1 Box Article

Unresolved Trade Disputes One Year On

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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

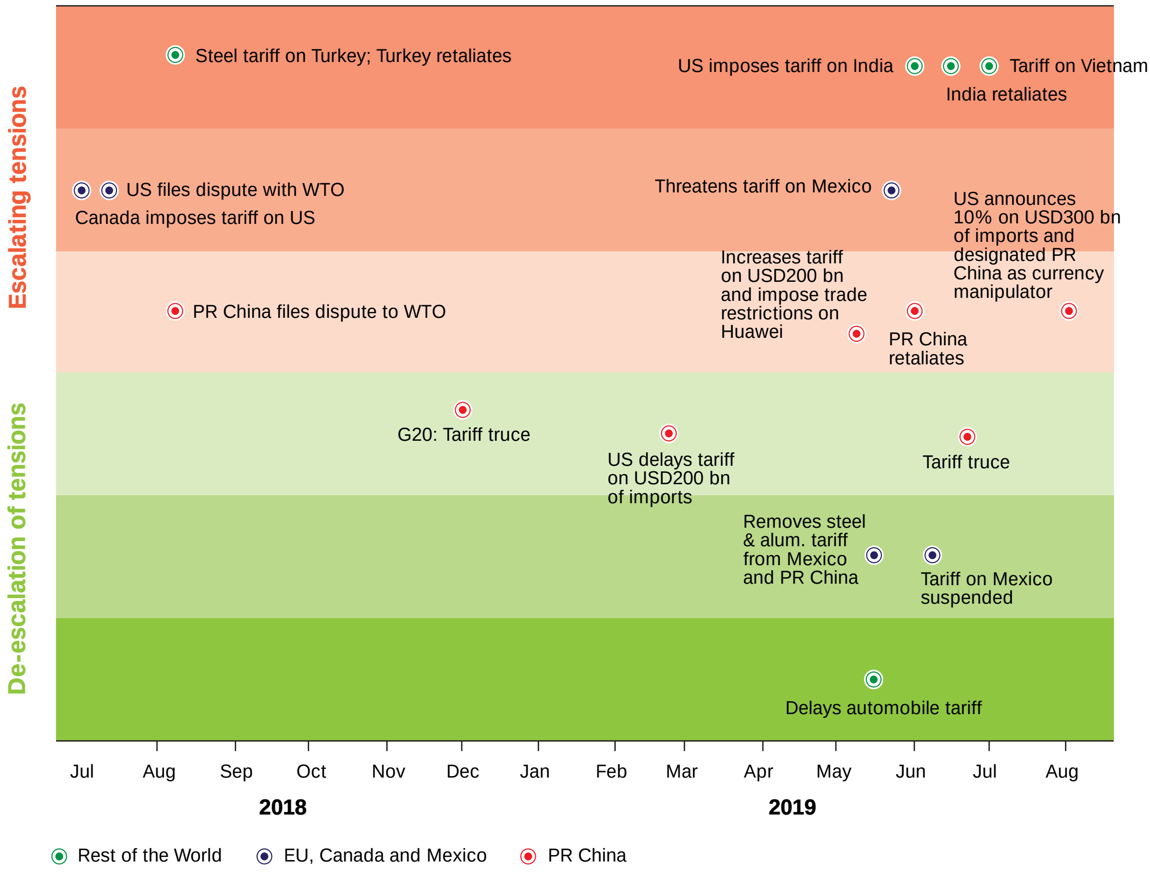
The second quarter of 2019 solidified fears of many since March 2018 that trade tensions were going to persist and propagate to other countries. After the US implemented tariffs of 10% on USD200 bn of imports from PR China in September 2018, tensions eased towards end-2018 as both countries agreed on 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

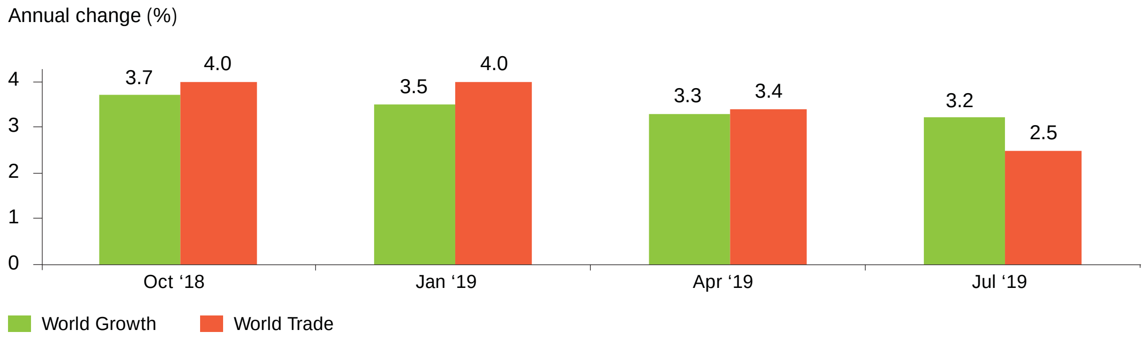
Trade tensions have contributed to a new global landscape

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.

