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Navigating Geoeconomic Balance: BRICS, Global Shifts, and Malaysia's Role

Trading Nation Must Deal with Decoupling Dynamics Amidst Fragmenting Landscape

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Scepticism about globalisation has increased. The US-Sino economic rivalry, Covid-19 pandemic, conflict in the Ukraine and the recent escalation of tensions in the Middle East have placed pressure on globalisation, upending the long-term trend of universal economic integration. Current trends point to a gradual fragmentation of a highly integrated financial and economic system with major power blocs seeking to decouple dependence from one another.

Global cooperation is slowly realigning; major economies are adopting a policy of strategic autonomy aimed at reducing economic dependency in various key sectors, which could potentially lead to geoeconomic fragmentation and zero-sum reasoning. Recent moves, such as the scrutiny over Chinese investments and trade in strategic sectors by US and EU authorities, serve as an important reminder that the strategic rebalancing of global trade remains an ongoing geoeconomic agenda. Moreover, such strategies encourage countries on the global periphery – such as Malaysia – to machinate their own brand of geoeconomic hedging, exercising caution, and examining the shadows of great powers.

Geopolitical tensions often imply adverse consequences for macro-financial stability. The imposition of financial restrictions, increased policy uncertainty and heightened risk aversion associated with these could exacerbate decoupling. Such policies might cause investors to reallocate their portfolios and reconsider credit lines along geopolitical fault lines, leading to unpredictable capital flows and declines in asset valuations. A fragmented geoeconomic landscape along geopolitical allegiances could, therefore, make the world more vulnerable to adverse shocks amid insufficient risk diversifications.

Against this backdrop of geoeconomic fragmentation, strategic realignments have emerged, including one in which the Global South could widen its influence in the world's financial architecture. Groupings like BRICS, a loose alignment of Global South nations, have stated their intent to explore new mechanisms to diversify traditional cross-border settlement systems, despite substantial challenges. Increasing discussion of cross-currency trade to strategically leverage against the dollar-dominated system in global finance is still in its early stages and has emerged somewhat in reaction to an increasingly weaponised dollar against geopolitical “threats” and “rivals.”

Notably, the future entry of trade-friendly, middle-income states like Malaysia and Thailand into BRICS might create further momentum for a more diversified global financial architecture. While long-held reliance on the traditional dollar-based trade system is unlikely to be upended any time soon, due to the entrenched role of traditional financial systems and institutions, new possibilities are emerging that could refocus the global economic and financial balance towards the Global South.

BRICS: Geopolitical Power Shifts or Pragmatic Alliance

BRICS, an acronym for Brazil, Russia, India, China, and South Africa, is primarily a forum for economic cooperation among emerging markets that aims to combine their geoeconomic weight and influence to promote the rights and interests of the Global South, particular in G20 and WTO talks and negotiations. BRICS is also presenting itself as an opportunity to deepen financial and market interlinkages and diversify the global payment architecture as declared at the 2023 BRICS summit[1].

In particular, the BRICS Payment Task Force (BPTF) announced plans to develop a report on the exploration of cross-border payment mechanisms, emphasising national currency use in trade and financial transactions. The strong desirability of national currency utilisation within and outside BRICS members has been a long-discussed topic, allowing flexibility both in settling balance of payments and financing national debts. Noting the undeniable role of the US dollar in global trade (making up 88% of foreign exchange transactions, 58% of global foreign exchange reserves and 55% of trade invoicing in 2023), the declaration deliberately avoided confrontational language and, crucially, was not proposed as a counterbalance against the prevailing role of the dollar-backed financial system.

Nevertheless, in a new age of geopolitical uncertainty, it signals that more nations are at least contemplating diversifying their financial options beyond the dollar for trade, especially in a time of geostrategic uncertainty. This effort is, however, driven by different levels of national security concerns. For countries like Russia and Iran, in particular, whose economies have been deeply affected by US sanctions, the internationalisation of national currencies is far more likely to serve a primary geoeconomic agenda. For nations like China, however, although already subject to some trade restrictions, primarily in sector-specific high-tech goods and sectors linked to human rights concerns, the possibility of facing more aggressive US trade action amid an escalating US-Sino trade rivalry is enough to place BRICS settlements high on its agenda to ensure market access.

