BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

The BNM Quarterly Bulletin presents a quarterly review of Malaysia's economic, monetary and financial developments. It includes the Bank's latest assessments on the direction of the economy going forward. The Bulletin also provides insights on current economic and financial issues, including highlights of policy initiatives undertaken by Bank Negara Malaysia in pursuit of its mandates.

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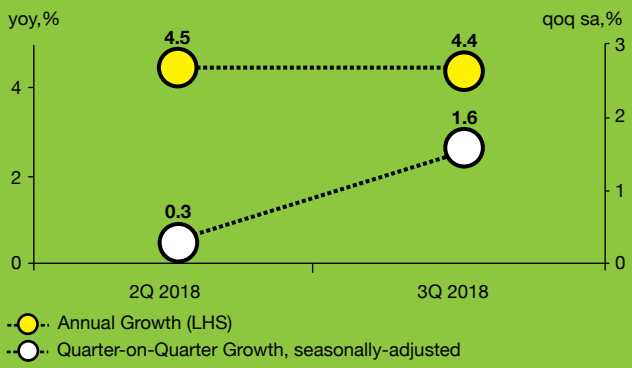
P41 **Annex**

Key Highlights on Economic and Financial Developments in 3Q 2018

Sustained economic growth of 4.4% despite global headwinds

Continued expansion in domestic demand amid commodity supply shocks

Real GDP Growth



Robust household spending
3Q18: 9.0%

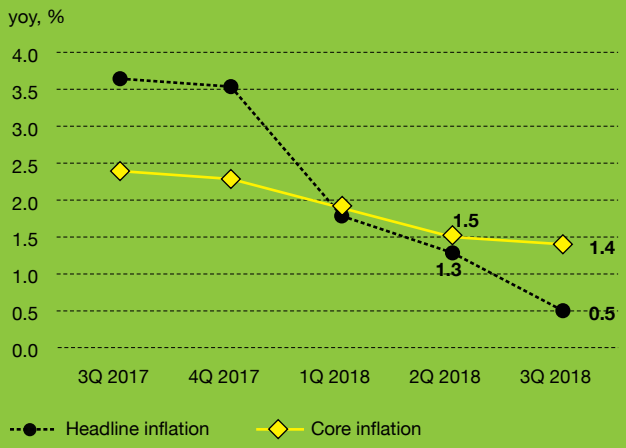
Higher private investment to meet positive growth prospects
3Q18: 6.9%

Lingering effects of supply shocks in agriculture and mining sectors

Headline inflation declined in the third quarter of 2018

Lower inflation during the quarter mainly reflected the impact from the GST zerorisation

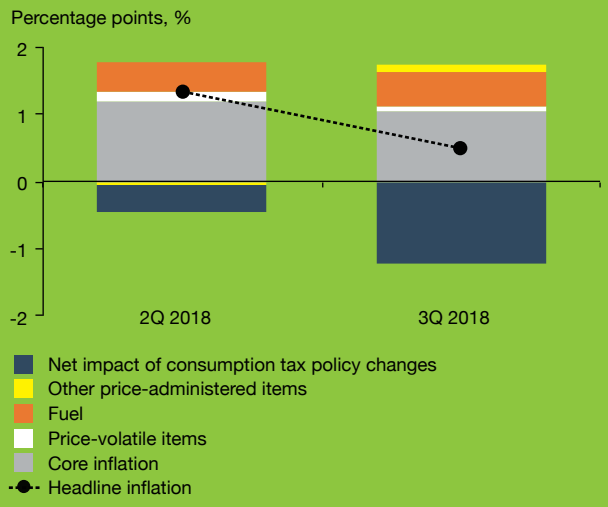
Headline and Core Inflation[1]



[1]Core inflation excludes the estimated direct impact of consumption tax policy changes

The SST implementation had a limited impact on inflation during the quarter

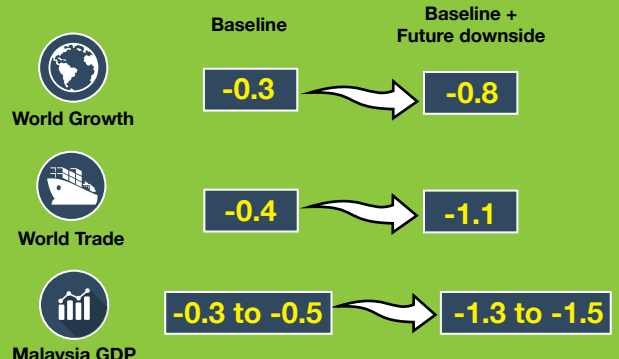
Contribution to Headline Inflation by CPI Components



Box Articles

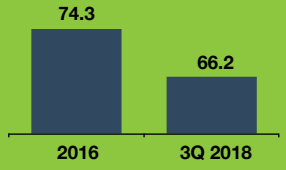
Further escalation in trade tensions to have more significant impact on growth prospects

Impact Estimates of Trade Protectionism Measures
Annual ppt. impact



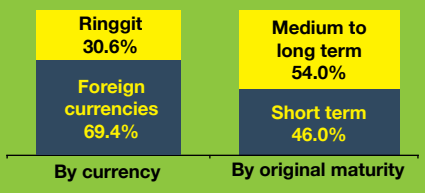
Ringgit-denominated external debt lowers exposure to foreign currency risk, while medium- to long-term external debt reduces rollover risk

External debt to GDP (% share)



- External debt declined to 66.2% of GDP as at end-3Q 2018

External debt by currency and original maturity (% share)



- About one-third of external debt is denominated in ringgit
- More than half of external debt is medium- to long-term, limiting rollover risk

Source: Department of Statistics Malaysia, Bank Negara Malaysia unless stated otherwise
For more information, visit www.bnm.gov.my

International Economic Environment

HIGHLIGHTS

- **Global economy moderated in the third quarter of 2018.**
- **Slower export growth in most regional economies.**
- **Financial market volatility remained elevated, while trade tensions escalated.**

Global economy grew at a more moderate pace

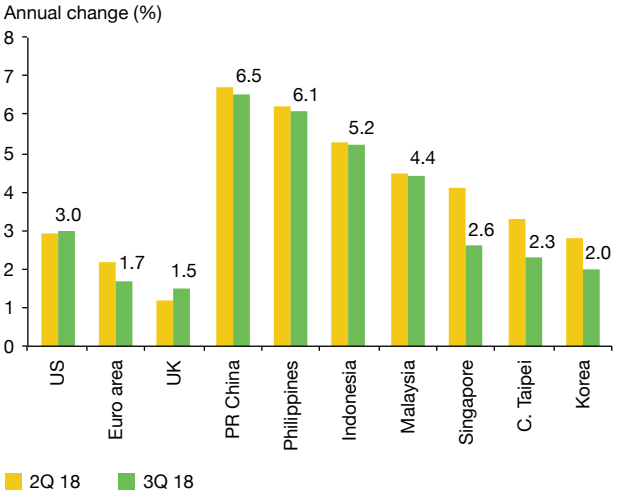
The global economy continued to expand, but at a more moderate pace in the third quarter of 2018. While the US and UK GDP accelerated, most emerging economies recorded more moderate growth.

In the advanced economies, labour markets remained supportive of private consumption, as unemployment rates continued to decline amid a steady increase in wage growth. These developments contributed to rising inflationary pressures as reflected by the gradual increase in Consumer Price Indices. Investment activity, however, moderated in the euro area, while in the US, business spending was lifted by the 2017 tax reforms.

Growth in the Asian region trended lower. PR China recorded slower growth, as continued policy driven credit tightening weighed on investment, particularly local government spending on infrastructure. Nevertheless, domestic demand in other Asian economies remained resilient, in part aided by ongoing policy support and higher infrastructure spending.

Global economic activity moderated in 3Q 2018

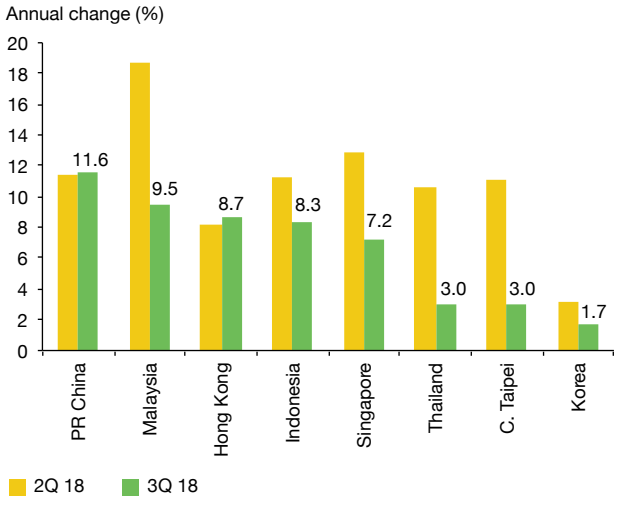
Chart 1: GDP Growth



Source: National authorities

Modest export performance in 3Q 2018

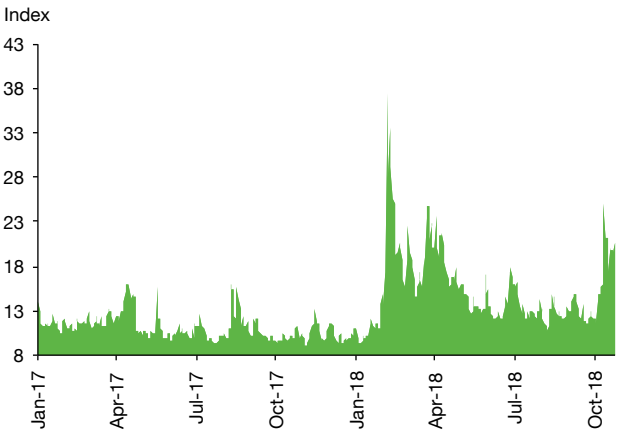
Chart 2: Export Growth of Selected Economies (in USD terms)



Source: Bloomberg

Higher volatility in the financial markets

Chart 3: Chicago Board Options Exchange (CBOE) Volatility Index (VIX)



Source: Bloomberg

Export growth moderated

Most regional economies recorded slower export growth in the third quarter of 2018. This reflects lower demand from major economies, such as the euro area and PR China. Of significance, demand for E&E products, which had driven shipments from Korea and Chinese Taipei in previous periods, have moderated.

Indicators suggest that the impact of the recent trade actions have started to materialise. The Purchasing Managers Index in several economies recorded slowdowns in the new orders and confidence sub-indices. Increasingly, firms noted that prolonged trade tensions would adversely affect input costs and threaten to disrupt their supply chain operations. Trade disruptions are likely to exacerbate the moderating growth momentum currently experienced by most economies.

Higher volatility in the financial markets

Financial market volatility re-emerged in October, as 10-year US Treasury yields rose to its highest level since 2011. This was attributable partly to adjustments in market expectations for a stronger US economy. Most emerging market economies recorded large capital outflows resulting in downward pressure on emerging market currencies and equities. In particular, financial conditions in Turkey and Argentina deteriorated rapidly, exacerbated by vulnerabilities in their domestic economies.

Heightened trade tensions also contributed to the elevated volatility in the third quarter of 2018. In September, the US implemented an additional 10% tariff on USD200 billion worth of imports from PR China and announced that the additional tariff will be raised to 25% in January 2019. This sparked retaliation from PR China which raised its tariff on USD60bn of US imports by 5-10%.

In the commodities market, Brent crude oil price rose slightly to an average of USD76 per barrel in 3Q 2018 (2Q 2018: USD75). During the quarter, OPEC's pledge to ease oil output cuts caused prices to moderate. Towards the end of the quarter, however, Brent crude oil price increased sharply, as reports of declining oil exports from Iran ahead of the imposition of sanctions by the US triggered heightened concerns over tighter supply conditions in the global oil market.

Developments in the Malaysian Economy

HIGHLIGHTS

- **The Malaysian economy expanded by 4.4% in the third quarter.**
- **Headline and core inflation declined to 0.5% and 1.4%, respectively.**
- **Current account surplus was sustained at RM3.8bn in the third quarter.**

The Malaysian economy registered a growth of 4.4%

The Malaysian economy recorded a sustained growth of 4.4% in the third quarter of 2018 (2Q 2018: 4.5%), supported by expansion in domestic demand amid a decline in net exports growth. Private sector expenditure remained the key driver of growth, expanding at a faster pace of 8.5% (2Q 2018: 7.5%), while public sector expenditure turned around to register a positive growth of 1.1% (2Q 2018: -1.4%). On a quarter-on-quarter seasonally-adjusted basis, the economy grew by 1.6% (2Q 2018: 0.3%).