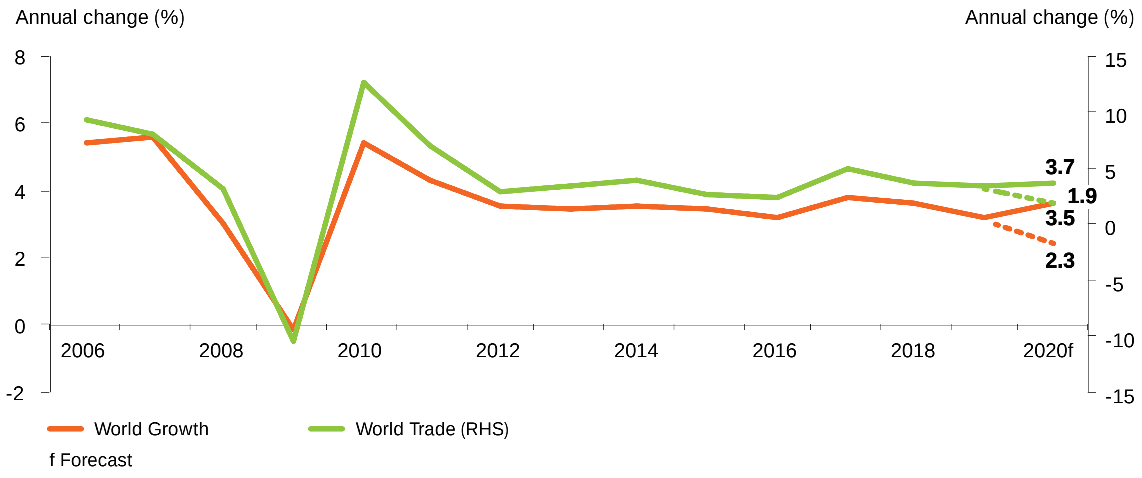
Chart 2: Evolution of IMF World GDP Growth and Trade Forecasts for 2019



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

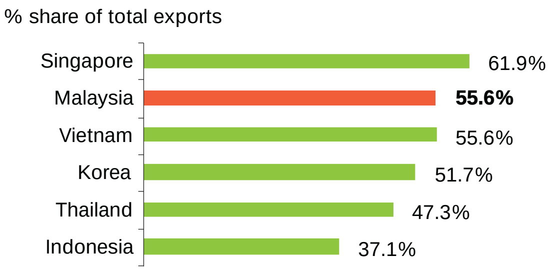


Source: IMF World Economic Outlook, authors' estimation

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

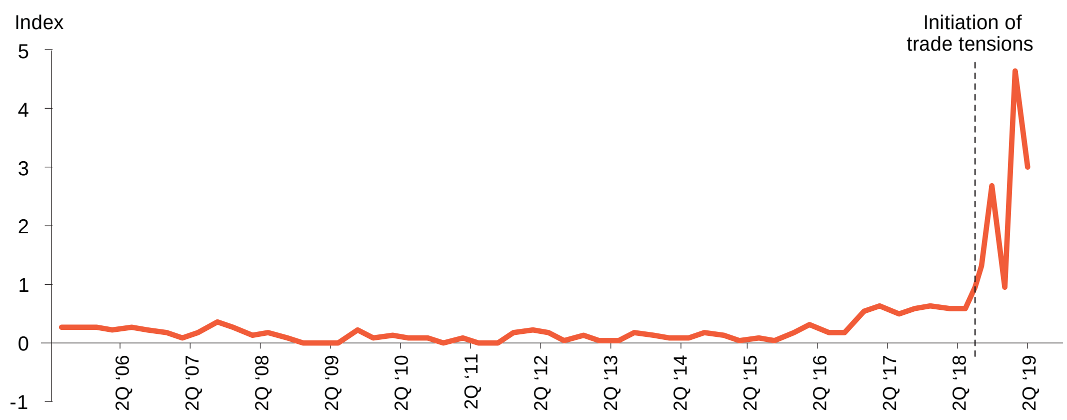
While the direct channel captures demand for Malaysia's exports that are consumed in the final destination country, the indirect channel refers to demand by countries within the GVC for Malaysia's exports which are used as intermediate inputs. Accounting for both direct and indirect channels, the ongoing 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