In contrast, for Brazil, India and South Africa, BRICS serves both as a platform for WTO cooperation and possibility for more diversified trading options with major consumer markets in the Global South. Nevertheless, another major driver for BRICS financial integration may be two-fold: first, the use of national currencies to raise debt mitigates exchange rate risk exposure compared to borrowing in dollar terms. Second, by encouraging the use of their own currencies, BRICS countries may also diversify their foreign exchange reserves, providing strategic autonomy in the global financial system. For some nations in the bloc, keeping strategic reserves in US dollar is often seen as a geoeconomic vulnerability – despite its stability and liquidity – should relations with the US deteriorate and sanctions expand.

BRICS | Brazil, Russia, India, China, and South Africa

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The economies of Russia and Iran have been deeply affected by US sanctions. China faces more aggressive US trade action amid an escalating US-Sino trade rivalry. Brazil, India and South Africa are a platform for WTO cooperation and possibility for more diversified trading options with major consumer markets in the Global South.

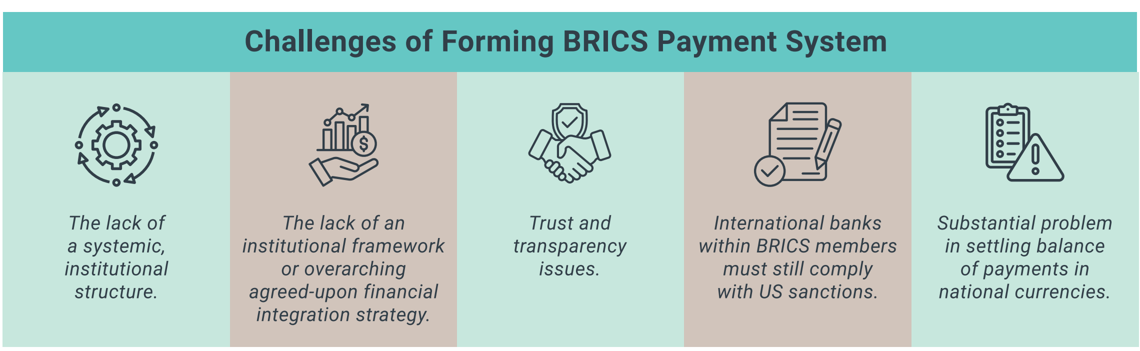
[1] *D.R.Chaudhury. 21 August 2023. The Economic Times. "15th BRICS Summit: BRICS expansion, national currency use among top agenda". https://economictimes.indiatimes.com/news/india/15th-brics-summit-brics-ex*

Diversifying Global Financial System Remains a Complex Task

Despite the political intentions of its members, forming a BRICS payment system remains a substantial challenge. The lack of a systemic, institutional structure within BRICS hinders meaningful integration. While its flexibility may be attractive to Global South states, as it does not place many obligations on its members, the lack of an institutional framework or overarching agreed-upon financial integration strategy prevents any meaningful financial integration. Trust and transparency issues, even between BRICS founding nations like China and India, whose relations remain hostile over border disputes, could complicate cross-currency settlements and the expansion of both currencies as a diversified reserve.

Additionally, it is important to note that international banks within BRICS members must still comply with US sanctions. Due to the financially integrated nature of many BRICS members and BRICS aspirants with the US-centric financial settlement system (this also applies to China), most commercial banks may not be willing to facilitate trade in sectors where US sanctions are most aggressively enforced, fearing secondary retaliation. This is evident given that even the New Development Bank (NDB), often referred to as the "BRICS Bank," continues to employ the US dollar to finance large-scale transactions[2]. Such arrangements underscore the complexities involved in establishing diversified financial systems.

