2 ASIA PACIFIC 2020 ECONOMIC OUTLOOK

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Asia Pacific economic outlook

Australia's Asia-Pacific neighbourhood has remained the main growth engine of the world economy this year, which also marks the thirtieth anniversary of the founding of the Asia Pacific Economic Co-operation (APEC) forum. The 2.9 billion people living in the APEC region represent 40 per cent of the world's population and produce 60 per cent of global GDP.

Over the past three decades the region's economy has almost trebled, and average incomes more than doubled. Extreme poverty has been drastically reduced, due mainly to hundreds of millions of Chinese benefiting from astounding economic growth rates. Trade in goods and services has contributed strongly to economic growth over this time, expanding (at 7.1 per cent) nearly twice as fast as GDP growth (at 3.7 per cent). However, since 2012 international trade growth in the region has slowed, corresponding more closely with GDP growth.[1]

As an open economy, Australia's economic growth depends heavily on international trade and investment links with the rest of the world. Close to three quarters of Australia's trade is with APEC members, measured on a two-way trade basis.

Economic growth

The Asia-Pacific region is expected to record 5.5 per cent economic growth in 2019, slightly more than in 2018, and above the latest International Monetary Fund (IMF) forecast for the world economy as a whole of 3.2 per cent.[2] Amongst the advanced Asia-Pacific economies, the United States (US) is forecast to grow 2.6 per cent this year, down from 2.9 per cent last year, as the positive effect of US company tax cuts diminishes while the negative effect of rising protectionism takes hold. Japan's growth remains subdued at 0.9 per cent, close to last year's 0.8 per cent outcome.

Amongst emerging APEC members, China's growth is expected to fall from 6.6 per cent in 2018 to 6.0 per cent in 2019, reflecting the impact of trade tensions with the US. The ASEAN-5, comprised of Indonesia, Malaysia, the Philippines, Thailand and Vietnam, are forecast to grow slightly less as a group at 5.0 per cent this year, compared to 5.2 per cent last year.

Meanwhile, (non-APEC) India continues to be the strongest performing economy in the broader Indo-Pacific region, with growth expected to rise slightly from 6.8 per cent in 2018 to 7.0 per cent in 2019. India now joins China, Japan, the US and South Korea as one of Australia's top 5 trading partners. See Table 1.

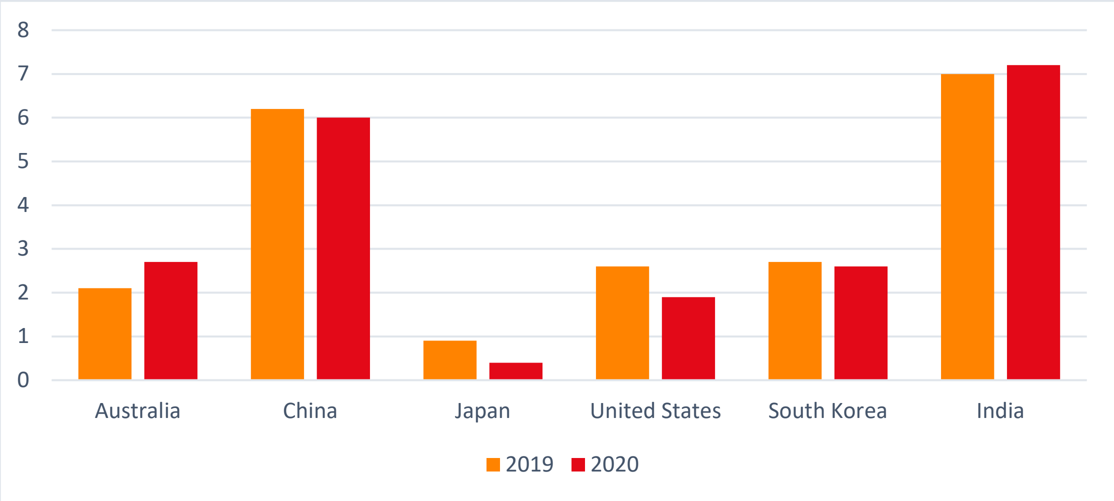
Table 1: Australia's top 5 trading partners in 2018

Rank	Country	Share of Australia's Trade %
1	China	24.4
2	Japan	9.7
3	United States	8.8
4	South Korea	6.5
5	India	3.6

Source: Department of Foreign Affairs and Trade.[3]

Figure 1 below compares Australia's forecast growth with predicted growth in our top five trading partners according to the latest IMF forecasts. Australia's economic growth improves in 2020, although growth is expected to be lower for China, Japan, the US and South Korea. The exception is India, again expected to outperform China, with growth rising slightly above its current 7 per cent rate to 7.2 per cent in 2020. The looming risks to growth for Australia and its trading partners are canvassed subsequently.

