CARBON BORDER ADJUSTMENT MECHANISM

Implications of EU CBAM to Malaysian exporters

KEY HIGHLIGHTS

- **The Carbon Border Adjustment Mechanism (CBAM) is a policy proposed by the European Union (EU) on 14 July 2021 and will begin to operate from October 2023 onwards in its transitional period. It is expected to enter its permanent system in 2026.**
- **EU's CBAM would initially apply to certain sectors that are particularly carbon intensive and are at most significant risk of carbon leakage such as cement, iron and steel, aluminium, fertilisers, electricity, and hydrogen.**
- **Starting October 2023, Malaysian exporters to the EU are required to report GHG emissions and companies exporting to the EU are required to buy carbon certificates.**
- **Exports of Malaysian SMEs are mainly contributed by the manufacturing and services sectors.**
- **The government also has plans to introduce key enablers and infrastructure to facilitate the transition towards a low carbon economy such as the Bursa Carbon Exchange (BCX), where Bursa Malaysia's introduction of the BCX is timely.**
- **EU's CBAM could impose significant compliance costs.**
- **Additionally, companies in the supply chain that support these exporters may also experience the impact of the CBAM.**

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INTRODUCTION TO THE CARBON BORDER ADJUSTMENT MECHANISM

Policy targeting imports to EU. The Carbon Border Adjustment Mechanism (CBAM)[1] is a policy proposed by the European Union (EU) on 14 July 2021 to address the risk of carbon leakage by targeting imports of certain goods that have greenhouse gas (GHG) emissions embedded in them. The CBAM aims to impose a carbon price on certain imported goods based on their carbon footprint, like the Emission Trading Scheme (ETS) within the EU.

It was first mooted by The European Commission in 2019[2], where a proposal for a carbon border adjustment mechanism was outlined as one of its key actions to set the EU on the path to a green transition and for the EU's ambitious plan to achieve climate neutrality by 2050.

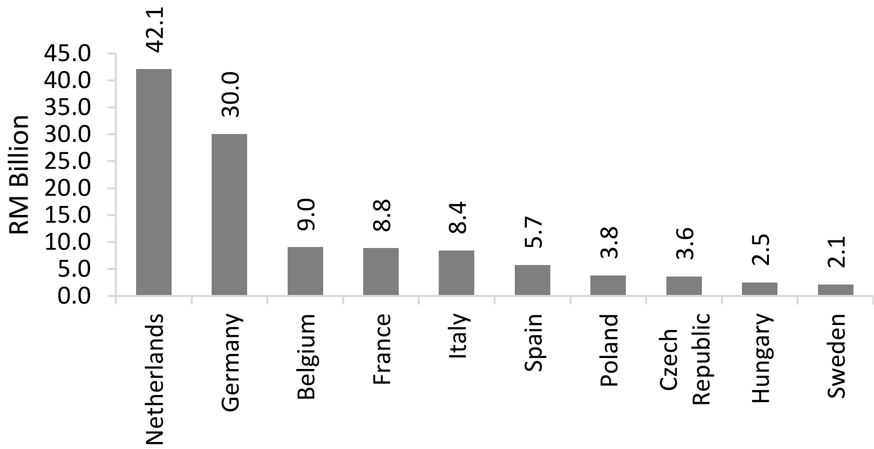
Will be operational from October 2023. On 13 December 2022, the EU Parliament reached a provisional agreement with the EU Council on the CBAM[3]. Under the provisional agreement, CBAM will begin to operate from October 2023 onwards in its transitional period and is expected to enter its permanent system in 2026, therefore, EU importers of products covered by the CBAM need to prepare for the reporting obligations by the transitional period.

Implications to Malaysian exporters. As the EU is a significant trading partner for Malaysia, the implementation of the CBAM could potentially have implications for Malaysian exporters. Understanding the impact of the CBAM on Malaysia is crucial for Malaysian businesses, policymakers, and stakeholders to prepare for potential changes in trade dynamics and to assess the competitiveness of Malaysian exports in the EU market. Strategies and policies can be developed to navigate the changing trade landscape, enhance competitiveness and potentially leverage opportunities arising from the CBAM implementation.