Lastly, the BRICS architecture presents a substantial problem in settling balance of payments in national currencies. Due to the less ubiquitous nature of non-US dollar currencies, a surplus of one nation's currency may not be readily convertible with other BRICS and non-BRICS members for settlement. Consider, for instance, in bilateral trade relations between Russia and India, where due to the former's trade surplus with India, there is an excess of rupees held by Russian banks. As such, if India is unable to produce the goods Russia wants to import, there are issues of convertibility that create currency imbalances that need to be resolved. Likewise, more advanced real-time algorithms and a robust system of currency convertibility will also need to be developed. Of course, as the economic and trade landscape within the bloc is highly China-centric, the Chinese yuan could, in principle, be used to link payments from one BRICS nation to another. However, whether China is ready to freely internationalise the yuan, and whether other BRICS members are willing to attach themselves to the yuan, is debatable.



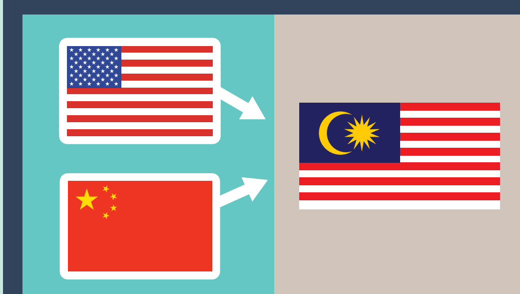
[2] Projects. New Development Bank Official Website. "Project portfolio by currency". https://www.ndb.int/projects/

Nevertheless, even such issues may still not be a hindrance to the political will of establishing diversified financial channels in the long term. While challenging, ultimately, current narratives among BRICS nations suggest that they are seeking creative solutions to such obstacles. It is likely that BRICS could form workarounds from US-sanctioned sectors and prioritise more trade and investment in neutral sectors like food, medical devices, and pharmaceuticals. Likewise, more serious balance of payments issues could find a common solution through the expansion of the BRICS Contingent Reserve Agreement (CRA) in stabilising and managing currency volatility and risk. In this regard, the potential for alternate settlement options offers promising advantages to Malaysia's trade-centric economy and foreign policy, catering to a multipolar world order where US sanctions are increasingly weaponised amid a more scrutinous global trade landscape.

Strategic Considerations for Malaysia's Entry into BRICS

BRICS's strategic positioning as a cooperation group of Global South nations has caught the attention of middle-income aspirants like Malaysia, which have for decades been closely integrated with both US and Chinese markets. Being situated in the heart of Southeast Asia, its trade flows are highly influenced by the vast economic gravity of China. Meanwhile, Malaysia's vibrant position and aspirations as a key intermediate supply chain player for US semiconductor companies is indisputable.

While it may seem that Malaysia's economy compared with the rest of BRICS is starkly different, with the latter being countries that command significant land mass and population size, Malaysia is keen on taking a long-term approach to trade. Forecasts by PricewaterhouseCoopers (PwC) in 2017 indicate that by 2050, China is set to overtake the US economy, with India overtaking the US in second place3. Indonesia, Russia, and Brazil will also rise to take the fourth, fifth and sixth places. Both the US and the EU will see their shares of global GDP decline, and by 250, the seven largest emerging economy nations could potentially be double the size of the G7. Malaysia is undertaking a pragmatic long-term and forward-looking gamble managing its economic and trade relations with the Global South.



Malaysia is closely integrated with both US and Chinese markets.

PricewaterhouseCoopers (PwC) in 2017 indicated that by 2050, China would overtake the US economy, India overtake the US in second place, and Indonesia, Russia, and Brazil rise to take the fourth, fifth and sixth places.

[3] *PriceWaterhouse Coopers (PWC). February 2017. The Long View: How will the global economic order change by 2050? https://www.pwc.com/gx/en/world-2050/assets/pwc-the-world-in-2050-full-report-feb-2017.pdf*

In the medium term, as Malaysia sees rising US-Sino tensions in the region gradually becoming more hostile, BRICS might be best seen as complementary to its multilateral engagement strategy and an opportunity to leverage on its trade openness to expand trade with both China and peer-emerging economies while maintaining neutrality with developed economies. Thus, the entry of Malaysia into BRICS, it is hoped, will enhance its mediating role as a connector economy in an increasingly multipolar world. Indeed, Foreign Minister Mohamad Hasan has stated that Malaysia's desire to join BRICS is to "ensure the country does not contribute to a unipolar world" but rather, as a platform to amplify the voice of emerging economies across many international platforms and promote the economic rights of the developing world[4]."