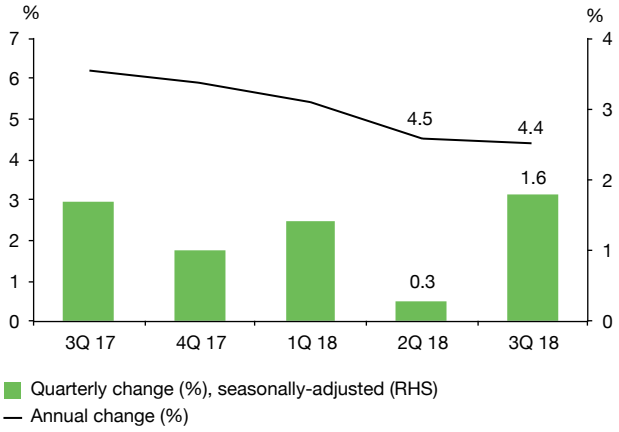
Domestic demand continued to be driven by the private sector

Domestic demand expanded at a faster pace during the quarter (6.9%; 2Q 2018: 5.6%), driven by private sector activity.

Private consumption growth accelerated to 9.0% (2Q 2018: 8.0%). Household spending was boosted in July and August 2018, following the zerorisation of the Goods and Services Tax (GST) rate[1], particularly on durable goods such as motor vehicles and furnishings, as well as food and beverages. Continued expansion in income and employment provided key support to household spending.

Sustained growth in 3Q 2018

Chart 4: Real GDP Growth

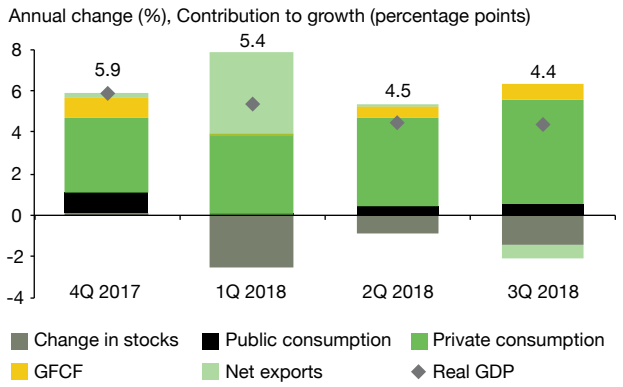


Source: Department of Statistics Malaysia

[1] The reduction in the GST rate from 6% to 0% beginning 1 June 2018 to 31 August 2018. The Sales and Services Tax (SST) was implemented beginning 1 September 2018.

Private activity supported growth

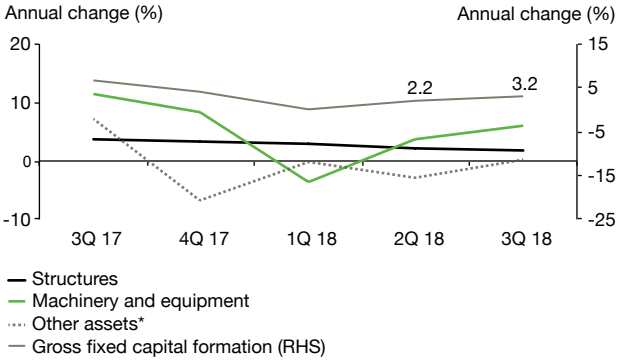
Chart 5: Contribution of Expenditure Components to Real GDP Growth



Source: Department of Statistics Malaysia

Further improvement in gross fixed capital formation

Chart 6: GFCF Growth by Type of Assets



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

Source: Department of Statistics Malaysia

Private investment growth edged higher to 6.9% (2Q 2018: 6.1%), underpinned mainly by capital spending in the manufacturing and services sectors. During the quarter, firms further expanded their capacity through increased machinery and equipment spending to cater to positive demand.

Public consumption grew at a faster pace (5.2%; 2Q 2018: 3.1%). This was attributable to a higher spending on supplies and services, which more than offset the moderation in emoluments growth.

Public investment registered a smaller decline during the quarter (-5.5%; 2Q 2018: -9.8%), due to improvements in General Government capital spending. However, capital spending by public corporations was lower as some projects were near completion.

Gross fixed capital formation (GFCF) increased at a faster pace of 3.2% (2Q 2018: 2.2%), supported by continued private sector capital spending. By type of assets, capital spending on machinery and equipment was higher at 5.9% (2Q 2018: 3.6%). Investment in other types of assets turned around to register a marginal positive growth of 0.1% (2Q 2018: -2.9%). Investment in structures grew at a moderate pace of 1.8% (2Q 2018: 2.1%), due mainly to continued weak investments in residential property.

Slower growth in commodity-related sectors offset by faster expansion in other sectors

On the sectoral front, growth was mainly affected by lingering commodity-specific supply shocks. Nevertheless, the impact on overall growth was mitigated by expansions in the other economic sectors, mainly the services, manufacturing and construction sectors which account for 82% of the economy.

Growth in the mining sector contracted further as natural gas production continued to be affected by unplanned supply outages and pipeline repairs in East Malaysian facilities. Meanwhile, agriculture sector growth remained weak due to the protracted recovery in crude palm oil production from adverse weather and production constraints in the previous quarter.

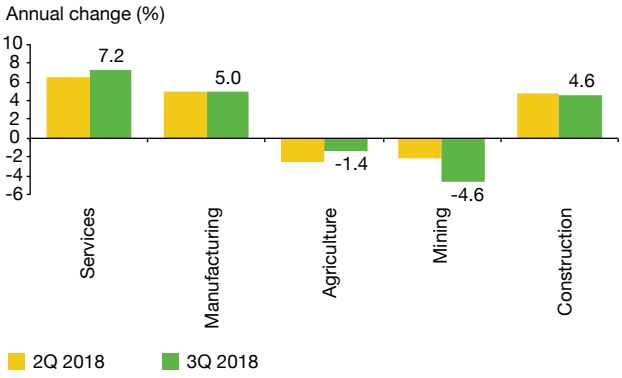
Growth in the services sector rose further during the quarter, driven mainly by the wholesale and retail trade sub-sector on account of higher consumer spending during the tax holiday period. The finance and insurance sub-sector also benefitted from the zerorisation of GST as seen in higher consumer loans disbursements and insurance premium payments, particularly in the motor vehicle segment. Growth in the transport and storage sub-sector improved, supported by higher air passenger traffic. The information and communications sub-sector continued to expand, amid continued demand for data communication services.

During the quarter, the manufacturing sector registered sustained growth, as improvements in the E&E and consumer-related clusters offset softer growth in primary-related output. Faster expansion in the E&E and consumer-related cluster was accounted by higher production of consumer-based electronics, household appliances, passenger cars and auto parts, following higher spending on durable goods during the tax holiday period. Manufacture of construction-related materials was sustained in line with activity in the construction sector. Primary-related output growth, however, slowed further during the quarter, weighed by lower output of natural feedstocks such as crude palm oil and natural gas.

The construction sector registered sustained growth in the third quarter. Despite the on-going review of several mega projects, construction activity in the civil engineering sub-sector remained supportive of growth, underpinned by steady progress in existing transportation, petrochemical and power plant projects. Growth in the non-residential sub-sector improved slightly, while growth in the residential sub-sector remained weak amidst the high number of unsold residential properties.

Faster expansions in other sectors, slower growth in commodity-related sectors

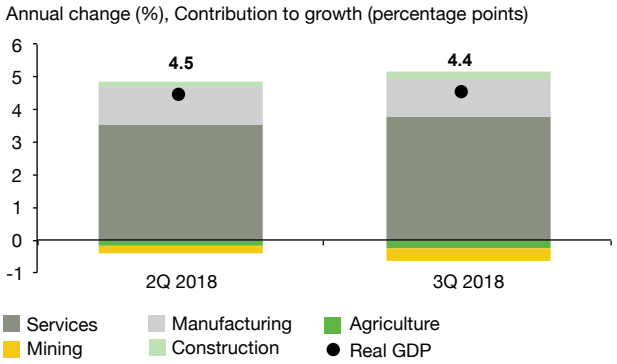
Chart 7: Growth by Sector



Source: Department of Statistics Malaysia

Services and manufacturing sectors remained the key drivers of growth

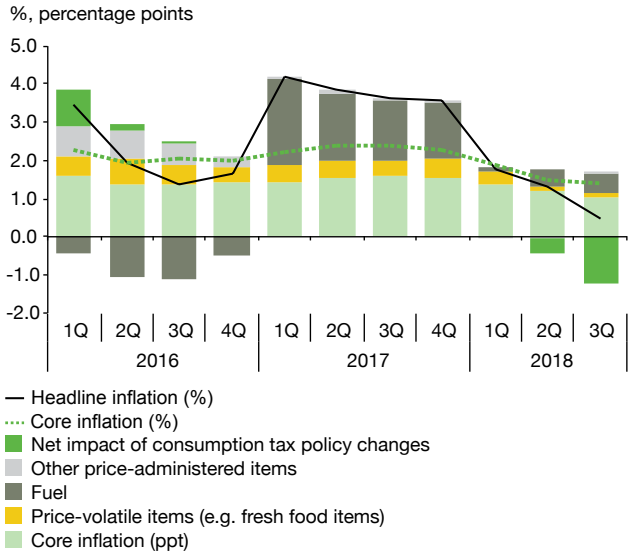
Chart 8: Real GDP by Economic Sector



Source: Department of Statistics Malaysia

The decline in inflation was mainly due to the impact from the GST zerorisation

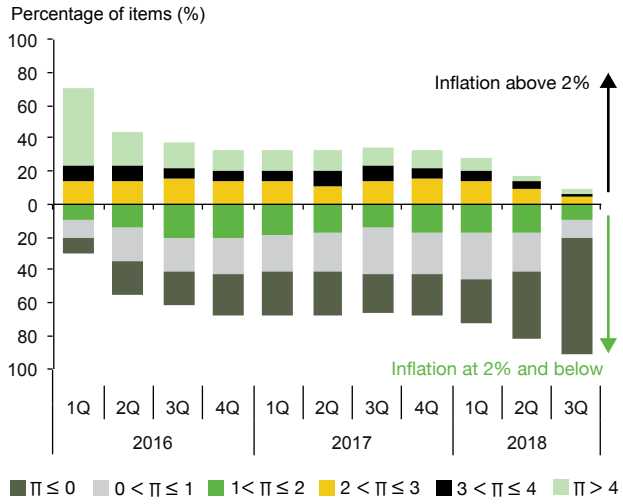
Chart 9: Contribution to Headline Inflation by Components



Source: Department of Statistics Malaysia and Bank Negara Malaysia estimates

Inflation pervasiveness continued to decline in 3Q 2018

Chart 10: Inflation Pervasiveness



Source: Department of Statistics Malaysia and Bank Negara Malaysia estimates

Lower inflation during the quarter mainly reflected the GST zerorisation

Headline inflation, as measured by the annual percentage change in the Consumer Price Index (CPI), declined to 0.5% in 3Q 2018 (2Q 2018: 1.3%).

The lower inflation mainly reflected the impact from the GST zerorisation. By category, the impact was broad-based and particularly evident for *communication services* and *recreational and cultural services*. The percentage of items in the CPI basket that had an inflation of more than 2% declined to 9% in the third quarter (2Q 2018: 18%). This was despite the implementation of the Sales and Services Tax (SST) beginning 1 September 2018. With the small average price increase for SST-taxable items in September, the SST impact on inflation during the quarter has been limited.

Core inflation, excluding the impact of consumption tax policy changes, moderated slightly to 1.4% (2Q 2018: 1.5%). Demand-driven inflationary pressures in the economy remained contained in the absence of excessive wage pressure and some degree of spare capacity in the capital stock.

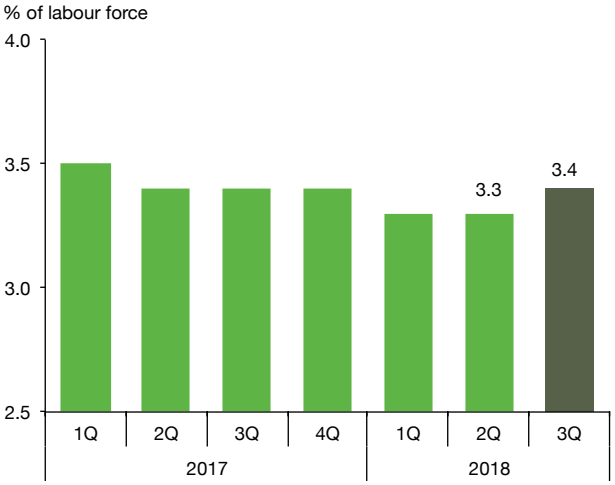
Positive labour market conditions

Labour market conditions remained supportive of economic activity. Although the unemployment rate edged higher in the third quarter (3.4%; 2Q 2018: 3.3%), this was mainly on account of higher labour force participation (68.5%; 2Q 2018: 68.4%) which offset improvements in employment growth (2.6%; 2Q 2018: 2.4%). Stronger net employment gains were recorded in the services and manufacturing sectors in the third quarter.