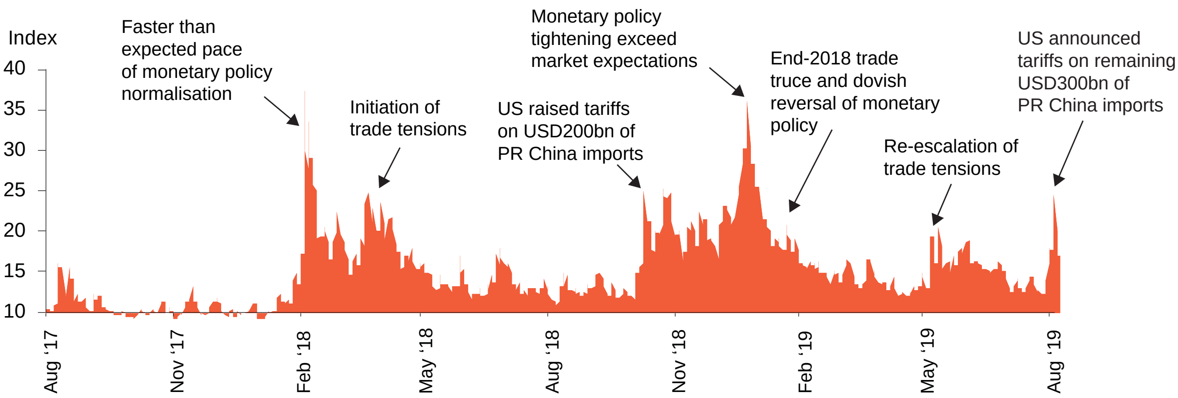
Source: Ahir, Bloom and Furceri, (2018) "The World Uncertainty Index"

[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).

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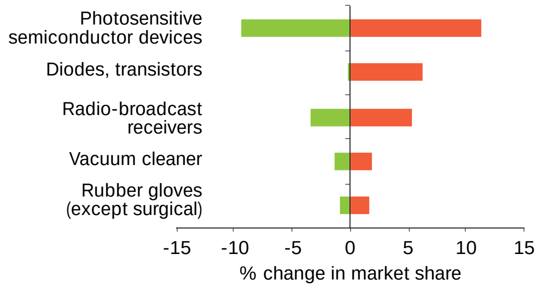
[6] The US Treasury Department has three criteria for identifying countries that possibly conduct unfair currency practices. These are (i) significant bilateral trade surplus with the US; (ii) material current account surplus, and (iii) persistent, one-sided intervention in currency markets.

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

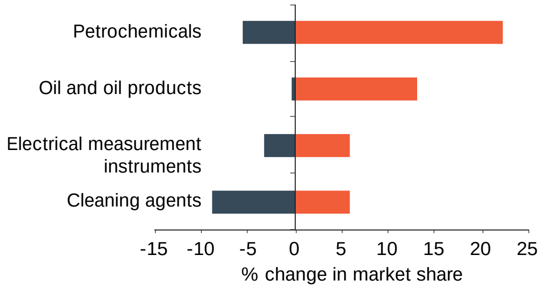
[8] Selected products are tariffed products in which Malaysia has a meaningful presence (Malaysia's exports account for at least 5% of US' import) and experienced an increase in share in the US at the expense of PR China between July 2018 and April 2019. The same method applies to PR China's imports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

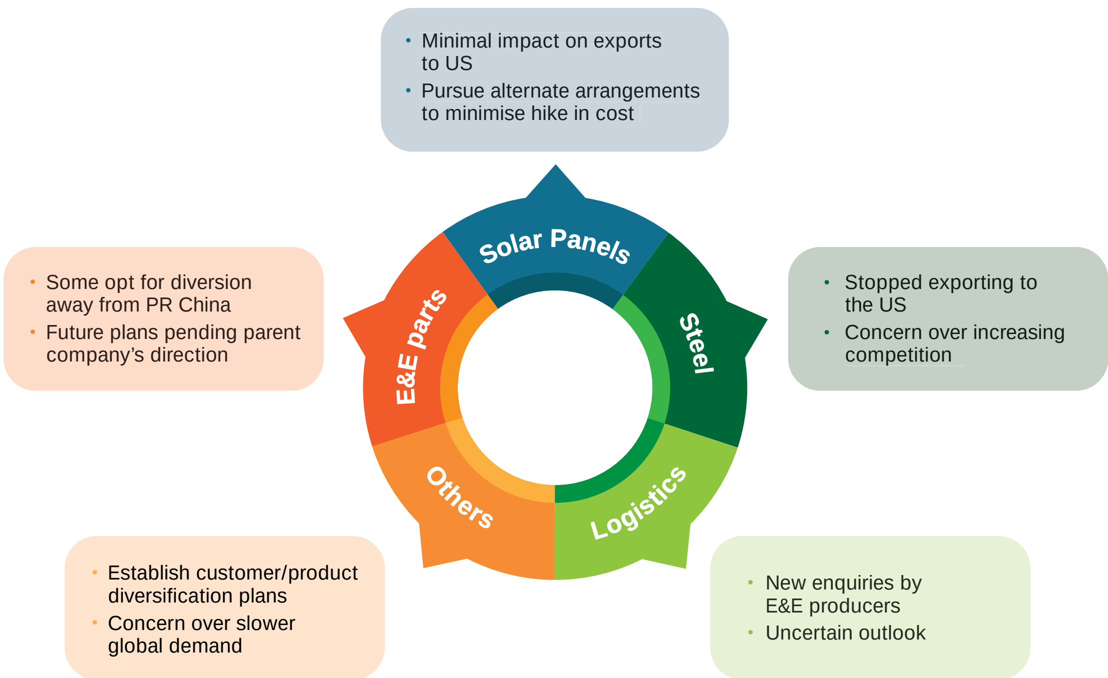


Source: Global Trade Atlas

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.

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[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).