From a geoeconomic standpoint, Malaysia's interest in BRICS could also extend to the international use of the US dollar in its balance of payments. As a small but significant trading nation (with total trade more than 140% of GDP), the relative strength of the US dollar vis-à-vis the ringgit has created balance of payments issues as import costs increase. A point which Prime Minister Datuk Seri Anwar Ibrahim has repeated several times, calling for an Asian Monetary Fund to "de-dollarise" the international trading system[5]. Critics have likewise claimed that Washington has been misusing its "exorbitant privilege" as the world's reserve currency to strangle non-friendly economies through unilateral sanctions[6].

Nevertheless, the diversification of global settlements is still unlikely to be an immediate national security priority as Malaysia sits highly integrated within the prevailing US-centric system. Indeed, with more than 80% of Malaysia's trade conducted in dollar-backed transactions, the status quo still dominates[7]. Similarly, reading too much into Malaysia's "China factor" is deceptive. For instance, Malaysia joined the US-led Indo-Pacific Economic Framework (IPEF) far earlier before expressing any intention for BRICS. Moreover, Anwar continues to pitch Malaysia as a "neutral and non-aligned" host for lucrative US semiconductor investments and that his government would continue to attract US$100 billion in investments amid the US-China tech rivalry.

However, Malaysia's own anxieties of possible US sanctions are not unfounded. For instance, Anwar's vocal response to not recognising unilateral US sanctions on Iranian oil, and his refusal to sanction Palestinian groups like Hamas[8] have invited the threat of secondary retaliation from the US. Already, the US Treasury has slapped sanctions on four Malaysian entities in December 2023 on accusations that they violated sanctions in exporting components to Iran to produce drones for militant proxy groups in the Middle East[9].

Malaysia is reading the writing on the wall as a signal that more intense global geoeconomic decoupling is underway. It is likely then that Malaysia may intend to leverage on a nascent BRICS settlement mechanism, especially if such decoupling intensifies or if the outcome of the 2024 US elections places more nations and their supply chains under the ire of Washington. Ultimately however, the consensus within Malaysia remains cautiously optimistic with a view to the upside on preparing for a future of greater geoeconomic flexibility.

[4] *Bernama News. 26 June 2024. "Malaysia has to be cautious in positioning itself in relations with other countries, Dewan Rakyat told". https://www.bernama.com/en/news.php?id=2311817*

[5] *Reuters. 10 October 2023. "Malaysia pursuing more de-dollarisation, increasing trading in local currency – PM". https://www.reuters.com/article/markets/currencies/malaysia-pursuing-more-de-dollarisation-increasing-trading-in-local-currency--idUSP8N34V028/*

[6] *A. Panetta. 13 March 2022. CBC News. "The U.S. has unleashed weapons of financial destruction, and economists are watching for long-term fallout" https://www.cbc.ca/news/world/us-reserve-currency-1.6382567*

[7] *Promoting Monetary Stability. 2023. Bank Negara Annual Report 2023. "Promoting Cross-border Local Currency Settlement (LCS)." Bank Negara Malaysia.*

[8] *Z. Saieed. 9 May 2024. "Malaysia rebuffs US on Iran oil sales, says it recognises only UN sanctions". The Straits Times. https://www.straitstimes.com/asia/se-asia/malaysia-rebuffs-us-on-iran-oil-sales-says-it-recognises-only-un-sanctions*

[9] *R. Rahim. 9 May 2024. "Sanctions imposed on four Malaysian-based companies accused of helping Iran have been impactful, says US Treasury official". The Star. https://www.the star.com.my/news/nation/2024/05/09/sanctions-imposed-on-four-malaysian-based-companies-accused-of-helping-iran-have-been-impactful-says-us-treasury-officia*