EXPORTS TO THE EU

EU was Malaysia's 4th largest trading partner. In 2020, Malaysia was the EU's 20th largest trading partner[4] and the EU was Malaysia's fourth-largest trading partner after China, Singapore, and the United States (US). In the latest trade performance review by Malaysia External Trade Development Corporation (MATRADE), trade with the EU accounted for 7.90% of Malaysia's total trade, with exports amounting to RM56.02 billion or 7.97% of the country's total exports. Of this total, approximately 10.5% are from Malaysian small- and medium-sized enterprise (SME) exporters (as of 2022)[5]. The top 10 EU markets based on Malaysia's total exports in 2022 are tabled in Figure 1 below.

Figure 1: Top 10 EU markets of Malaysia's total exports in 2022



Source: MATRADE

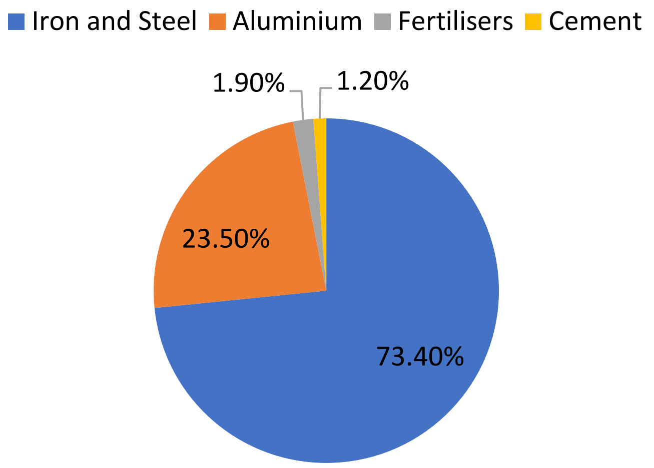
BREAKDOWN OF INDUSTRIES BEING TAXED

Industries covered by the CBAM. The EU's CBAM would initially apply to certain sectors that are particularly carbon intensive and are at most significant risk of carbon leakage such as cement, iron and steel, aluminium, fertilisers, electricity, and hydrogen.

Malaysia exports to EU by industry. For Malaysia, exports to the EU were up by 21.8% to a record high of RM126.31 billion in 2022[6]. In terms of specific industries, the top Malaysia exports to the EU in 2022 were manufactured goods, accounting for 88.7% of Malaysia's total exports to the region. Higher exports were also seen for electrical and electronic (E&E) products, petroleum products, manufactures of metal, iron and steel products as well as palm oil-based manufactured products. In the first quarter of 2023, trade with the EU grew by 4.5%. Despite a 2.3% decline in exports, primarily due to lower exports of E&E products, the decrease was offset by an increase in petroleum product exports. Imports from the EU also rose by 14.7%.

CBAM-related exports to the EU. Based on a study by the Commonwealth Secretariat of The Economic and Social Commission for Asia and the Pacific (ESCAP)[7], the reliance on the EU market varies widely for different Commonwealth Asia-Pacific countries, affecting its relative exposure to the CBAM. It was found that 14% of CBAM-related exports from South Asian countries were sent to the EU in 2019, with Malaysia accounting for 15% of these. The composition of the CBAM-related exports to the EU are mainly from the iron and steel sector of 73.4% (Figure 2). Overall, the United Kingdom (UK), followed by India, Canada, Malaysia and South Africa in that order, accounts for around three quarters of the Commonwealth's total exports to the EU. These countries are likely to be exposed to CBAM charges especially if the coverage of the CBAM is extended to more sectors.

Figure 2: CBAM-related exports to the EU by sector (2019)



IMPACT TO MALAYSIAN EXPORTERS TO THE EU OR PART OF THE EU SUPPLY CHAIN

Starting October 2023, Malaysian exporters to the EU are required to report GHG emissions, embedded in its goods without any financial payments or adjustments. During this period, the implementation of the CBAM will be done gradually, allowing for a careful and predictable transition for both EU and non-EU businesses, as well as public authorities. It also serves as a pilot and a learning phase for all stakeholders including Malaysian exporters.

