1 Box Article

Trade Disputes: Implications for Trade and Investments

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HIGHLIGHTS

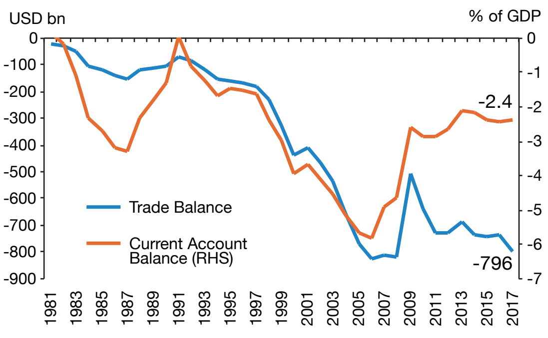
- **Recent trade disputes have introduced downside risks to global growth. The possibility of higher tariffs poses a downside risk to the strong growth momentum from the previous year.**
- **In its current state, the proposed tariff measures by the US and PR China are estimated to have minimal impact on global and regional growth.**
- **Malaysia must continue to take a pragmatic stance on open trade policies by widening its trade relationships and ensuring that domestic policies continue to support economic growth.**

Global trade liberalisation since the 1980s has unlocked a vast source of growth for many advanced and emerging economies. However, there has recently been a shift towards a more protectionist stance, which may undermine this important source of growth. This box article assesses the potential effects of the recent protectionist trade policies on the global economy and Malaysia.

Background

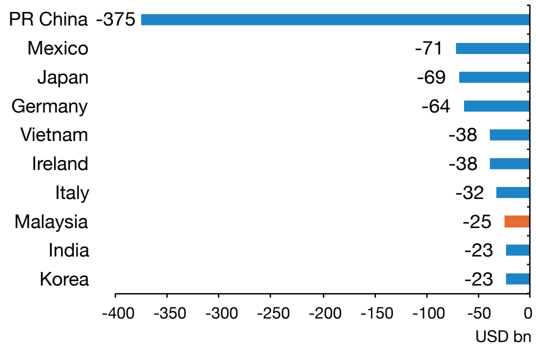
The US has continued to record a prolonged and widening trade deficit as it imports more goods from its trading partners than it exports (Chart 1). Among its trading partners, PR China accounts for almost 50% of the US' trade deficit (Chart 2). This partly underlies the basis for the US to enact higher tariffs on other countries, including PR China. The US claimed that PR China has taken an unfair advantage of its lower domestic input costs to deflate prices of tradable goods globally, and that increasing the US tariff rate on imports from PR China may level the playing field for American businesses.

Chart 1: US Trade and Current Account Balance



Source: US Census Bureau, US Bureau of Economic Analysis

Chart 2: US Trade Balance by Country (2017)



Source: US Census Bureau, US Department of Commerce

Developments and Details

The series of trade actions initially rose in January 2018, when the US announced a blanket rise in tariffs on solar panels, followed by steel and aluminium in March (Table 1: Stage 1). The trade actions became more country-specific by end-March and early-April when the US unveiled the findings of its Section 301 report on PR China's intellectual property practices, and the proposal to increase import tariffs on 1,333 products from PR China worth USD50 billion. In response, PR China announced proposed tariffs on 106 US products worth USD50 billion (Table 1: Stage 2).

Table 1: Details of Trade Actions Between the US and PR China

Details of Actions	United States	PR China
Stage 1	**Jan 2018 - Mar 2018** **Blanket tariff on all countries*** • Solar panels (+30%) • Steel (+25%) • Aluminium (+10%)	**Early Apr 2018** **Targeted tariff on products from the US** • Fresh and dried fruits, wine, ethyl alcohol, and steel pipes (+15%) • Pork-related products and recycled aluminium (+25%)
Stage 2	**Mar - Apr 2018** **Import tariffs on products from PR China** • +25% import tariffs on 1,333 products worth USD50 bn • E.g. home appliances, machinery, electrical equipment	**Mid-Apr 2018** **Targeted tariff on products from the US** • +25% import tariffs on 106 products worth USD 50 bn • E.g. soybeans, automotive parts and aircraft.

* Countries exempted from the steel and aluminium tariffs include Canada, Mexico, Korea and the euro area
Source: US Trade Representative Office, PR China Ministry of Commerce, Newsflows

The announced products that will be subject to higher tariffs account for 13% of PR China's exports to the US, and 41% of US exports to PR China. While these figures may seem substantial on a bilateral basis, the products targeted with higher tariffs constitute only a small portion of the US' and PR China's total exports to the world (2.4% and 3.4% of the total US and PR China's exports, respectively).