Private sector wages registered sustained growth of 5.7% (2Q 2018: 5.7%). This was driven mainly by higher wage growth in the services sector 3.9% (2Q 2018: 3.7%), supported by the wholesale and retail trade sub-sector. The manufacturing sector registered slower wage growth (9.6%; 2Q 2018: 10.1%), weighed by the more moderate wage growth in the domestic-oriented industries (6.1%; 2Q 2018: 8.6%). Nonetheless, wages in the export-oriented sub-sectors grew at a faster pace (10.9%; 2Q 2018: 10.6%), supported by continued growth in the E&E segment.

Marginal increase in unemployment rate

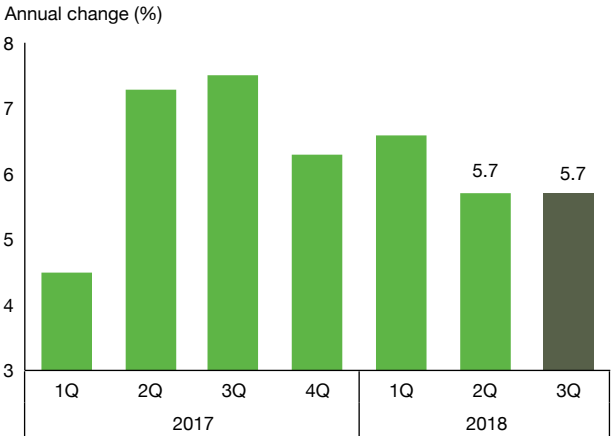
Chart 11: Unemployment rate



Source: Department of Statistics Malaysia

Sustained private sector wage growth

Chart 12: Private sector wages



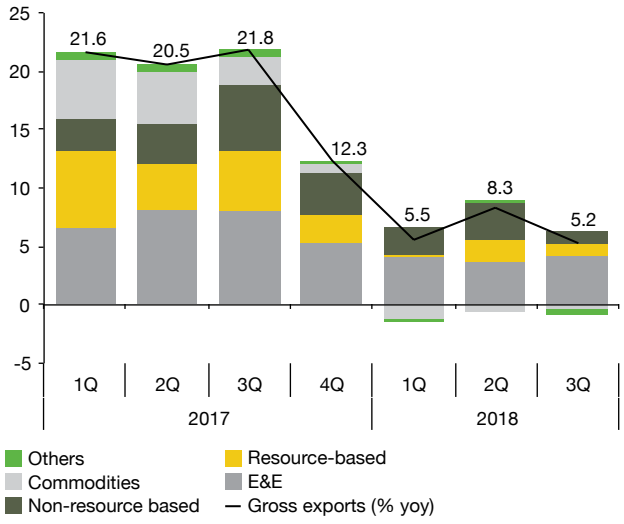
* Private sector wages is derived from the salaries and wages data published in the Monthly Manufacturing Statistics and Quarterly Services Statistics by the Department of Statistics, Malaysia (DOSM). It covers 62% of total employment.

Source: Department of Statistics Malaysia and BNM estimates

E&E remained the key driver of exports

Chart 13: Gross Exports by Products

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

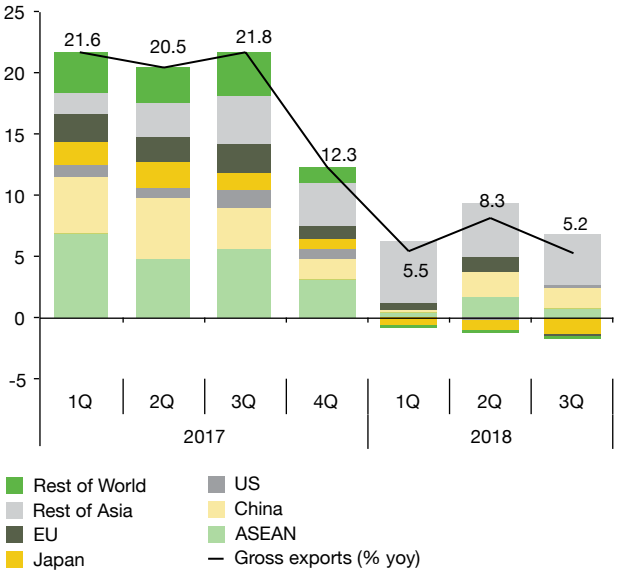


Source: Department of Statistics Malaysia

Continued growth in exports to most major markets

Chart 14: Gross Exports by Markets

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



Source: Department of Statistics Malaysia

Moderation in exports and imports

In the third quarter of 2018, gross exports expanded by 5.2% (2Q 2018: 8.3%), supported mainly by manufactured exports. Domestic exports[2] declined by -0.2% (2Q 2018: 0.2%) due to the contraction in commodity exports. The trade surplus stood at RM25.2 billion (2Q 2018: RM27.1 billion).

Manufactured exports grew by 7.4% (2Q 2018: 10.7%), supported by higher E&E exports (10.7%; 2Q 2018: 9.8%), with continued demand from major trading partners, particularly in the Asian region. Of significance, growth of semiconductor exports remained robust at 24.2% (2Q 2018: 21.0%), reflecting continued expansion in the global technology cycle. However, non-E&E exports moderated, particularly in petroleum products, and manufactures of metal and transport equipment. Commodities exports registered a smaller contraction of -3.0% (2Q 2018: -3.8%) as the continued decline in crude palm oil exports was partly offset by the stronger growth in mineral exports (9.3%; 2Q 2018: 8.1%), particularly in crude petroleum exports.

Gross imports growth moderated to 6.3% during the quarter (2Q 2018: 8.5%) following a deceleration in capital imports and lower imports for re-exports. Consumption imports rebounded to 5.5% (2Q 2018: -2.8%) due to the surge in domestic spending during the tax holiday period and a smaller contraction in intermediate imports.

[2] Domestic exports is defined as gross exports excluding re-export activity.

Sustained current account surplus

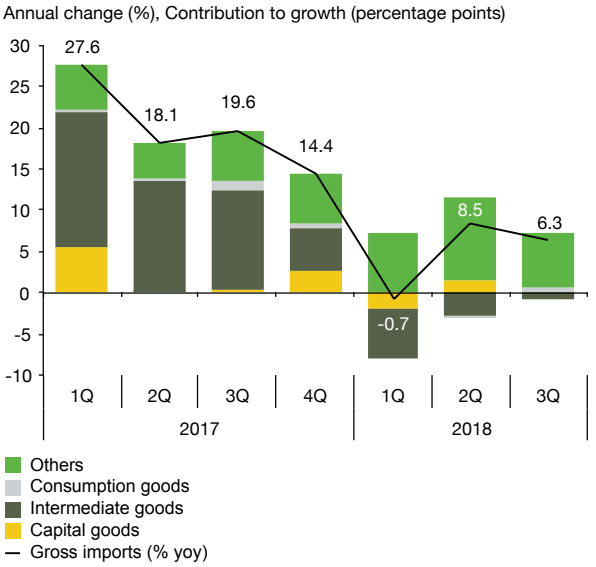
The current account surplus was broadly sustained at RM3.8 billion in the third quarter of 2018 (2Q 2018: RM3.9 billion), or 1.1% of GNI (2Q 2018: 1.2% of GNI). This was due a higher goods surplus[3] and lower services deficit, amid a larger deficit in the primary income account.

The goods surplus increased to RM26.6 billion (2Q 2018: RM26.1 billion), owing to higher E&E exports. The deficit in the services account narrowed to RM3.3 billion (2Q 2018: -RM6.2 billion). This was attributable mainly to a larger surplus in the travel account (RM8.0 billion; 2Q 2018: RM6.6 billion) due to higher tourist arrivals and lower construction services deficit (-RM1.3 billion; 2Q 2018: -RM3.2 billion) following the cancellation and deferment of selected major projects.

The primary income account recorded a larger deficit of RM15.0 billion (2Q 2018: -RM11.2 billion) as profits earned by foreign investors in Malaysia continued to outpace that of Malaysian firms investing abroad (RM16.3 billion; 2Q 2018: RM13.8 billion), particularly in the mining and manufacturing sectors. Of note, 26.4% of the profits earned by the foreign investors were reinvested (2Q 2018: 10.7%). The secondary income account recorded a sustained deficit of RM4.5 billion (2Q 2018:-RM4.7 billion), reflecting continued outward remittances by foreign workers.

Imports moderated on account of slower capital goods and re-export activity

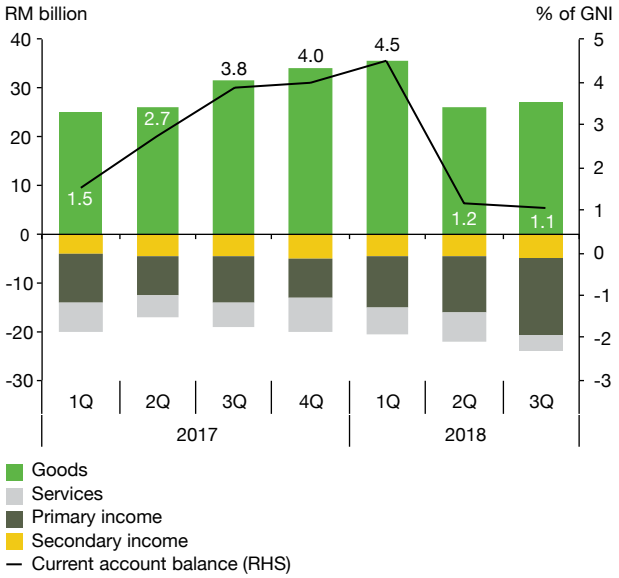
Chart 15: Gross Imports by Products



Source: Department of Statistics Malaysia

Current account surplus sustained

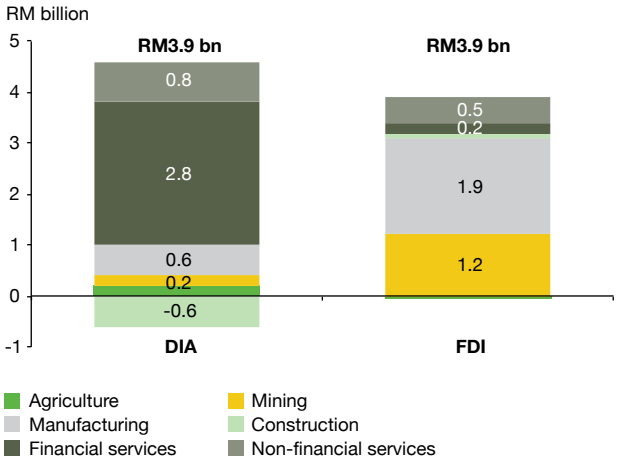
Chart 16: Current account balance



Source: Department of Statistics Malaysia

Marginal net inflows in the direct investment account

Chart 17: Net Direct Investment Flows by Sector

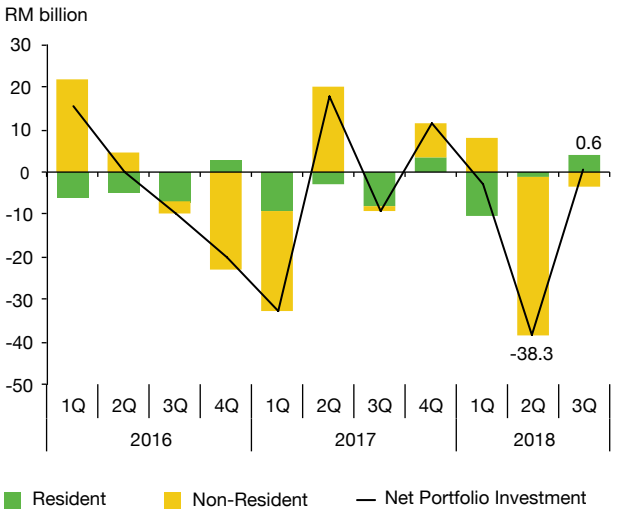


Note: For DIA, positive values refer to net outflows while negative values refer to net inflows

Source: Department of Statistics Malaysia and Bank Negara Malaysia

Net inflow in portfolio investment account attributable to residents

Chart 18: Portfolio Investments



Source: Department of Statistics Malaysia and Bank Negara Malaysia

Financial account recorded a small net inflow

In the third quarter of 2018, the financial account registered a small net inflow of RM0.2 billion (2Q 2018: net inflow of RM9.2 billion). Net inflows in portfolio and direct investment were partially offset by net outflows in other investments.