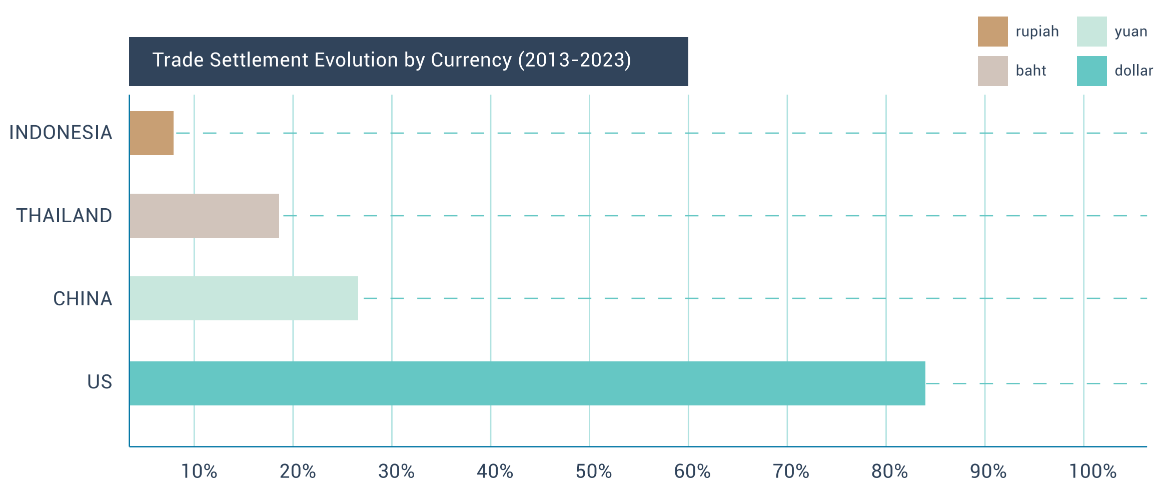
Future of Malaysia's Financial Architecture

BRICS, which started primarily as a geoeconomic initiative to facilitate the diversification of economic clout towards the Global South, has grown into a multilateral platform representing the common interests of emerging powers. However, with US-Sino trade tensions likely to escalate in the near and medium term, the strong trade relations ASEAN states have developed with China over the past decade conflict with their dependence on the US-based international financial system for trade. This leaves ASEAN feeling vulnerable and, as such, it continues to promote cross-currency settlement mechanisms as a workaround in response to possible hostile scenarios. It makes geostrategic sense, therefore, that the 42nd ASEAN Summit would promote the use of local currency transactions.

There exists a substantial gap between such geoeconomic concerns and reality. Peering into Malaysian trends reveals interesting details on the extent of cross-border local currency settlements. Over the past decade, Malaysia's relative trade share with China and ASEAN increased collectively by 6 percentage points to 44%, while trade with the US declined by 2 percentage points to 10%. Despite this, the bulk of Malaysian trade (82%) in 2023 continued to be settled in US dollars. The overriding preference for the greenback among local exporters is largely to ensure that dollar incomes match their external debt exposure, while also ensuring the ease of cross-border settlements among large corporations. This phenomenon is not unique to Malaysia, as the dominance of the dollar is structural to global settlements[10].

However, the expansion of the yuan and ASEAN currencies in bilateral trade is a noteworthy emergence. A decade ago, cross-border yuan settlements were virtually non-existent but in 2023, 27% of Malaysia's trade settlements with China used local currencies. Similar observations can be made about inter-ASEAN trade where now 16% of settlements in 2023 were done through local currencies, constituting 19% of trade with Thailand and Indonesia (8%) compared with 6% and 5% a decade ago.

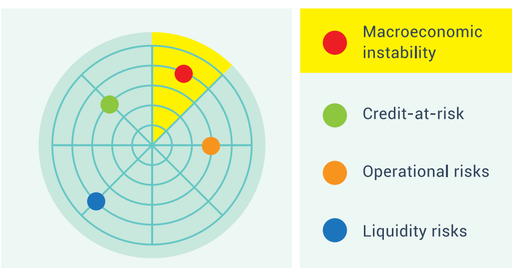
In this there appears to be, at least on the surface, synergic opportunities between the ASEAN and BRICS bloc. It is likely that the push for cross-currency settlement mechanisms will remain a key policy agenda.