Impact on the Global Economy

Thus far, the proposed trade actions are expected to have only marginal effects on the global economy, mainly through the trade and investment channels.

For the trade channel, the assessment is conducted in multiple steps. First, a measure of trade elasticity is used to estimate the impact of price increases (via higher tariffs) on import volume for the US and PR China, respectively. Second, the indirect spillover to regional countries via the global value chain is computed. For the investment channel, the impact to GDP growth is assessed through lower profits from exporters, the deterioration in financial conditions, and the resultant dampening on business sentiments and investment activities. Third, the adverse effect of lower trade on labour income and potentially higher prices is accounted for.

The proposed tariffs imposed by the US is estimated to reduce PR China's GDP growth by 0.04 ppt, and the region's GDP growth by 0.01 – 0.02 ppt (Table 2). This result highlights the high integration of EA-8 economies in PR China's production value chain, particularly for E&E products with ~18% share of value-added (VA share) sourced from the region. As such, regional economies such as Chinese Taipei and Korea, who are key suppliers of intermediate goods to PR China, are the most affected by the higher bilateral tariffs.

On the other hand, corresponding measures by PR China on the US is estimated to reduce US GDP growth by 0.06 ppt, while the region's GDP growth is reduced by less than 0.01 ppt. Regional GDP growth is only marginally affected by PR China's retaliatory tariffs because North American countries such as Canada and Mexico are more integrated in the US' production value chain than countries in the Asian region.

Table 2: Impact on GDP Growth via the Trade Channel

Ppt. Impact (% yoy)	Impact of US Tariffs	Impact of PR China Tariffs
PR China	-0.04	
US		-0.06
Asia ex. PR China	-0.01 - 0.03	
Global Growth	-0.02	
Global Trade	-0.02	

Note: Asia ex. PR China includes Hong Kong, Korea, Singapore, C. Taipei, Indonesia, Malaysia, Philippines, Thailand and Vietnam. Asia ex. PR China growth rates are calculated in US Dollar terms.

Source: Bank Negara Malaysia staff estimates

These preliminary results indicate that the implementation of higher tariffs will adversely affect the US more than PR China. In part, this is due to the higher value-added (VA) sourced domestically for the US (~82% VA share) compared to PR China (~64% VA share). For example, the manufacturing of most consumer E&E products, such as smartphones, in PR China requires component parts from many regional countries (OLED display panel from Korea and semiconductor chips from Chinese Taipei). In this regard, PR China's deep integration with Asian economies and its more diversified sources of value-added growth from the region works to its advantage by mitigating some of the decline in its GDP growth.

The combined effect of the announced US and PR China tariffs through trade is estimated to lower global GDP growth marginally by 0.02 ppt, with a corresponding 0.02 ppt decrease in global trade. Research and past episodes also suggest that the adverse effects through investment, due to deteriorating business sentiments may lower global GDP by an additional 0.03 ppt. Taking both trade and investment effects into consideration, global GDP is estimated to be lower by up to 0.05 ppt, with a corresponding 0.06 ppt decrease in global trade growth (Table 3).

Table 3: Combined Impact on GDP Growth via the Trade and Investment Channel

Ppt. Impact (% yoy)	Global Growth	Global Trade
Impact from Trade Channel	-0.02	-0.02
Impact from Investment Channel	-0.03	-0.04
Combined Impact on GDP Growth	-0.05	-0.06

Source: Bank Negara Malaysia staff estimates

Given Malaysia's trade and financial openness, the proposed trade actions by the US and PR China, if implemented, would have an impact on Malaysia's growth prospects. Lower trade activity would weigh on firms' profitability and households' income. Greater financial market volatility would also dampen sentiments. Nonetheless, as the materialisation of the current proposed trade actions is estimated to have limited effects on the global economy, the impact to Malaysia is assessed to only be a marginal decline of 0.05 – 0.15 ppt in GDP growth. These impact estimates would be further mitigated by potential trade re-direction away from the US and PR China as source countries to the rest of the world. However, the impact estimates also have the potential to increase should the trade actions escalate beyond those currently proposed.