The direct investment account registered a marginal net inflow of RM0.06 billion (2Q 2018: net outflow of RM0.7 billion). During the quarter, foreign direct investments (FDI) registered a larger net inflow of RM3.9 billion (2Q 2018: net inflow of RM2.8 billion). FDI inflows were mainly channeled into the manufacturing and mining sectors. Meanwhile direct investments abroad (DIA) by Malaysian companies recorded a higher outflow of RM3.9 billion (2Q 2018: net outflow of RM3.6 billion). DIA outflows were channeled mainly into the services sector, particularly the financial services sub-sector.

The portfolio investment account registered a net inflow of RM0.6 billion, a significant turnaround from a net outflow of RM38.3 billion in 2Q 2018. This reflected the net liquidation of residents' portfolio investment holdings abroad (3Q 2018: net inflow of RM4.3 billion; 2Q 2018: net outflow of RM1.0 billion). Portfolio investment by non-residents recorded a smaller outflow of RM3.6 billion (2Q 2018: net outflow RM37.2 billion) following the net liquidation of non-resident holdings of ringgit-denominated domestic debt securities. This took place amid significant financial market volatility globally.

The other investment account recorded a net outflow of RM0.8 billion (2Q 2018: net inflow of RM48.4 billion). The banking sector's reduction of their interbank placements abroad was offset by a net outflow from the non-bank private sector, particularly deposits. Net errors and omissions amounted to -RM7.4 billion, or -1.5% of total trade. The international reserves of Bank Negara Malaysia amounted to USD103.0 billion as at end-September 2018, compared to USD104.6 billion as at end-June 2018.

Manageable external debt

Malaysia's external debt stood at RM947.9 billion or 66.2% of GDP as at end-September 2018 (end-June: RM936.5 billion or 65.4% of GDP). The higher external debt reflects largely the revaluation adjustment from the lower ringgit against major and regional currencies in the third quarter of 2018 and an increase in non-resident (NR) deposits in the domestic banking system. These were partly offset by some repayment of interbank borrowing.

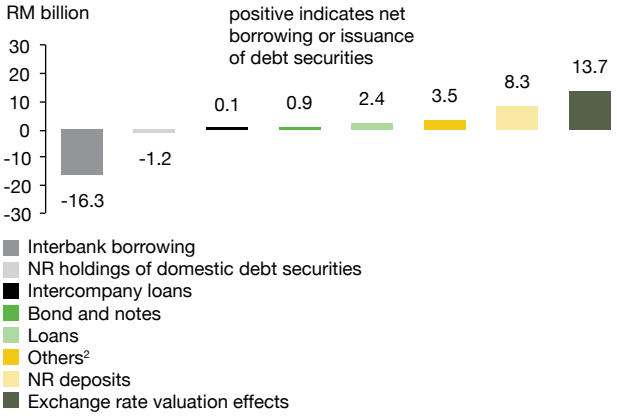
Malaysia's external debt remains manageable given its currency and maturity profiles, and the availability of large external assets. Close to one-third of external debt is denominated in ringgit (30.6%; end-June: 31.2%), mainly in the form of NR holdings of domestic debt securities (63.4% share) and in ringgit deposits (17.7% share) in domestic banking institutions. As such, these liabilities are not subjected to valuation changes from the fluctuations in the ringgit exchange rate.

The remaining external debt of RM657.9 billion or 69.4% of total external debt is denominated in foreign currency (FC), the bulk of which comprises offshore borrowings. As at end-September 2018, offshore borrowing declined to RM584.9 billion or 40.9% of GDP (end-June: RM586.5 billion or 41% of GDP), much lower compared to 60% of GDP during the Asian Financial Crisis in 1997-98. The corporate sector accounted for slightly more than half of FC-denominated external debt. Of which, about three-quarters were hedged, either naturally through FC-denominated revenue streams or financially-hedged with onshore banks.

Of the total FC-denominated external debt (inclusive of valuation effects), 38.1% (or amounting to RM250.4 billion) represents interbank borrowings and FC deposits in the domestic banking system. 76.2% of interbank borrowings are intra-group borrowings. The interbank borrowings largely reflect banks' centralised liquidity and funding management practices. Notably, banks' FC-denominated external debt remained stable during the quarter as reduced interbank borrowings was offset by increases in debt issuances abroad and non-resident deposits. Banks remained vigilant and proactive in managing their funding and liquidity risks. Foreign-currency risk, measured in net open position of FC denominated exposures stood at 5.3% of banks' total capital. Of this, USD net open position was low at 3.4% of banks' total capital.

Higher external debt in 3Q 2018

Chart 19: Changes in External debt
Net change[1]: +RM11.4 billion

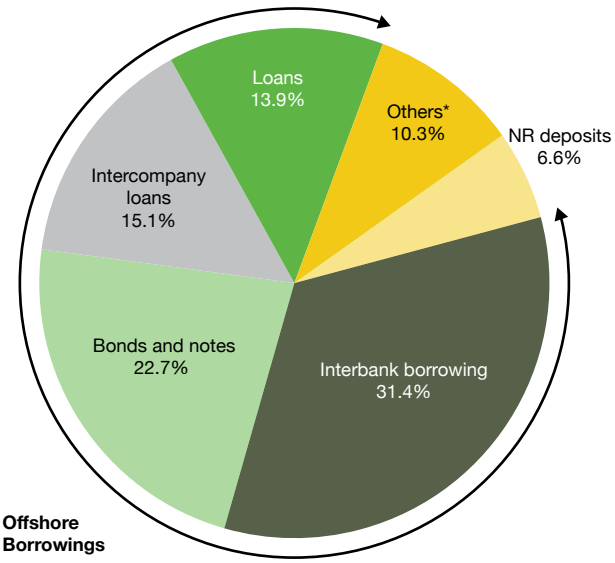


[1] Changes in individual debt instruments exclude exchange rate valuation effects
[2] Comprises trade credits, IMF allocation of SDRs and other debt liabilities
Note: NR refers to non-residents

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

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

Chart 20: Breakdown of Foreign Currency-denominated External Debt (% share)



*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

Long-term bonds and notes issued offshore stood at RM149.3 billion as at end-September 2018, accounting for 22.7% of total FC-denominated external debt. These were mainly by non-financial corporations and channeled primarily to finance asset acquisitions abroad. Intercompany loans (RM99.0 billion or 15.1% of FC-denominated external debt) are typically on flexible and concessionary terms, such as no fixed repayment schedule or low interest rate. Close to 70% of intercompany loans were obtained by non-resident controlled companies (MNCs) from parents or affiliates abroad.

From a maturity perspective, more than half of the total external debt is skewed towards medium- to long-term tenure (54.0% of total external debt; end-June: 52.0%), suggesting limited rollover risks. Short-term external debt accounts for the remaining 46% of external debt. Of which, 36.1% is accounted by stable intragroup placements among banks, thus less susceptible to sudden withdrawal. About another 13% is accounted by trade credits, largely backed by export earnings and are self-liquidating. 4% are intercompany loans, which are typically on flexible and concessionary terms *(For more granular breakdown of external debt, please refer to the Box Article on 'Profile of Malaysia's External Debt').*

As at 31 October 2018, international reserves stood at USD101.7 billion. The reserves position is sufficient to finance 7.5 months of retained imports and is 1.0 time the short-term external debt.

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 greater decentralisation of reserves. In particular, banks and corporations hold three-quarters of Malaysia's external assets (as at end-3Q 2018: RM1.3 trillion). These external assets can be drawn upon to meet banks' and corporations' external debt obligations (RM752.4 billion), without creating a claim on international reserves. The adequate level of international reserves, together with the availability of substantial foreign currency and external assets by banks and corporations, and a flexible exchange rate, will continue to serve as important policy buffers against potential external shocks.

Box Article 1

Profile of Malaysia's External Debt

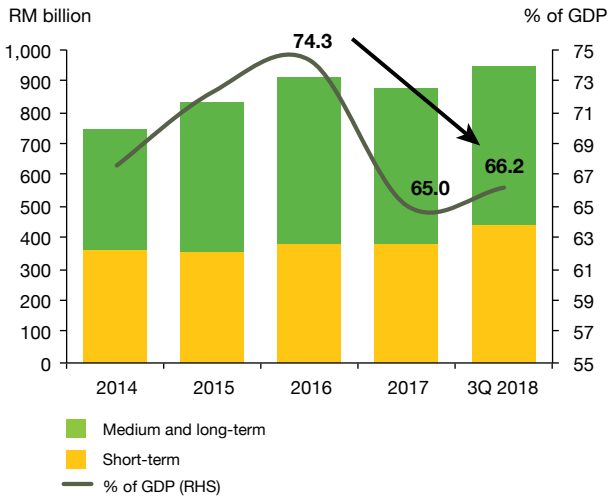
Author: Ahmad Faisal Rozimi, CFA

HIGHLIGHTS

- Malaysia's total external debt has declined to 66.2% of GDP as at end-3Q 2018 from a peak of 74.3% of GDP as at end-2016. The bulk of the external debt is by corporations and banks.
- Foreign currency-denominated external debt stood at 46.0% of GDP as at end-3Q 2018, compared to the highest level of 60.0% of GDP during the 1997 Asian Financial Crisis. Of note, Government's foreign-currency denominated external debt is very low (1.2% of GDP).
- While risks surrounding external financing conditions have increased, risks to Malaysia's external debt, including short-term external debt, remain manageable. This is anchored by a favourable external debt profile and borrowers' resilient repayment capacity.
- Reflecting the progressive liberalisation of Malaysia's foreign exchange administration rules and the decentralisation of international reserves, Malaysian entities have accumulated significant external assets abroad.
  - Of significance, Malaysia's non-reserve external assets have doubled from RM622 billion as at end-2010 to RM1.3 trillion as at end-3Q 2018. Domestic corporations and banks now hold about three-quarters of Malaysia's RM1.7 trillion external assets.
  - This accumulation has contributed to Malaysia having a net foreign currency asset position. This provides a defence against sharp exchange rate depreciation.
  - Crucially, these assets can be drawn upon to meet borrowers' external debt obligations without creating a claim on Bank Negara Malaysia's international reserves.

External debt has declined after peaking at 74.3% of GDP at end-2016. More than half of external debt is skewed towards medium to long-term tenure, limiting rollover risk

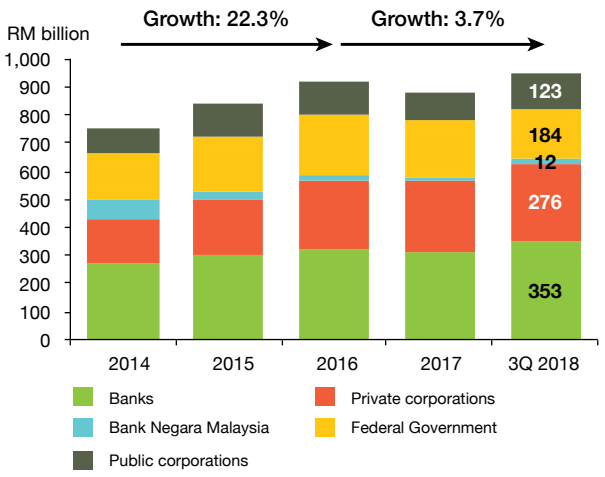
Chart 1: External Debt by Maturity (RM billion)



Source: Bank Negara Malaysia

External debt growth has slowed substantially since 2016

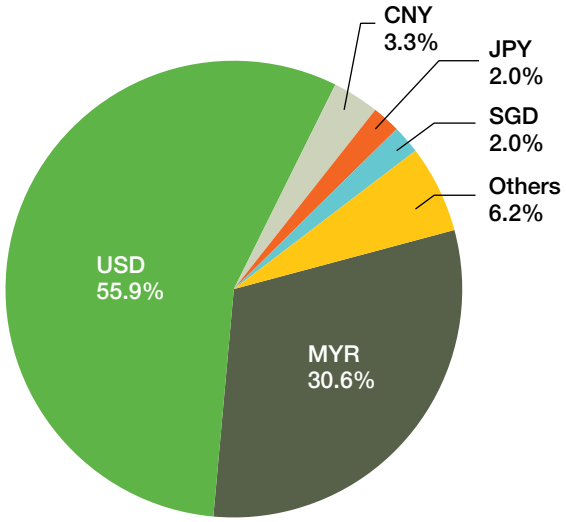
Chart 2: External Debt by Institution (RM billion)



Source: Bank Negara Malaysia

About a third of external debt is denominated in ringgit, lowering the exposure to currency fluctuations

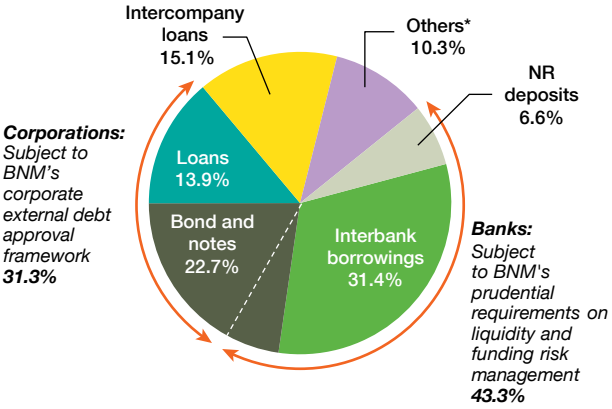
Chart 3: External Debt by Currency (% share)



Source: Bank Negara Malaysia

Foreign currency-denominated external debt stood at 46% of GDP, of which about three quarters are subject to BNM's prudential requirements and approval framework[1]

Chart 4: Breakdown of Foreign Currency-denominated External Debt (% share)



[1] Banks' exposure (43.3% share of foreign currency-denominated external debt) in the form of interbank borrowings, NR deposits and debt issuances are subject to prudential requirements on liquidity and funding risk management while corporations (31.3% share of foreign currency-denominated external debt) are subject to an approval framework to ascertain that external borrowings are utilised for productive purposes and that they are supported by foreign currency earnings or sufficiently hedged.