Companies exporting to the EU are required to buy carbon certificates. Once the permanent system comes into force in 2026, companies exporting to the EU are required to buy carbon certificates corresponding to the carbon price under the EU's carbon pricing rules for domestic production. In December 2020, the EU carbon prices have experienced a significant rise, surging from approximately EUD30 per tonne of CO2 to EUD80 in December 2021 and further reaching EUD100 in February 2023[8]. It dipped below EUD88 per tonne in April 2023 and has been around EUD85 per tonne in June 2023[9]. If companies can prove that a carbon price has already been paid during the production of the good, the corresponding amount can be deducted. This could add administrative burdens and costs to Malaysian exporters.

CBAM-related goods to the EU could be subject to the carbon border tax charges in full. Since the carbon pricing mechanism is still under consideration for Malaysia[10], exporters of CBAM-related goods to the EU could be subject to the carbon border tax charges in full, raising the cost of exporting goods to the EU and placing companies at a comparative disadvantage. We expect this may likely to affect Malaysian exporters to the EU and this may have negative implications.

Further down the line, the CBAM could also impact the supply chain as companies in the EU seek to reduce their exposure to carbon taxes, resulting in changes to sourcing practices and other adjustments that could impact Malaysian exporters.

In terms of SMEs, the CBAM will depend on the sectors in which it operates, the carbon intensity of its production processes and their ability to adapt to changing market conditions. For CBAM-related sectors, the increased costs associated with compliance and carbon taxes could place a burden on already-strained budgets. SMEs may also face challenges in adapting its production processes to be more carbon-efficient, as it may lack the resources or technical expertise to make significant changes. Nevertheless, those that already incorporate carbon-efficient production processes or products may be able to benefit from new market opportunities as companies in the EU seek lower-carbon products.

Exports of Malaysian SMEs are mainly contributed by the manufacturing and services sectors, at 9% and 2.5% of total exports in 2021, respectively. In terms of total SMEs' exports, the manufacturing sector dominated the overall value with a contribution of 76.6% of total SME exports in 2021, stimulated by miscellaneous manufactured articles, manufactured goods, and chemicals. Since the manufacturing sector is a broad sector that includes a wide range of products and processes, the CBAM could potentially affect some Malaysian SMEs in the manufacturing sector that produce CBAM-related goods. However, data from the Department of Statistics Malaysia (DOSM)[11] shows that the three major destinations for SMEs' exports under the manufacturing sector was Singapore (18.8%), China (16.5%) and the US (10.3%), which means that exports to the EU would only be less than 10.3%.

READINESS LEVEL AND GUIDANCE FOR MALAYSIAN EXPORTERS

Malaysia's transition to a Low Carbon Economy. As of now, there is no official program or policy in place in Malaysia specifically designed to prepare exporters for the CBAM. However, there are several initiatives underway related to carbon pricing and emissions reduction which could help support exporters in meeting the CBAM requirements. In Bank Negara Malaysia's (BNM) Annual Report 2022[12], it stated that the Malaysian government is working to develop the Long-Term Low Emissions Development Strategy (LT-LEDS), a tool to enable businesses and financial institutions to align its own strategies to reduce its GHG emissions. The government also has plans to introduce key enablers and infrastructure to facilitate the transition towards a low carbon economy such as the Bursa Carbon Exchange (BCX).

Bursa Malaysia's introduction of the BCX is timely as it allows market to put a price on carbon emissions[13]. Prices discovered in the Voluntary Carbon Market (VCM) can serve as a benchmark for corporates to develop an internal carbon pricing mechanism to offset carbon tax paid under the CBAM, thus mitigating its impact.

The government has set several pre-conditions to implement the national carbon accounting framework. Additionally, the national carbon accounting framework would be a key enabler for the transition as it provides a framework for measuring climate impacts of GHG emissions, hence, enabling climate goals to be reliably measured towards Malaysia's net zero goals and mitigating adverse impacts from the transition. The government has set several pre-conditions to implement the national carbon accounting framework including capacity building within businesses for carbon accounting, measurement, and reporting.

