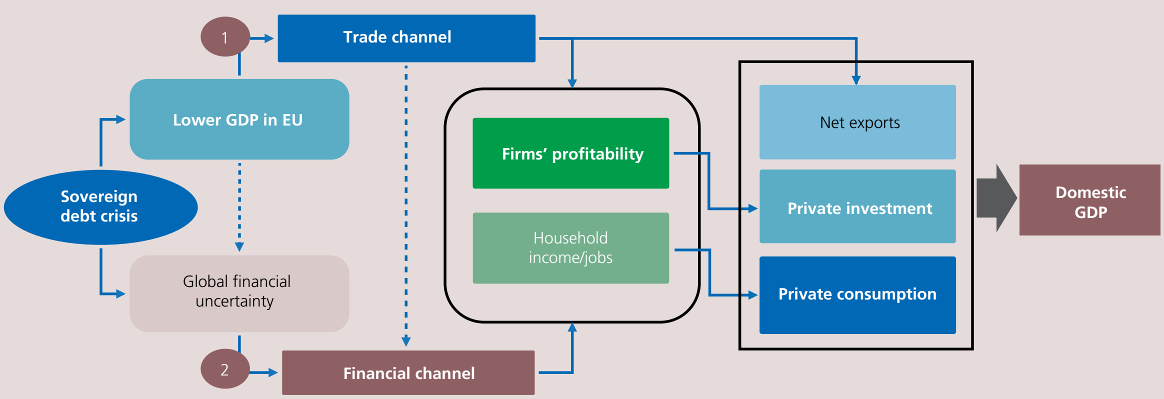
Impact of the European Sovereign Debt Crisis on Malaysia

Introduction

The European sovereign debt crisis poses a key risk to the global economy, as its potential escalation may have significant spillover effects on the real economy and the financial markets. The transmission of the impact of the Euro debt crisis to the Malaysian economy is through two major channels, namely the trade and financial flows (Chart 1). While Malaysia faces downside risks to growth from such external shocks, the resilience of the economy has improved steadily over the years. This is attributable mainly to the country's sound macroeconomic fundamentals, more resilient economic structure, stronger and more developed financial system, and the efficacy and flexibility of its macroeconomic policies.

Chart 1

Transmission of the European Sovereign Debt Crisis to Malaysia



Channels of Transmission to the Malaysian Economy

On the real sector side, Malaysia is exposed to the Euro debt crisis mainly through the trade channel, with potential subsequent spillover effects on private investment and consumption spending. In 2011, Malaysia's direct exports to EU[1] accounted for a relatively small share of 10.4% of total exports (2000: 13.7%). A more complete assessment of trade exposure, however, has to include indirect exports, in particular, exports of intermediate goods that are processed and subsequently exported to EU (Chart 2). Based on an analysis of intermediate goods flowing from Malaysia to the East Asian economies (Chart 3), which are then processed and exported worldwide, the indirect exposure to EU is estimated to be around 3.8% of Malaysia's total exports in 2011[2]. This brings the overall exposure to EU to approximately 14.2% of total exports[3]. The main products exported to EU are E&E manufactures, particularly semiconductors, and computers and parts. The types of goods exported, however, have become more diversified to include more commodity and resource-based manufactured products such as rubber gloves and chemical and chemical products (Chart 4). These changes reduce the nation's vulnerability as exports become less dependent on any specific product.

[1] EU includes all 27 countries in the union.

[2] The method assessed intermediate goods exports to EA8 economies, which are processed and then exported globally, with a smaller share of the goods going to the EU. This method only provides an estimate of the indirect exposure for the purpose of analysis.

[3] Other studies have shown similar results. For example, Pula and Peltonen (2009) argued that based on an updated 2006 Asian Input-Output table, Malaysia's total exposure to EU15 (a smaller group of European countries) is estimated to be 9%.