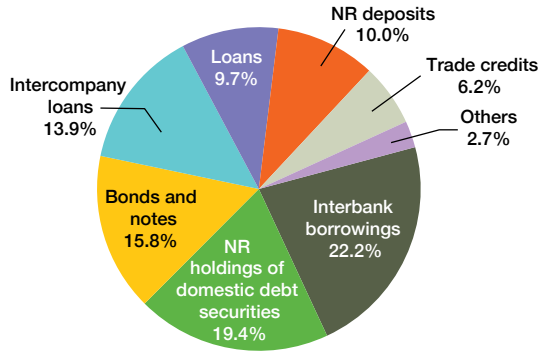
* Includes trade credits and miscellaneous, such as insurance claims yet to be disbursed and interest payables on bonds and notes.

Note: NR refers to non-residents

Source: Bank Negara Malaysia

Banks' external debt and corporates' foreign currency borrowings are subject to BNM's prudential and external debt approval framework, respectively while intercompany loans are typically on flexible and concessionary terms

Chart 5: External Debt by Instruments



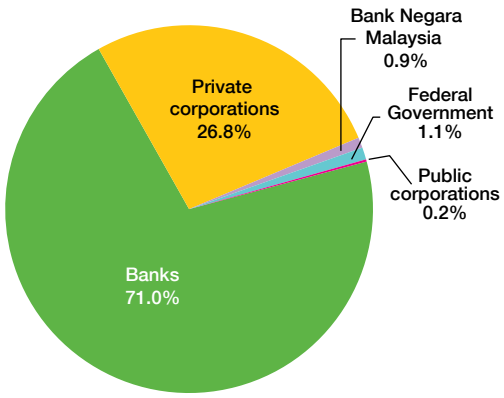
Source: Bank Negara Malaysia

Key Characteristics of External Debt

1. **Interbank borrowings and NR deposits (32% share)**
   - ☑ Subject to prudent liquidity management including limits on funding and maturity mismatches
2. **Intercompany loans (14% share)**
   - ☑ Flexible and on concessionary terms
3. **Trade credits (6% share)**
   - ☑ Backed by export earnings which serve as a natural hedging tool against exchange rate shocks
4. **Bonds and notes and medium to long term loans (22% share)**
   - ☑ Mainly for investment abroad that will raise future foreign-currency income which enhances repayment capacity and hedges against exchange rate fluctuations

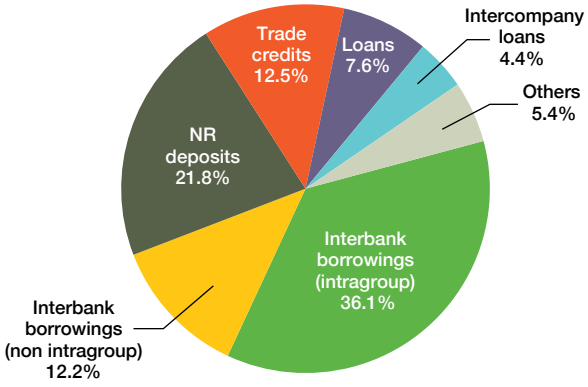
About 70% of short-term external debt is held by banking institutions, reflecting primarily sizeable presence of foreign banks in the domestic economy and strong regional footprint of Malaysian banks

Chart 6: Short-term External Debt by Institution (% share)



Source: Bank Negara Malaysia

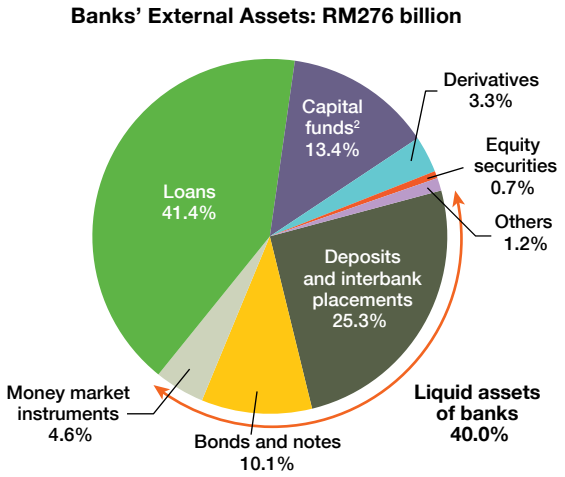
Chart 7: Short-term External Debt by Instrument (% share)



Source: Bank Negara Malaysia

Banking institutions hold substantial external assets, including liquid instruments which can be drawn upon to meet their external debt obligations

Chart 8: Banks' External Assets (% share)

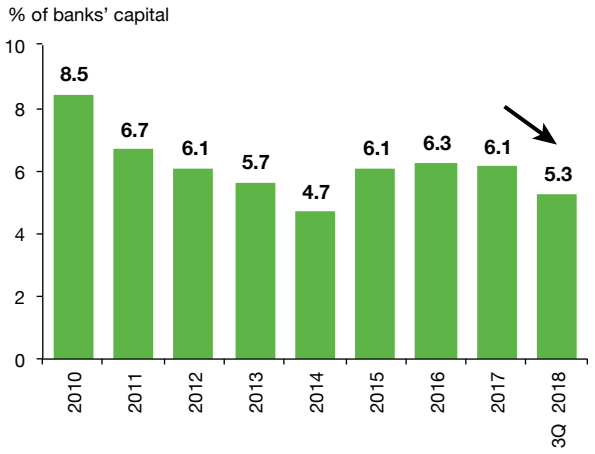


[2] Consist of equity investments and retained earnings held in subsidiaries and branches abroad. This is attributable to domestic banking groups which have a strong regional presence.

Source: Bank Negara Malaysia

Banks' net foreign currency open position remains small relative to banks' total capital

Chart 9: Banks' Net Foreign Currency Open Position[3] (% of banks' capital)

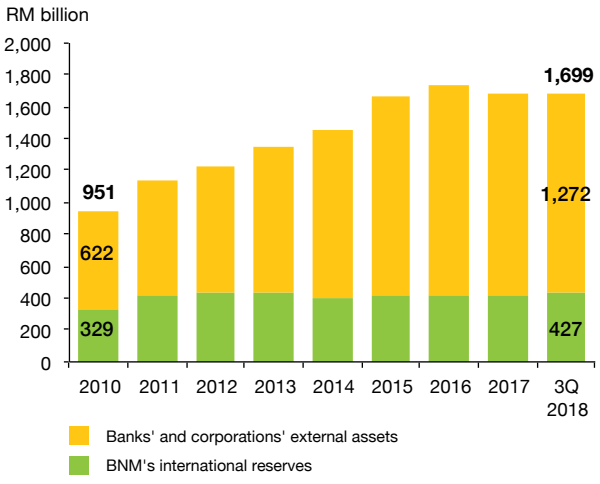


[3] Refers to the aggregated sum of the net short or long foreign currency positions accross all currencies for banks

Source: Bank Negara Malaysia

Malaysia's non-reserve external assets doubled from RM622 billion as at end-2010 to RM1.3 trillion as at end-3Q 2018

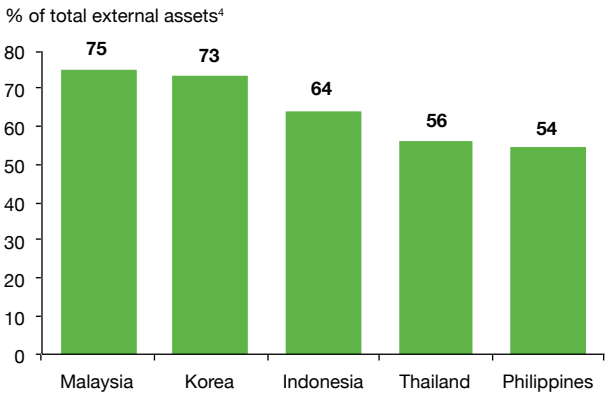
Chart 10: External Assets (RM billion)



Source: Bank Negara Malaysia and Department of Statistics Malaysia

Three quarters of Malaysia's RM1.7 trillion external assets are accounted for by domestic corporations and banks

Chart 11: Share of External Assets excluding Reserves to Total External Assets (% share)

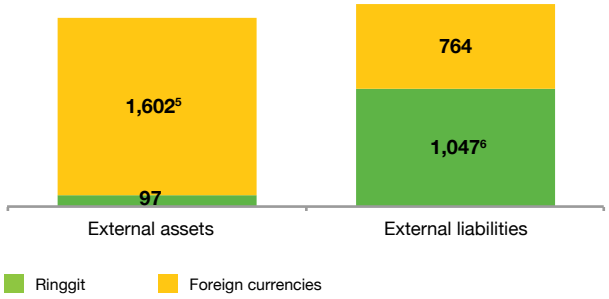


[4] External asset position as at end-3Q 2018 for Malaysia and as at end-2Q 2018 for other countries.

Source: Bank Negara Malaysia and Haver Analytics

Malaysia's foreign currency external assets far exceed its foreign currency external liabilities, thus mitigating the impact of ringgit depreciation i.e. bigger increase in external assets than external liabilities when ringgit depreciates

Chart 12: International Investment Position (IIP) by Currency as at end-3Q 2018 (RM bil)



[5] Includes mainly direct and portfolio investments abroad.
[6] Comprises non-resident holdings of domestic debt securities and placement of deposits in the domestic banking system, as well as holdings of equity securities in the form of foreign direct and portfolio investments.

Source: Bank Negara Malaysia and Department of Statistics Malaysia

Excluding international reserves, Malaysia has a small net foreign currency external debt liability position[7]. This further underscores that servicing the external debt obligations will not create a claim on the international reserves

Table 1: Malaysia's Net Foreign Currency External Debt Position (excluding international reserves)

	Foreign-Currency External Debt		
	Assets	**Liabilities**	**Net**
	(RM billion)		
Deposit placements	74.4	43.5	30.9
Bond and notes	91.3	149.3	-58.0
Interbank lending/borrowings	62.5	206.9	-144.4
Intercompany loans	214.5	99.0	115.5
Trade credits	77.9	53.8	24.1
Loans	107.1	91.5	15.6
NR holdings of domestic debt securities	0.0	0.0	0.0
Others	13.6	13.7	-0.1
Total	**641.4**	**657.9**	**-16.5**
% of GDP	***44.8***	***46.0***	***-1.2***

[7] The difference between Malaysia's foreign currency-denominated external debt liabilities (liability side, i.e. borrowings by Malaysian residents from non-residents) and foreign currency-denominated external debt assets (asset side, i.e. lending from Malaysian residents to non-residents).