CBAM conversations in Malaysia. Alongside the efforts to advocate for a low carbon economy, many public authorities and organisation have had discussions on the implementation of the CBAM. In one of the press conferences held with Malaysian Investment Development Authority (MIDA) and Ministry of Investment, Trade and Industry (MITI), it is mentioned that Malaysia foresees 6%-7% of sectors to be impacted in the first year of implementation. However, future impact is expected to be greater if the needs to fulfil the mechanism are not addressed. Furthermore, one of MITI's efforts to develop the National Environmental, Social and Governance Industry (i-ESG) Framework for SMEs in the manufacturing sector, is already underway and is expected to be completed in 2024[14]. The framework is designed to assist SMEs in implementing environmental, social and governance (ESG) into their business practices, namely in standards, financial support and incentives, capacity building, and market mechanisms (including carbon trading and carbon pricing).

During 2022, a seminar titled "*An EU-Malaysian Dialogue: Fighting Climate Change with Market Mechanisms*"[15] saw the discussion of carbon market schemes by EU representatives including the sharing of the EU ETS and the EU CBAM. Companies and local stakeholders were invited to give their views about implementing such mechanisms and their efforts to build a sustainable growth.

Readiness for Net Zero. In the Net Zero Readiness Index by KPMG International (2021)[16], Malaysia ranks 21st overall, with a ranking of 21st in sector readiness and 22nd in national preparedness. In terms of political direction, it acknowledged Malaysia's commitment to a 45% reduction in emissions intensity of GDP by 2030 as well as the programmes and schemes announced by the government on tackling a carbon-neutrality target of 2050. In terms of policy signals, KPMG observed that the main drivers of climate change action are largely by private initiatives from the business sector like PETRONAS.

Given the relatively long lead time before the CBAM is fully implemented, Malaysian exporters have some time to prepare and adjust their operations to manage relevant carbon price regimes, hence, remain internationally competitive. On the other hand, SMEs may face challenges in implementing the necessary changes due to limited resources and expertise.

CONCLUSION ON THE IMPACT OF THE CARBON TAX, PARTICULARLY ON MALAYSIAN SMES

EU's CBAM could impose significant compliance costs. Based on the available information, we opine that the EU's CBAM could impose significant compliance costs, even for large enterprises. There could certainly be an impact of the EU's CBAM to Malaysian exporters, particularly those that are heavily reliant on exports to the EU and those that produce carbon-intensive products. While there are some surveys and reports that indicate Malaysian companies' efforts to address sustainability issues, the government is also developing carbon pricing and emission reduction frameworks to support these efforts. It seems likely that some Malaysian companies may face challenges in adapting to the CBAM, however, it is worth noting that these government efforts could mitigate these impacts and ultimately help prepare businesses for the transition to a low-carbon economy as the CBAM phase-in period approaches in 2026.

In terms of SMEs, with the manufacturing sector dominating SME exports, it is likely that the CBAM could impact these exporters. Although there is no available data published on the amount of SME exports to the EU, the impact could be relatively small. In the meantime, government efforts such as the i-ESG framework developed by MITI would act as a guide for SMEs in the manufacturing sector in understanding and adapting to the CBAM progressively. We believe that tt may also be beneficial for SMEs to explore strategies to reduce their carbon footprint and enhance their sustainability efforts, especially if more countries follow suit in implementing a cross border carbon tax. Subsequently, if the scope of the CBAM is expanded to cover more sectors in the future, SMEs could be significantly affected and need assistance to meet these obligations.

Additionally, companies in the supply chain that support these exporters may also experience the impact of the CBAM. This includes suppliers of raw materials, components, and services to carbon-intensive industries. These companies may face increased scrutiny and requirements from their customers to reduce carbon emissions and meet sustainability standards, hence, it is crucial for them to proactively assess their carbon footprint, adopt sustainable practices, and implement measures to reduce emissions.

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