Chart 2

Direct and Indirect Linkage in Malaysia's Exports, an Illustrative Example

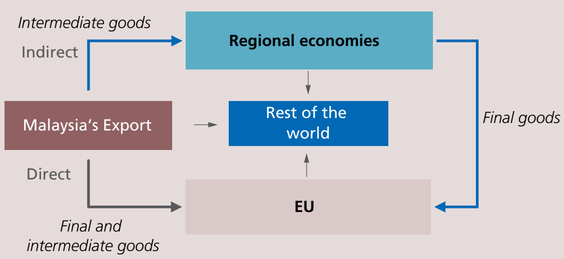
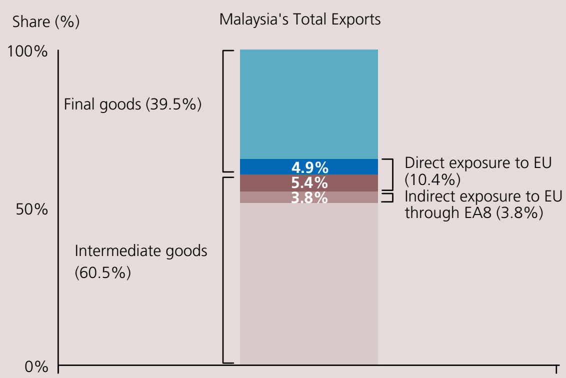


Chart 3

Exposure of Malaysia's Exports to EU



Note: EU includes all 27 countries in the union;
EA8 includes PR China, Hong Kong SAR, Singapore, Korea, Chinese Taipei, Philippines, Thailand, and Indonesia;
Numbers may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 4

Share of Malaysia's Exports to EU by Product

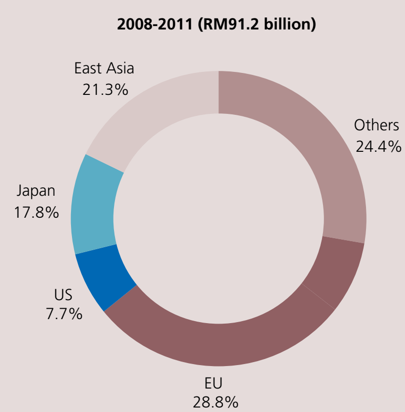
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Shocks to trade may also spill over to other demand components. If such spillover effects materialise, they would have an impact on production activity and capacity utilisation rates, and may prompt businesses to delay investments in new capacity and products. Naturally, the manufacturing export-oriented industries, which account for about 30% of total private investment spending in 2011, will likely be the most affected. More directly, foreign direct investment (FDI) may also be affected, particularly by firms with direct linkages with the EU, and with other major trading partners of Malaysia that are also affected by the crisis. On average, net FDI flows from the EU accounts for about 29% of total net FDI flows into Malaysia between 2008 and 2011 (Chart 5).

Furthermore, firms may undertake cost-cutting measures, including shorter working hours, wage cuts, or even retrenchments. Thus, household consumption spending may be affected by the resultant loss in income, especially among workers in the export-oriented manufacturing sector (about 12.2% of total employment) and in the trade-related services sector, such as transportation services (4.8% of total employment). Ultimately, the magnitude of the spillover impact would depend largely on the size of shock to the trade channel. However, given

Chart 5

Cumulative Flows of Net Foreign Direct Investment by Blocks of Countries



Source: Department of Statistics, Malaysia

Malaysia's diversified trade structure, any shock to Malaysia's overall trade arising from the EU would have a limited impact on the economy.

On the financial side, the impact from the European sovereign debt crisis will be transmitted mainly via increased uncertainty and volatility in the global financial markets, and the attendant rise in deleveraging activity, particularly among European financial institutions. Due to the close correlation that exists across markets and across asset classes, the heightened uncertainty in global financial markets may lead to significant volatility in the movement of cross-border capital. Uncertainty in the financial markets could affect not only confidence and subsequently domestic spending, but may also dampen fund-raising activity of businesses. At the same time, the weaker capital positions of some European banks create concerns that deleveraging by these institutions may restrain the availability of credit, including trade credit.