Source: Bank Negara Malaysia

Monetary and Financial Developments

HIGHLIGHTS

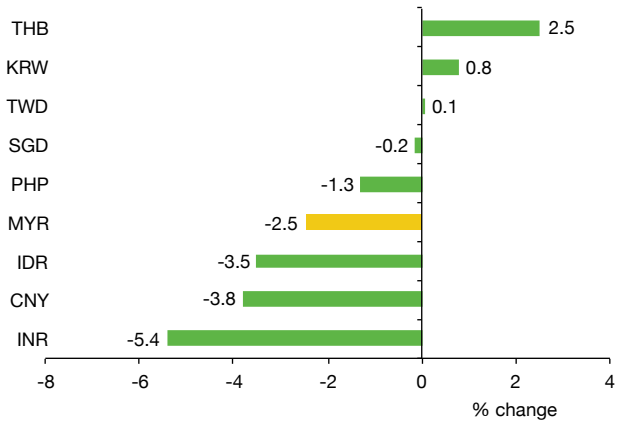
- **The ringgit depreciated along with most regional currencies amid non-resident portfolio outflows and continued strength in the US dollar.**

The ringgit depreciated against the US dollar in the third quarter

In line with most regional currencies, the ringgit depreciated against the US dollar in the third quarter of 2018 as external uncertainties continue to drive non-resident portfolio outflows amid a strengthening US dollar. The continued strength in the US dollar was supported by positive US economic data and outlook. Investor sentiments were also negatively affected by rising trade tensions and concerns over contagion risk from vulnerable emerging market economies. Going forward, the ringgit will continue to be influenced by external uncertainties as well as the trajectory of the US dollar.

Most regional currencies depreciated against the US dollar

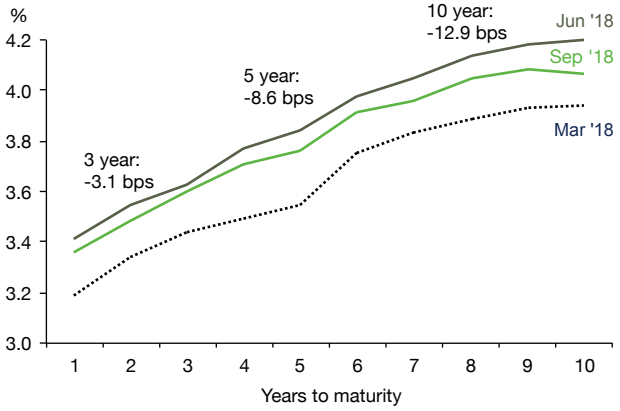
Chart 21: Summary of Performance of Regional Currencies Against the US Dollar (1 July - 28 September 2018)



Source: Bank Negara Malaysia

MGS yield curve shifted downwards during the third quarter

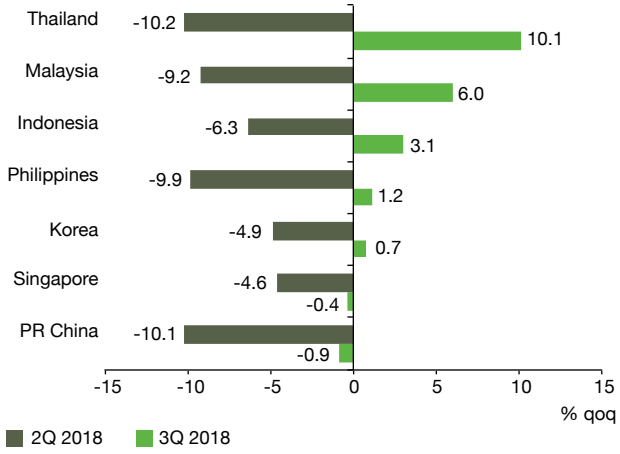
Chart 22: Trend in MGS Yields



Source: Bank Negara Malaysia

Domestic equity market improved during the third quarter

Chart 23: Performance of Regional Equity Markets



Source: Bloomberg

Government bond yields trended lower due to continued demand by domestic institutional investors

Domestic bond yields declined across tenures during the third quarter largely due to sustained demand by domestic institutional investors. This was mainly driven by expectations of supportive economic conditions and greater policy clarity by the Government. In September, however, the trend temporarily reversed, as heightened risk aversion in global financial markets led to further non-resident outflows from regional bond markets, including Malaysia. Total non-resident outflows from the domestic Government bond market during the quarter amounted to RM2.4 billion[3]. Overall, the 3-year, 5-year and 10-year MGS yields declined by 3.1, 8.6 and 12.9 basis points, respectively during the quarter.

FBM KLCI increased in the third quarter driven by positive domestic sentiments

The FBM KLCI recovered strongly in the third quarter, increasing by 6.0% to close at 1,793.2 points as at end-September (end-June 2018: 1,691.5 points). The improved performance during the period was mainly due to active buying from domestic institutional investors, driven by improved clarity on the status of major infrastructure projects, higher crude oil prices and positive earnings results in selected large-cap companies. Externally, however, investor sentiments continued to be affected by lingering downside risks, resulting in non-resident outflows of RM1.7 billion during the period[4].

[3] Source: Bank Negara Malaysia
[4] Source: Bursa Malaysia

Higher real interest rates during the quarter amid lower inflation

Nominal interest rates in the wholesale and retail markets were stable throughout the third quarter. With the 3-month KLIBOR unchanged at 3.69%, interbank rates across other maturities were also broadly stable. In the retail market, both the weighted average base rate (BR) and the weighted average lending rate (ALR) on outstanding loans were stable at 3.90% (2Q 2018: 3.89%) and 5.41% (2Q 2018: 5.43%), respectively.

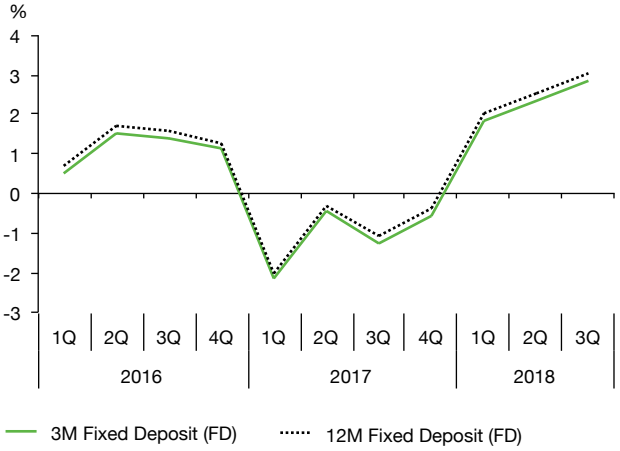
Against moderating inflation, real fixed deposit (FD) rates continued to increase in the third quarter. In particular, the real 12-month FD rate increased to 3.03% from 2.53% in the second quarter.

Liquidity conditions remained sufficient to facilitate financial intermediation

Liquidity conditions In the banking system remained sufficient at both the institutional and system-wide levels. The level of surplus liquidity placed with the Bank remained relatively stable during the quarter, reflecting the moderation of net outflows. At the institutional level, most banks continued to maintain surplus liquidity positions.

Real deposit rates increased, reflecting lower inflation

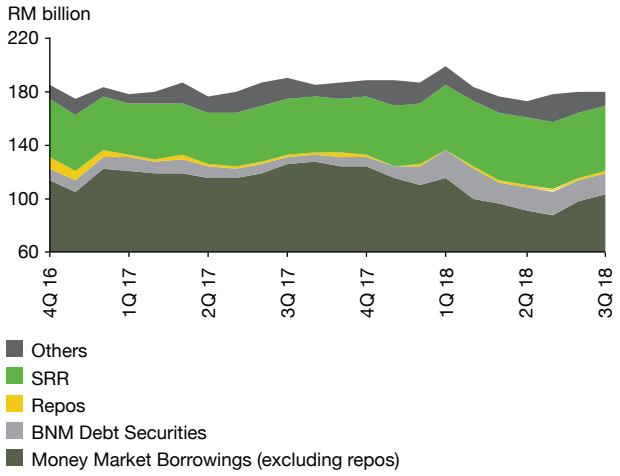
Chart 24: Real Fixed Deposit Rates (by Maturity), as at End-period



Source: Bank Negara Malaysia

Outstanding surplus ringgit liquidity placed with the Bank remained stable

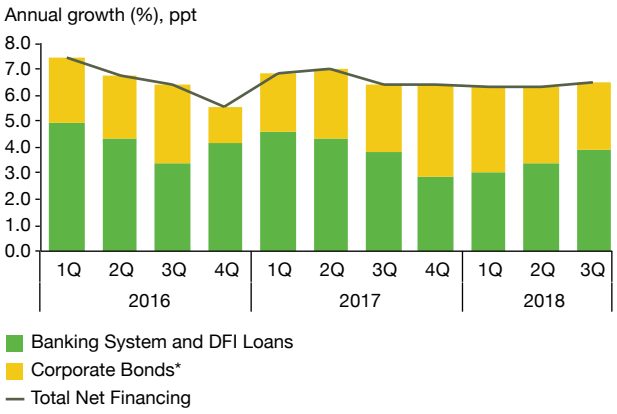
Chart 25: Outstanding Ringgit Liquidity Placed with Bank Negara Malaysia, as at End-period



Source: Bank Negara Malaysia

Net financing growth driven by growth of loans and corporate bonds

Chart 26: Contribution to Net Financing Growth



Note: Net financing comprises outstanding banking system and DFI loans, and outstanding corporate bonds
*Excludes issuances by Cagamas and non-residents

Source: Bank Negara Malaysia

Net financing increased during the quarter

The annual growth of net financing increased to 6.5% in the third quarter (2Q 2018: 6.3%), mainly reflecting the higher growth in outstanding loans[5] of 5.1% during the quarter (2Q 2018: 4.4%). Net outstanding issuances of corporate bonds[6] continued to expand at a double-digit rate of 10.8% (2Q 2018: 12.4%) despite some moderation due to the high base for the same period in previous year. During the quarter, corporate bonds were mainly issued to finance capital expenditure and operating expenses. Total outstanding business loans increased by 3.6% (2Q 2018: 2.2%), driven mainly by the *construction; wholesale and retail trade, restaurants and hotels;* and *manufacturing* sectors. Despite the lower outstanding loan growth for SMEs of 2.4% (2Q 2018: 4.6%), the amount of loans disbursed to SMEs was higher during the quarter (RM77.2 billion; 2Q 2018: RM73.4 billion). The growth of outstanding household loans increased to 5.5% during the period (2Q 2018: 5.3%), driven partly by higher growth of loans for the *purchase of passenger cars,* amid stronger car sales following the zerorisation of the GST rate.

[5] Loans extended by both banking system and development financial institutions (DFIs).
[6] Corporate bonds exclude issuances by Cagamas and non-residents.

The Bank's Policy Considerations

HIGHLIGHTS

- **The MPC maintained the Overnight Policy Rate at 3.25% in July, September and November, assessing that the current monetary policy stance remains supportive of economic activity.**

The OPR remained accommodative

The Monetary Policy Committee (MPC) kept the Overnight Policy Rate (OPR) unchanged at 3.25% at the July, September and November 2018 meetings. At this level of the OPR, the stance of monetary policy remains accommodative and supportive of economic activity.

The Malaysian economy is expected to remain on a steady growth path, with private consumption the main driver of growth, investment activity sustained and exports providing an additional lift to growth, albeit to a lesser extent. Underlying economic factors are providing continued support to domestic economic growth, including low unemployment and a surplus in the current account of the balance of payments.

Headline inflation is expected to increase going forward, primarily due to higher projected global oil prices and the prospective floating of fuel prices. Underlying inflation, which excludes the impact of consumption tax policy changes, is expected to remain contained in the absence of strong demand pressures.

Risks to the global growth outlook remain tilted to the downside, which could cause headwinds to the domestic economy. These include any further escalation in trade tensions; and spillover effects to emerging economies in an environment of greater volatility in the international financial markets and a faster pace of monetary policy normalisation in the advanced economies. Domestically, risks remain from prolonged weakness in the mining and agriculture sectors.

In line with regional economies, the domestic financial markets continue to experience non-resident portfolio outflows due to global developments. Nevertheless, the financial markets remain orderly with domestic monetary and financial conditions supportive of economic growth. Exchange rate flexibility plays an important role as a shock absorber for the domestic economy. The financial sector is sound, with financial institutions operating with strong capital and liquidity buffers. Monetary operations will continue to ensure sufficient liquidity to support the orderly functioning of money and foreign exchange markets and intermediation activity.

Other policy highlights in the third quarter of 2018

Given advancements in technology, coupled with the pace of product innovation by financial institutions, the Bank has issued an exposure draft on Risk Management in Technology. The exposure draft provides a foundation for the development of an effective technology risk management programme, necessary for assessing and mitigating risks identified within technology systems. It is aimed at enabling financial institutions to better manage technology risks and enhance technology resiliency.

The Bank further refined the proposals on Outsourcing taking into consideration feedback received during the first round of consultation in 2017. Given material changes in the requirements, the Bank had issued a second exposure draft on Outsourcing in September 2018 for a one-month consultation period. The feedback received is currently being assessed, the outcomes of which will be incorporated in the final document, which is expected to be issued by end-2018.