Uncertainty Over Implementation and Financial Market Reaction

Despite the many announcements of higher import tariffs by the US and PR China, at this juncture, the announced measures remain a rhetoric. This is because the implementation of these tariffs are subject to several proceedings which include:

1) The US seeking public feedback on the proposed tariffs on 1,333 products from PR China until end-May 2018; while PR China does not have a clear implementation timeline.

2) The US utilising discretion for tariff exemptions, as shown in allowing exemptions to seven countries for its steel and aluminium tariffs.

3) Greater political will in the US and PR China to negotiate before pursuing higher tariffs.

The overall impact to the Malaysian economy is also subject to several factors, such as the coverage of tariffed products, Malaysia's exposure to the product segments and the timing of implementation. The impact on the real economy could also be larger in the longer run, as prolonged uncertainty over trade policy dampen sentiments among firms and households could generate negative spillover effects on economic activity beyond the industries involved.

Moreover, the risk to growth prospects will be exacerbated if financial market conditions deteriorate, leading to higher volatility in currency movements and a decline in asset prices. This would be the case if the trade actions between the US and PR China are prolonged or if the actions extend beyond trade and into currency-based measures. Prolonged uncertainties about trade policy could lead to capital outflows from countries perceived to be heavily affected by the potential trade actions. While it remains unlikely, trade and currency wars are unfavourable scenarios for the global economy.

Policy Imperatives for Malaysia

In pursuing Malaysia's vision to transform into a high-income and high-performance economy, Malaysia has always been committed to a growth model premised on openness. This is in recognition that Malaysia's businesses thrive on being innovative, efficient, competitive and on actively expanding their global reach to access new markets. In trade, Malaysia has consciously undertaken policy efforts to diversify its products and markets to mitigate the risks of over-reliance on certain products and markets. This has reduced the risks of external market volatility on overall growth and employment. While Malaysia has embraced trade liberalisation through active participation in bilateral, regional and global trade negotiations, recent events have demonstrated an even greater need for swift and decisive policy actions to counter the rise of trade protectionist measures. Malaysia remains committed to its existing trade policies, and can only benefit by widening and deepening its trade relationships.

Disruptions in trade have adverse effects not only on growth among the economies directly involved, but also those in the supply chain. Global value chains, which encompass activities in the production of goods from materials sourcing to final assembly that happens across different countries, are now more integrated than ever before. In Malaysia, this includes the production of parts and components for international brands such as Apple, Samsung, Intel, BMW and Airbus.

While it has tremendously improved the scale and speed of production of many traded goods, global value chains also amplify the downside risks of trade protectionism for the economies that are involved in this global production ecosystem. In the prevailing environment of global trade uncertainty, it is important for Malaysia to take a broader perspective in which the country taps into globalisation to support our long-term economic development goals. Wide-spread automation has changed the dynamics of production and services delivery. A low-cost growth model dependent on foreign labour is neither sustainable nor capable of improving competitiveness in this current global economic landscape. Technological upgrading, further automation and innovation must be embraced more fervently for Malaysia to expand our production capabilities and to move up the value chain. There is room for Malaysia to enhance our economic resilience via greater diversification of the product mix and product complexity. Some of these products include those from the electronics and commodity sectors, and increasingly the chemical and plastic industries. Malaysia has vast experience and significant productive capabilities in these industries (*refer to BNM Annual Report 2017 Box Article on Complexity and Growth: Malaysia's Position and Policy Implications*).

Reforms are also urgently needed to ensure that domestic demand in Malaysia remains resilient. This includes undertaking policies to raise labour productivity through upskilling and reskilling initiatives to remain relevant in an increasingly competitive and globalised world. Efforts should be directed towards the more treasured source of value-added in the future, and the provision of quality services. Malaysia's policies in this area emphasise the development of world-class human capital through comprehensive education, effective communication and high competitiveness. Diversifying our sources of growth is critical to ensure our sustainability going forward.

Conclusion

Trade disputes that have the potential to disrupt global trade activity pose a downside risk to growth. At the current juncture, the risks to global growth prospects and the Malaysian economy remain marginal. However, the adverse effects could rise if the uncertainty over trade policy is prolonged and, in particular, if global financial conditions deteriorate as a result. These trade actions will not only affect those countries directly involved, as the impact will likely spillover to the rest of the world via the global supply chain, investment activity and financial channels. Trade disputes should be resolved through dialogue and negotiations. The policy imperative for major and emerging economies today is to reaffirm the common goal of economic prosperity through open and fair trade.