Malaysia, however, is somewhat insulated from the deleveraging by European banks. In Malaysia, all foreign banks are locally-incorporated subsidiaries with dedicated capital committed to the Malaysian operations as required under the Malaysian banking legislations. These subsidiaries are funded domestically, well-capitalised and are subject to the same standards of rigorous supervision and regulation that Bank Negara Malaysia imposes on domestic-owned banks. Given the strong and consistent financial performance and sustainable returns of the Malaysian operations of the locally-incorporated European banks, a material scale back of Malaysian operations as a result of deleveraging by the European parent banks is unlikely. Even in the unlikely event of a wide-scale retreat of European banks from the Malaysian market, domestic intermediation activity would continue to be well-supported by the domestic-owned and non-European banks in Malaysia that are well-capitalised and have strong liquidity positions. A more detailed exposition of the impact of external developments on the Malaysian financial system can be found in *Managing Contagion from External Developments* from Chapter 1 of Bank Negara Malaysia's Financial Stability and Payment Systems Report 2011.

Resilience of the Malaysian Economy

Malaysia's resilience and capacity to withstand the Euro debt crisis, and other potential external shocks from its major trading partners, have steadily improved over the years. Malaysia's strength could be broadly classified into four broad areas, namely sound macroeconomic fundamentals, more resilient economic structure, stronger and more developed financial system, and greater policy efficacy and flexibility.

The economy has been on a steady growth path, in an environment of low and stable inflation, while the financial system is now more developed with improved regulatory and supervisory structures. The external position remains favourable, with a sustained current account surplus and a high level of international reserves providing the buffer against the volatility in global financial flows.

Moreover, the economic structure has grown to become more resilient. Trade has become more diversified both in terms of products and markets. Malaysia's reliance on trade with the advanced economies including the EU is now smaller. The direction of trade has shifted progressively towards the regional economies, reflecting robust final demand amid the rising affluence of a large and expanding middle-class population in Asia. As a result, Malaysia's trade with the East Asian economies has surpassed that with the advanced economies, accounting for 47% of total exports in 2011 (2000: 40.2%). In terms of product mix, Malaysia's exports have also become more diversified, as its dependence on E&E exports has declined, with higher exports of commodities and non-E&E manufactured products. At the same time, domestic demand has been an anchor of growth in the Malaysian economy for the past few years, especially household consumption spending, benefiting from the steady increase in incomes and continued access to financing. These healthy fundamentals and a more resilient economic structure, therefore, place the economy in a better position to endure external shocks to the economy.

The financial system is also on a stronger footing. The domestic financial markets are deeper and broader, and the range of counterparties have over the years become more diversified, which means that financial shocks such as volatile capital flows can be absorbed more effectively. Having a broad range of instruments for monetary operations has also increased the efficiency of domestic liquidity management. Greater exchange rate flexibility through the managed float regime and high external reserves provide the necessary flexibility to adjust to external shocks. In addition, intensified supervision and a strengthened regulatory framework have ensured that financial globalisation and openness do not undermine the stability of the domestic financial system. Of significance, Malaysian banking system has remained resilient, supported by strong financial buffers even during the peak of the Global Financial Crisis. Given the prudent levels of capitalisation, a stable ringgit deposit-based funding structure, and limited exposure to European counterparties, Malaysian banking institutions are well-positioned to withstand potential shocks emanating from the more challenging external environment.

More importantly, unlike the crisis-affected countries, there are no domestic imbalances to constrain the transmission of policy impulses. Inflation is low, while household debt is still at a manageable level. Impaired loans of businesses have been on a declining trend. There is, therefore, flexibility to implement counter-cyclical policies to manage potential shocks coming from the external environment.

Conclusion

The European sovereign debt crisis poses a key downside risk to domestic growth prospect. Thus far, the impact on the domestic economy has been manageable. While Malaysia continues to face risks from potential escalation of the Euro debt crisis, the economy has sufficient buffers against shocks emanating from the external environment. Sound macroeconomic fundamentals, a resilient economic structure, a stronger and more developed financial system and the authorities' ability to implement policies effectively and efficiently are expected to put Malaysia in a good position to manage potential external shocks to the economy. Nevertheless, given the possible scale and intensity of the shocks from Europe, domestic policy makers are in a high state of vigilance in monitoring and assessing the situation. In this respect, closer cooperation among regional authorities will contribute to efforts to improve regional surveillance and monitoring systems against potential shocks, in particular, from volatile capital flows into the region. Malaysia has been active in promoting policy surveillance and coordination with other regional economies to further strengthen the country's and the region's defense mechanisms against external shocks.