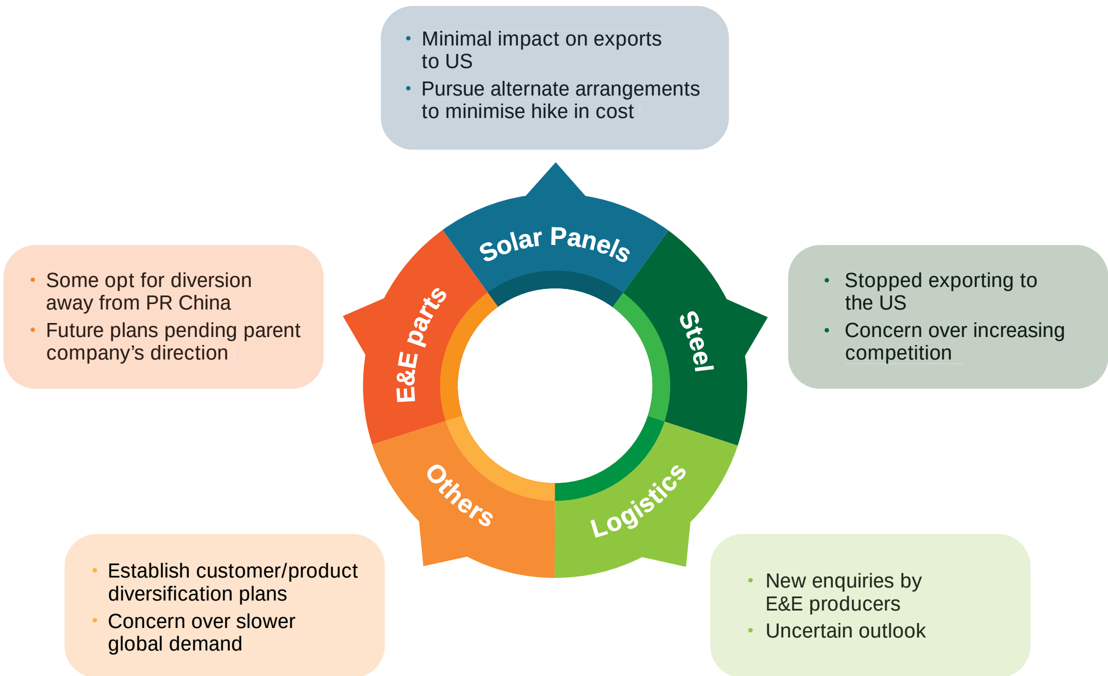


Source: Global Trade Atlas

In other cases, firms that have presence in PR China and across the region have leveraged on their network to set up dual supply chains, namely one to cater for PR China demand and one for other markets. The decoupling of the supply chain involves tasking Chinese factories to produce goods for the domestic market or destinations other than the US, while instructing other regional production plants to meet the orders from the US.

Apart from sourcing inputs from other countries, firms have also signaled more willingness to diversify their supply chain by investing in production facilities in other countries given the persistence of the ongoing trade tensions. However, such investment re-direction will most likely only be realised in the longer term. A recent survey by the American Chamber of Commerce China noted that 30.2% of its

Chart 9: Summary of Feedback from Industry Players



Source: BNM Regional Economic Surveillance member companies are now seeking to source their components from outside of PR China[9], while 18.3% are considering relocating some or all of their operations to other countries, predominantly to Southeast Asian countries. Among the more notable announcements, Apple has signaled for its suppliers to shift approximately 15% to 30% of its production capacity from PR China to Southeast Asian countries[10]. Similarly, Li & Fung, a major global supply chain player in the consumer product industry, has also announced that it will source less than half of its goods from PR China for the first time in 15 years[11].

Such developments point towards a reordering of global manufacturing supply chains as new trade flows of intermediate and final products among countries break existing linkages while creating new ones. It is likely that even if trade tensions subside, the current structure of GVCs are likely to be structurally altered as firms seek to diversify their exposure to any particular country to insure against trade policy shocks. This brings about new opportunities for economies to the extent that these countries are able to capitalise on them.

Opportunities arising from GVC reconfiguration

High tariff costs and the uncertainty over the future of US and PR China relations have compelled global manufacturers to reroute production facilities from PR China to new markets in Asia. While there are early signs of several global E&E manufacturers indicating intentions to relocate operations to Malaysia[12], this is unlikely to offset the adverse impact from unresolved trade conflicts in the immediate term given the long lead time required to reorient supply chains.

Conclusion

An eventful year of trade developments has passed. There were episodes of intense action followed by swift retaliation, punctuated by negotiations and tenuous ceasefires. Throughout this period, trade tensions have induced heightened volatility in financial markets and generated substantial uncertainties for firms planning to invest and policymakers striving to promote growth. A reflection of the recent past suggests that trade tensions will continue, possibly into the medium- to long-term. Smaller countries that are well-integrated in the GVC must tread carefully to avoid circumventing established trade restrictions of the major economies, and thus risk being caught in the crossfire. As such, any further escalation could amplify current trade tensions into a global trade war, in which there will be no winners.

In this environment of heightened uncertainty, swift, nimble and adroit policy measures are critical to ensure that Malaysia remains resilient and well-positioned to weather any downside risk of a trade war. First, structural reforms such as promoting high value-added industries, diversifying our export products and markets, enhancing labour market flexibility, and attracting quality investments that would create high-value jobs, should continue to be pursued. Second, Malaysia's position in the GVC should be consistently reassessed in order to leverage on opportunities to fortify our role in the ecosystem. Third, Malaysia must proactively pursue multilateral and bilateral trade pacts with other economies. Crucially, these policy thrusts will contribute towards enhancing the resilience of the Malaysian economy.

---

[9] "Impact of US and Chinese Tariffs on American Companies in China", AmCham China & AmCham Shanghai (2018).

[10] "Apple weighs 15%-30% capacity shifts out of China amid trade war", Nikkei Asian Review (2019).

[11] "Li & Fung cuts China's role in supply chain as it shifts sourcing to cheaper markets in Southeast Asia", SCMP (2019).

[12] "More foreign investors turning to Malaysia due to trade war", The Edge Markets (2018).