[10] Ibid.

Diversifying Global Financial System Remains a Complex Task

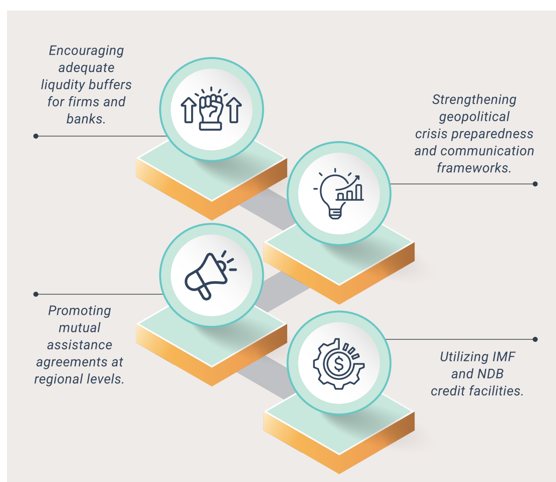
The spectre of more intense financial decoupling poses multiple risks and challenges to future macroeconomic stability of the global financial order. In a "real economy" sense, disruptive bifurcation policies that concentrate supply chains among geostrategic allies impacts macro-level growth and inflation, and creates adverse credit exposures, ultimately reducing both risk diversification and asset price stability. From a firm-level perspective, this primarily means increased risk premiums and funding costs, lower profitability and eventually, less liquidity in the macro economy. Ergo, banks with lower capitalisation ratios are likely to be more adversely impacted than banks with greater capital buffers against geopolitical risks.



Indeed, a 2023 panel data analysis by the IMF confirms that an increase in "geopolitical distance" with foreign creditors has significant adverse impacts on banking performance indicators. On average, emerging markets experienced a 0.6% increase in banks' funding costs, resulting in total loan disbursements falling by over 6% (with a 13% drop recorded in extreme cases). Moreover, when controlling for banks with high (more than the 75th percentile) versus low capitalisation ratios, profitability for the latter group declined 15% more than their highly capitalised bank counterparts[11].

Therefore, Malaysian policymakers should be aware of the macro-financial risks associated with a sudden global rise in geopolitical tensions, especially if this spills over into more heated conflict. Firms and financial institutions reliant on external financing should, in response to such risks, ensure adequate liquidity buffers and safety nets. The transmission of geopolitical shocks should consider the quantification of credit-at-risk, liquidity, and operational risks in the supply chain, calibrated and stress-tested to protect against the losses of tail risks.

Policymakers should also encourage and strengthen geopolitical crisis preparedness, communication, and management frameworks to deal with potential financial and non-financial instability arising from escalations in geopolitical tensions, not only at the national but also regional level. Moreover, mutual assistance agreements could help smaller nations manage such shocks. In particular, the International Monetary Fund (IMF) and the NDB could play an important role in the mitigation of risks through credit facilities and policy advice.



[11] Global Financial Stability Report. April 2023. Chapter 3. "Geopolitics and financial fragmentation: Implications for macro-financial stability." International Monetary Fund (IMF)

Geopolitically, Malaysia's interest in BRICS also seems to mirror the ambitions of other non-aligned, trade-oriented members like the United Arab Emirates (UAE), where the nation remains staunchly non-aligned. Like Malaysia, the nation considers its BRICS membership as a strategic opportunity to enhance its trade access to new markets in the Global South while maintaining neutrality with Western markets. The UAE is also a shareholder in the NDB, providing loans for development financing projects in emerging markets while leveraging on diversified financing options for its consumers. This leaves open the possibility for deeper bilateral partnerships and synergies between both Malaysia and the UAE, such as creating new innovative financial tools in Islamic financing, leveraging on global business opportunities in other emerging markets and providing technical support.

While the impact of BRICS is unlikely to usurp the global financial architecture's status quo any time soon, in the new global landscape of shifting geoeconomic groupings and the possible election victories of populist candidates in advanced economies, it is best to err on the side of caution, keeping in mind that the needle of global trade could move in more rapid and unpredictable directions should trade tensions worsen.

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