Box Article 2

Escalating Trade Tensions and Potential Spillovers to Malaysia

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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).

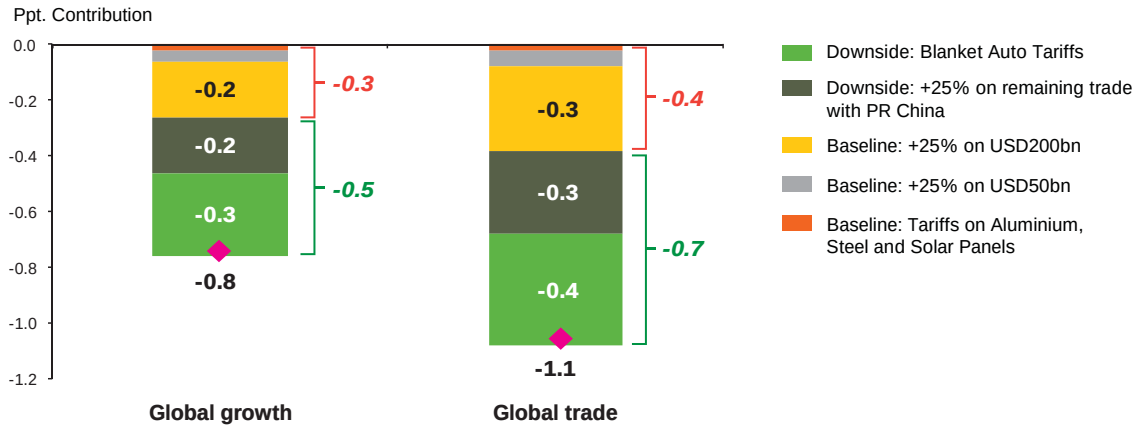
The trade actions that have already been implemented (Stages 1, 2 and 3 in Table 1) are estimated to lead to a reduction in annual global growth of 0.3 ppt[1] (Figure 1). The largest portion of the impact is expected to manifest in 2019 given the timeline of the tariff implementation. This reduction 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

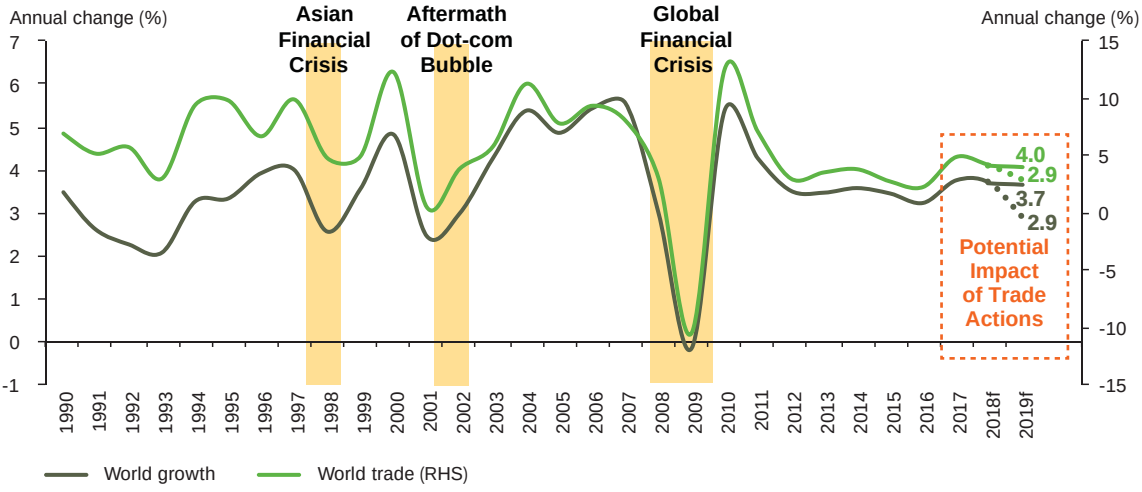
Figure 1: Impact Estimates of Trade Actions on Global Growth and Trade



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

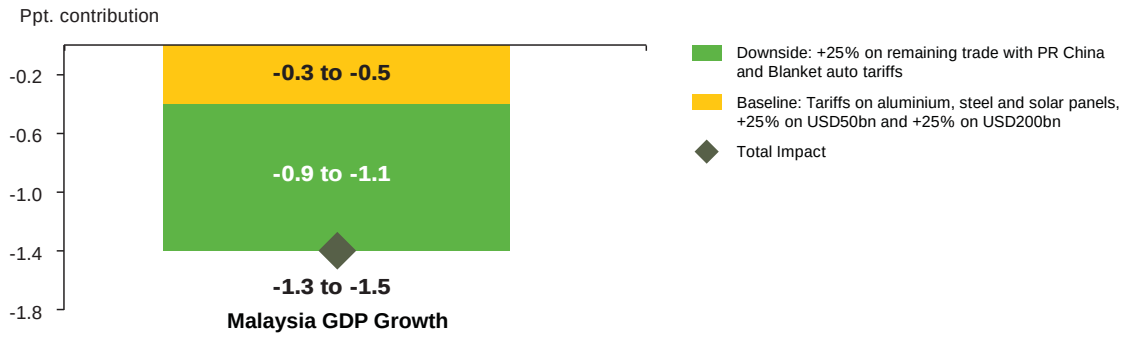
As a small open economy, Malaysia will inevitably be affected by the escalating global trade tensions. The impact of trade tensions to the economy can be assessd via the trade, income and investment channels. With total trade amounting to 131% of GDP[3], Malaysia would be primarily affected via the trade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

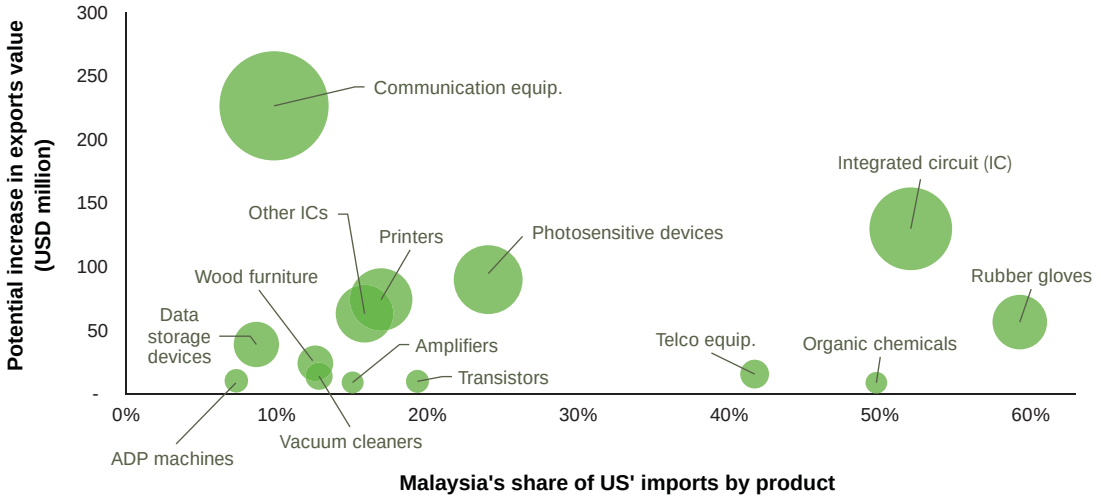
[3] In 2017

[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.