The Bank has issued 3 consultative documents to facilitate the practical adoption of Value-based Intermediation (VBI). The Implementation Guide for VBI provides examples of banking practices that illustrate the underpinning thrusts of VBI and highlights key implementation challenges together with potential solutions. The VBI Financing and Investment Impact Assessment Framework (VBIAF)[7] aims to facilitate the implementation of an impact-based risk management system for assessing financing and investment activities of Islamic banking institutions in line with their respective VBI commitment. Meanwhile, the VBI Scorecard[8] covers key assessment components and the proposed measurement methodology for assessing the performance of Islamic banking institutions advancing the VBI agenda.

The Bank has extended the observation period for the Net Stable Funding Ratio (NSFR) reporting by one year to 31 December 2019. During the extended observation period, the Bank will conduct further assessments to validate the maturity and robustness of liquidity and funding practices of banks. At present, all banks maintain adequate liquidity buffers against short-term liquidity stress, with most banks already reporting NSFR levels above the minimum 100% based on observation data.

[7] The paper is jointly developed with the World Bank and INCEIF.
[8] The paper is jointly developed with the Global Alliance for Banking on Values.

Macroeconomic Outlook

HIGHLIGHTS

- **Global economy to grow at a more moderate pace in the fourth quarter of 2018. In 2019, global growth is expected to remain sustained.**
- **The Malaysian economy will continue to remain on a steady growth path in 2018.**
- **Headline inflation is expected to increase going forward primarily due to higher projected global oil prices and the prospective floating of fuel prices.**

Moderating global growth momentum in the fourth quarter of 2018, with sustained performance in 2019

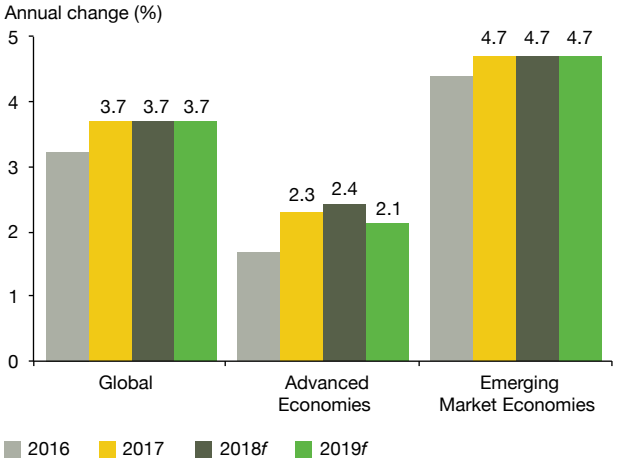
The global growth momentum is projected to moderate in the fourth quarter of the year amidst intensifying trade tensions and tightening financial conditions among several emerging market economies. Going forward, the global economy is expected to expand at a sustained pace in 2019.

The global expansion will remain supported mainly by the advanced economies, particularly the US. Growth in selected emerging market economies (EMEs) will be weighed by slower trade activity amid steady domestic demand. Country-specific vulnerabilities and tighter domestic financial conditions will also weigh on growth prospects of several EMEs.

In advanced economies, strong labour conditions will support private consumption. In the US, the effects from expansionary fiscal policies that were introduced in 2017 and 2018 will continue to support robust business spending for the rest of the year, but is expected to wane in 2019. Meanwhile, investment activity in the euro area is expected to moderate, amid a normalisation in construction-related investments.

Sustained global growth in 2019

Chart 27: GDP Growth



Source: IMF World Economic Outlook (October 2018)

Growth in the Asian region is expected to moderate further. Of significance, growth in PR China is expected to be slower, reflecting ongoing structural reforms in the country. The continued normalisation of the global trade cycle as well as higher tariffs on its exports to the US will weigh on China's exports. In some Asian economies, expansionary fiscal measures are anticipated to stimulate higher infrastructure spending and employment.

Going forward, downside risks to global growth remain elevated. Further escalation of trade tensions will likely be detrimental to global growth and trade. Latest developments suggest that trade tensions are likely to persist in the coming quarters, following the announcement by the US administration of a further tariff hike to 25% from 10% on USD200bn of imports from PR China effective from January 2019. A further increase in tariff on USD267bn of products from PR China has also been proposed, if PR China retaliates.

Downside risks also arise from the ongoing monetary policy normalisation among the advanced economies, particularly the US. Amid rising inflationary pressures, a faster-than-expected pace of interest rate increase could accelerate capital outflows from emerging economies, posing further risk to the global outlook. Given the heightened downside risks, the international financial markets are expected to continue experiencing bouts of volatility going forward.

The Malaysian economy to remain on a steady growth path in 2018

Despite the heightened global trade tensions and tighter financial conditions, Malaysia's economy continued to register a sustained growth in the third quarter.

For the remainder of the year, growth is expected to improve and benefit from the gradual recovery in commodity production. On the external front, higher commodity production would provide support to improvements in commodity exports. However, domestic demand is projected to expand at a more moderate pace, attributed to slower private sector spending. Going into 2019, growth prospects for the Malaysian economy are expected to remain driven by private sector activity amid the continued rationalisation of public sector expenditure, particularly public investment by public corporations. Exports are likely to moderate but would be supported by demand from major trade partners and the gradual recovery in commodities exports.

Risks to growth remain tilted to the downside. These stem mainly from a more persistent-than-expected supply disruption in the commodity sector and a potential escalation of trade tensions between the US and PR China.

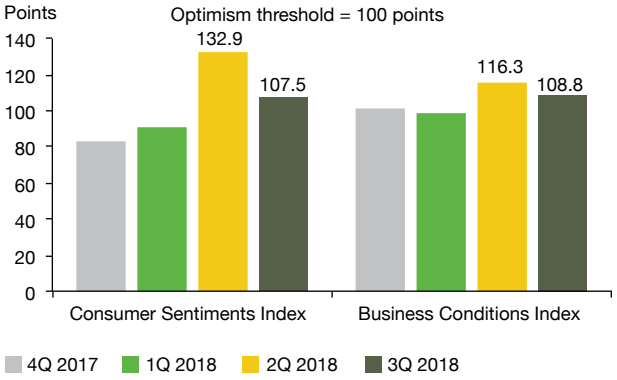
While headline inflation is expected to be low in 2018, it is projected to increase going forward primarily due to higher projected global oil prices and the prospective floating of fuel prices

The annual average headline inflation is expected to be low in 2018, mainly reflecting the impact from the GST zerorisation and the stable domestic fuel prices. Going forward, headline inflation is expected to increase mainly due to higher projected global oil prices and the floating of fuel prices in 2Q 2019. While the impact of the consumption tax policy will contribute to higher headline inflation in 2019, it will lapse towards the end of 2019.

Underlying inflation, which excludes the impact of consumption tax policy changes, is expected to remain contained in the absence of strong demand pressures.

Continued expansion in sentiment indicators in 3Q 2018

Chart 28: MIER Consumer Sentiments and Business Conditions Index



Source: Malaysian Institute of Economic Research (MIER)

Box Article 2

Escalating Trade Tensions and Potential Spillovers to Malaysia

Authors: Muhamad Aizuddin, Lim Boon Seong, Daryl Yong, Chang Wen Huei, Rantai ak Naga, Ooi Kiesha, Catharine Kho

HIGHLIGHTS

- **The recent implementation of higher tariffs by the US on an additional USD200 bn of imports from PR China has raised concerns about how escalating trade tensions will affect global growth and trade.**
- **These trade actions pose risks to growth, but might provide redirection opportunities to Malaysia, most notably, in the manufacturing sector.**
- **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.**

Trade tensions between the US and PR China, which began in the first quarter of 2018 have escalated, with the US implementating higher tariffs on USD200 bn of imports from PR China on September 2018. The US' intention to undertake further trade actions on PR China and other major economies, and its spillover effects to the rest of the world must be carefully considered, especially amid the ongoing moderation in global growth prospects. This box article provides an updated assessment of the potential effects of escalating trade actions on the global economy and Malaysia (refer to BNM Quarterly Bulletin 1Q 2018 Box Article on 'Trade Disputes: Implications for Trade and Investments').

Previous Trade Actions

Trade actions by the US began in early 2018, when the US imposed blanket tariffs of 30%, 25% and 10% on solar panel, steel and aluminium imports, respectively. Since then, the products and countries affected have broadened, and the quantum of goods subject to higher US tariffs have increased. In June, the US allowed exemptions on steel and aluminium tariffs that were previously granted to its major allies, including Canada, Mexico and the EU, to lapse. This resulted in retaliation by the affected countries, who raised their tariffs on US imports. In July, the US implemented its Section 301 tariffs mainly on tech-related imports from PR China worth USD50 bn.

Latest Development

Most recently, on 24 September 2018, the US implemented higher tariffs on more than 5,700 products from PR China worth USD200 bn. The affected items are subject to 10% higher tariffs, which would be further raised to 25% on 1 January 2019. The US also indicated it was considering imposing tariffs on an additional USD267 billion of imports if PR China retaliates. PR China retaliatied by raising tariffs on USD60 bn imports from the US by 5-10%. The tariffs by PR China are expected to be increased to 5-25% in 2019.

In May 2018, the US also announced a proposal to raise tariffs on all automobile imports. This proposal was strongly opposed by the US' major trading partners, particularly the EU. Despite subsequent dialogue between the US and EU to put these tariff increases on hold, trade tensions have the potential to reignite unpredictably until a formal trade pact is established. A consolidated list of past and potential trade actions is summarised in Table 1.

Table 1: Details of Trade Actions

Trade Actions	US	PR China	Other Major Economies
Currently Implemented			
Stage 1 **Jan. – Mar. 2018**	**Blanket tariffs** • Solar panels (+30%) • Steel (+25%) • Aluminium (+10%)		**Retaliation (Canada, Mexico and the EU)[1]** • +10 to 25% on USD3-13 bn worth of US imports
Stage 2 **Mar. – Jul. 2018**	**Targeted tariffs** • +25% on USD50 bn worth of PR China imports	**Retaliation** • 25% on USD50 bn worth of US imports	
Stage 3 **Jul. – Sep. 2018**	**Targeted tariffs** • +10% on USD200 bn worth of PR China imports	**Retaliation** • +5 to 10% on USD60 bn worth of US imports	
Expected to be Implemented			
Stage 3 **Jan. 2019**	**Targeted tariffs** • +25% on USD200 bn worth of PR China imports	**Retaliation[2]** • +5 to 25% on USD60bn worth of US imports	
Potential Escalation			
All remaining bilateral trade between the US and PR China	**Targeted tariffs** • Remaining PR China imports worth USD267bn	**Retaliation** • Remaining US imports worth USD150bn	
Blanket tariff on automobiles and parts	**Blanket tariffs** • Automobiles and parts		**Retaliation (rest of the world)** • Automobile and parts imports from the US

[1] Implementation of retaliatory tariffs when the US' steel and aluminium tariff exemptions to allies lapsed on June 2018
[2] Based on announcement on August 2018

Source: US Trade Representative Office, PR China Ministry of Commerce, Newsflow, BNM estimates

Impact on the Global Economy

The impact of these trade actions on global GDP and trade is analysed through trade and investment channels (refer to BNM Quarterly Bulletin 1Q 2018 Box Article on 'Trade Disputes: Implications for Trade and Investments' for details of the methodology).

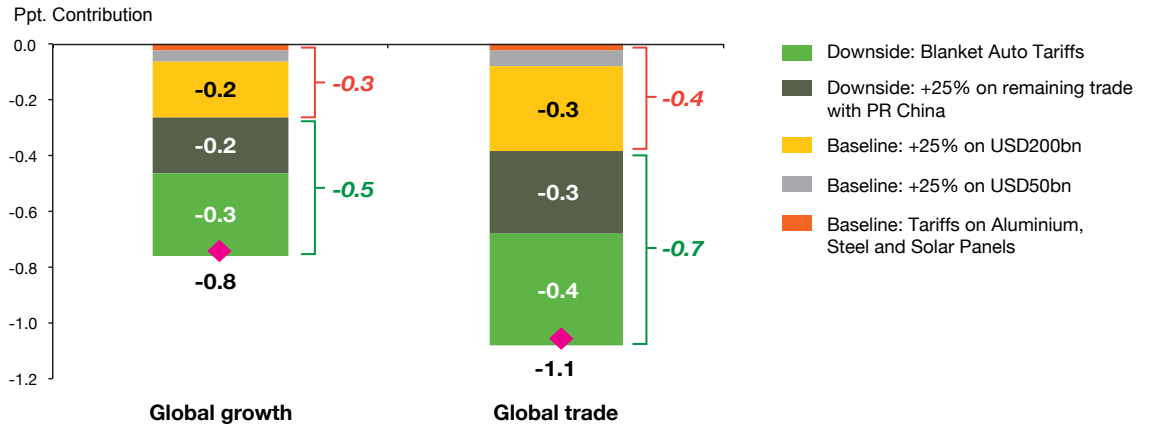
The trade actions that have already been implemented (Stages 1, 2 and 3 in Table 1) are estimated to lead to a reduction in annual global growth of 0.3 ppt[1] (Figure 1). The largest portion of the impact is expected to manifest in 2019 given the timeline of the tariff implementation. This reduction is due mainly to the recent implementation of tariffs on USD200 bn worth of goods by the US, and PR China's subsequent retaliation.

[1] The impact to global growth in 2018 and 2019 are -0.02 ppt and -0.26 ppt, respectively.

Given potential for further escalation in trade tensions following recent announcements of more tariffs by the US, the impact of two downside risk scenarios to global growth and trade is estimated:

1) +25% higher tariffs by the US on remaining imports from PR China worth USD267 bn, and retaliation by PR China[2]; and
2) Blanket tariffs on automobiles and parts by the US, and subsequent retaliation by the affected countries

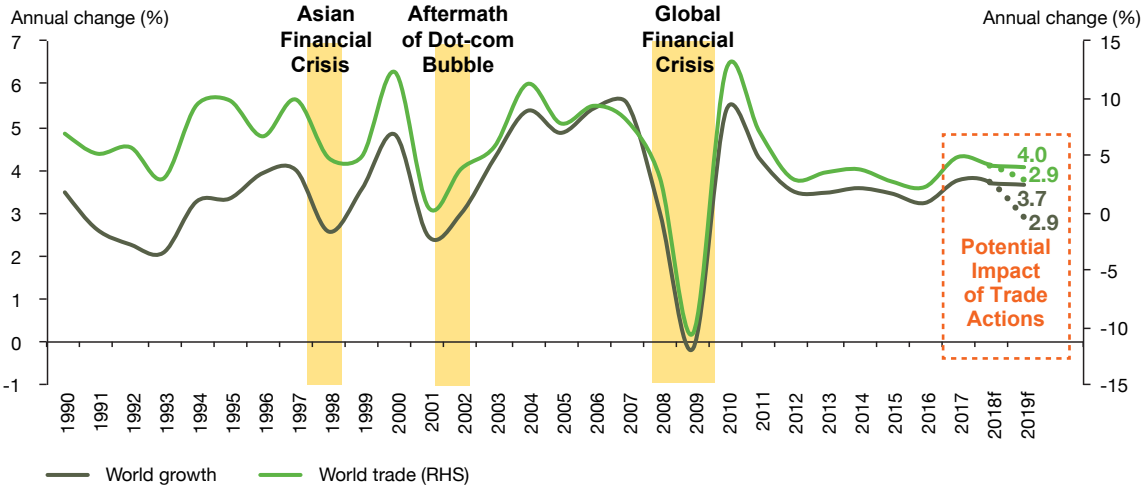
Figure 1: Impact Estimates of Trade Actions on Global Growth and Trade



Source: BNM estimates

The downside risks to global growth and trade will be more severe if trade tensions intensify further. In the scenario of an escalation of tariffs that encompass all remaining trade between the US and PR China, global growth and trade is estimated to be lower by an additional 0.2 ppt and 0.3 ppt annually (Figure 1). If this is compounded by a blanket tariff on all automobile imports by the US, global growth and trade is projected to be lower by a total of 0.8 ppt and 1.1 ppt, respectively. This would rank as one of the major shocks to the global economy in the past two decades (Figure 2).

Figure 2: Long-Term Global GDP and Trade Growth



Source: IMF World Economic Outlook (October 2018), BNM estimates

[2] As the value of PR China's total imports from the US (USD150 bn) is less than the value of the US' total imports from PR China (USD505 bn), trade retaliation by PR China is assumed to be implemented through adjusting its tariff rate to match the impact of the US' trade actions against it.

Impact to the Malaysian Economy

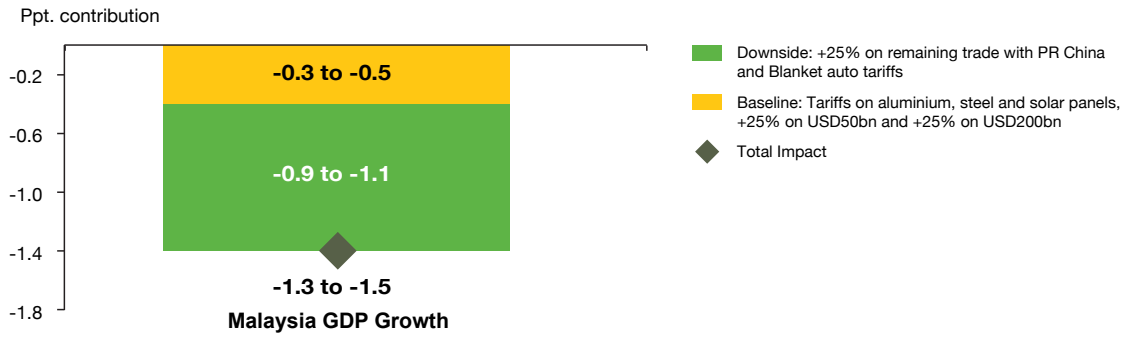
As a small open economy, Malaysia will inevitably be affected by the escalating global trade tensions. The impact of trade tensions to the economy can be assessd via the trade, income and investment channels. With total trade amounting to 131% of GDP[3], Malaysia would be primarily affected via the trade channel.

Malaysia's exports are expected to be affected directly via lower demand from affected countries and indirectly via slower production in the global value chain. Trade protectionism measures implemented since the beginning of this year are expected to weigh down on gross exports by 0.6 – 1.0 ppt. This mainly reflects the lower final demand from PR China, the US and the EU, which account for 38.4% of Malaysia's final export demand. If trade tensions intensify further, the downside risk to export growth will be more severe. In the event that both downside risks materialise, the total impact to Malaysia's exports growth could be a reduction of as much as 1.8 – 2.7 ppt.

Weaker trade activity would also incur some spillovers on Malaysia's domestic economy. In particular, this is expected to weigh on private sector spending mainly through the income and investment channels. For workers, especially those in the export-oriented industries, the moderation in export growth is expected to adversely affect employment and income, in turn, lowering household spending. Lower export orders and proceeds would also have a negative bearing on firms' profitability. As a result, firms' need and ability to invest in capacity expansions are constrained, reducing private investment activity for the year.

Taken altogether, in its current form, trade tensions are expected to weigh down Malaysia's GDP in 2019 by 0.3 – 0.5 ppt (Figure 3). However, the overall impact on growth could be as large as a reduction of 1.3 – 1.5 ppt should both downside risks materialise. It is also important to note that rising trade hostilities could increase volatility in the global and domestic financial markets, thereby posing additional headwinds to growth.

Figure 3: Impact Estimates of Trade Tensions on Malaysia's GDP Growth



Source: BNM estimates

Potential gains for Malaysia from trade substitution opportunities

There could, however, be some potential offsetting effects. Several regional countries stand to benefit from potential trade diversion from PR China. These include Malaysia, Thailand, Indonesia and Vietnam. Collectively, the potential diversion of US' imports away from PR China to other countries is estimated to amount up to USD140 billion[4]. While there is potential for higher exports for individual countries, this would not fully offset the impact of lower global growth on trade activities.

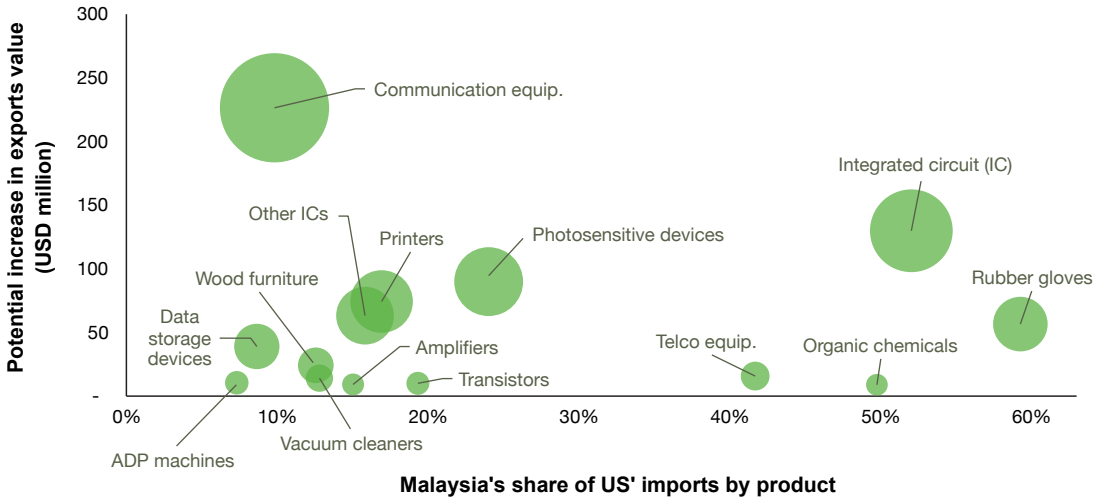
[3] In 2017

[4] Estimated using US' import demand elasticities for the tariffed items to be imposed on Chinese products. The elasticities used are based on the methodology developed by Kee, Niccita & Olarreaga (2008), "Import Demand Elasticities and Trade Distortions". Products with higher elasticities imply larger possibility of diversion from PR China subject upon several conditions (e.g. other countries' capacity to absorb the higher demand).

From this amount, it is estimated that Malaysia could potentially gain from trade substitution up to USD970 million[5]. This includes products in which Malaysia already has meaningful presence in the US (defined as Malaysia's exports that account for at least 5% of US' import market share), coupled with the ability to ramp up production capacity. The products that Malaysia would likely gain from are mostly in the E&E industry, such as electrical machines, electronic integrated circuits and semiconductors for solar panels cells (Figure 4).

Materialisation of trade diversion could reduce the negative impact of trade tensions on Malaysia's gross export growth in 2019 by about 0.1 – 0.4 ppt. This, in turn, would benefit private sector spending, thereby potentially mitigating the moderation in domestic demand and GDP growth.

Figure 4: Malaysia's Exports to the US: Potential Gain from Trade Substitution



Note: Bubble size reflects potential value of gain. For clarity, chart only illustrates US import products in which at least 5% of those imports are sourced from Malaysia.

Source: ITC Trade Map, Global Trade Atlas, BNM Estimates

Anecdotal evidence from firms

Overall, the impact of bilateral trade tensions on Malaysia's export performance is largely dependent on the substitutability of the affected products, manufacturing capacity constraints and Malaysian firms' value proposition. Insights from BNM's industrial engagement[6] has confirmed that several local companies in the E&E industry has benefitted from an increase in orders from the US as companies switch orders from PR China to Malaysia to avoid the high tariff on Chinese imports.

Manufacturing capacity constraints, however, could limit the potential substitution gains for companies. Production constraints could lead to orders for other export markets to be re-routed to different production centres within the global value chain. This has been reported by several local subsidiaries of multinational firms that have only experienced marginal increase in export volume despite trade diversion.

On the other hand, firms affected by the blanket tariffs have reported neutral to mildly negative impact. Some local manufacturers of steel products have stopped exporting to the US following the US' blanket tariff on import of steel products. Meanwhile, manufacturers of solar panels and components have indicated that the US' blanket tariff on solar panels has not affected their exports and production volumes, given the strong demand.

[5] The trade diversion to Malaysia has been adjusted for constraints on capacity utilisation in the manufacturing sector.
[6] Conducted by the BNM Regional Economic Surveillance team.

Conclusion and Policy Strategies

An expansion of the coverage of tariffed products and further retaliation could amplify current trade tensions into a global trade war, in which there will be no winners given the strong trade interlinkages among countries in the current global landscape. Economies affected by the trade actions will not only face weaker growth prospects through lower trade, but also heightened volatility in the financial markets, which will further exacerbate the impact of trade tensions on growth.

In this prevailing environment of heightened global uncertainty, decisive and timely policy strategies are crucial to ensure that Malaysia remains resilient and well-positioned to benefit and mitigate risks from its trade openness. First, structural reforms to improve the flexibility of economic agents to respond to external shocks should continue to be implemented. This includes promoting high value-added industries, diversifying our export products and markets, enhancing labour market flexibility and attracting quality investments that would raise overall economic complexity and create high-value jobs.

Second, Malaysia's position in the global value chain should be re-examined in order to capitalise on opportunities to expand and strengthen our role in the ecosystem. Third, Malaysia must continue to proactively pursue multilateral and bilateral trade pacts with other economies. Importantly, these policy strategies will contribute towards enhancing the resilience and future-readiness of the Malaysian economy.