Figure 1: 2020 forecast economic growth in Australia's top 5 trading partners (%)

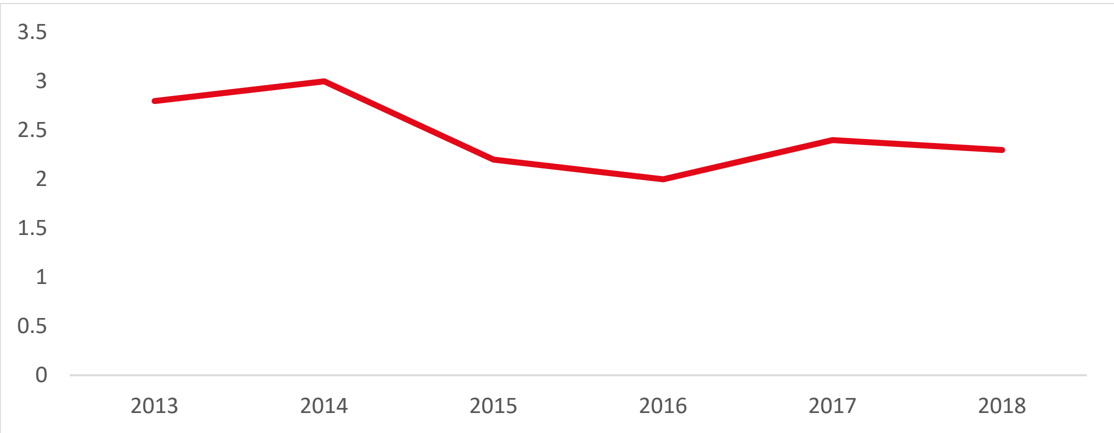


Source: Based on 2019 IMF data.[4]

Inflation

Inflation across the APEC region remains between 2-3 per cent on average (see Figure 2), slightly above Australia's inflation, which since 2015 has been under the Reserve Bank of Australia's 2-3 per cent target band. Major central banks have continued to maintain broadly neutral monetary policies, except Japan, which has pursued quantitative easing involving asset purchases and experienced the lowest official interest rates of any economy in the Asia-Pacific region.

Figure 2: Average inflation in APEC economies



Source: Based on data in APEC.[5]

International trade

Australia is the world's twenty third largest exporter, with the nation's exports growing 8 per cent last year. Australia is the world's largest exporter of iron ore, coal and wool, and the second biggest exporter of alumina, beef, lentils and cotton. Other major merchandise exports are liquified natural gas and wine. Meanwhile, the major services exports are international education services and tourism. Some nine million international tourists visited in 2018, the largest number coming from China (some 1.7 million).[6]

China remains by far Australia's largest overall trading partner, accounting for close to a quarter of total two-way trade (exports plus imports), well ahead of two-way trade with the next two most important, Japan (9.7 per cent) and the US (8.8 per cent). See Table 1. The United Kingdom and Germany are the only European economies in the top 10, although they account for just 6 per cent of Australia's total goods and services trade. Of Australia's top 10 trading partners, seven are APEC members, with India, a non-APEC member, rising from seventh to fifth most important partner.

India and APEC

2019 marks APEC's 30th year as the Asia Pacific's most comprehensive forum for trade liberalisation and regional integration. Three decades on from Prime Minister Bob Hawke's initiative to establish an institution to facilitate trade and investment between Asia-Pacific countries, India, one of the world's biggest emerging economies, is not a member. Many now argue that having India in APEC is in the strategic and economic interests of a broader Indo-Pacific sphere.

Historical reasons for India's exclusion in 1989 were its weak economic integration in the Asia Pacific and resistance to trade liberalisation. India's trade as a proportion of GDP was also much lower than the economies of most other members. India is now on track to become the second largest economy in the world by 2050 and is a key player in regional affairs, with a seat at the East Asia Summit and G20.

India has been aspiring for APEC membership since 1994. A moratorium on new membership ended in 2010, but India has yet to gain entry. India's accession challenges APEC's traditional geographical remit with some concerned that Indian membership would make APEC too tilted towards Asia, while others point to India's protectionist tendencies as a barrier to achieving deeper economic integration.

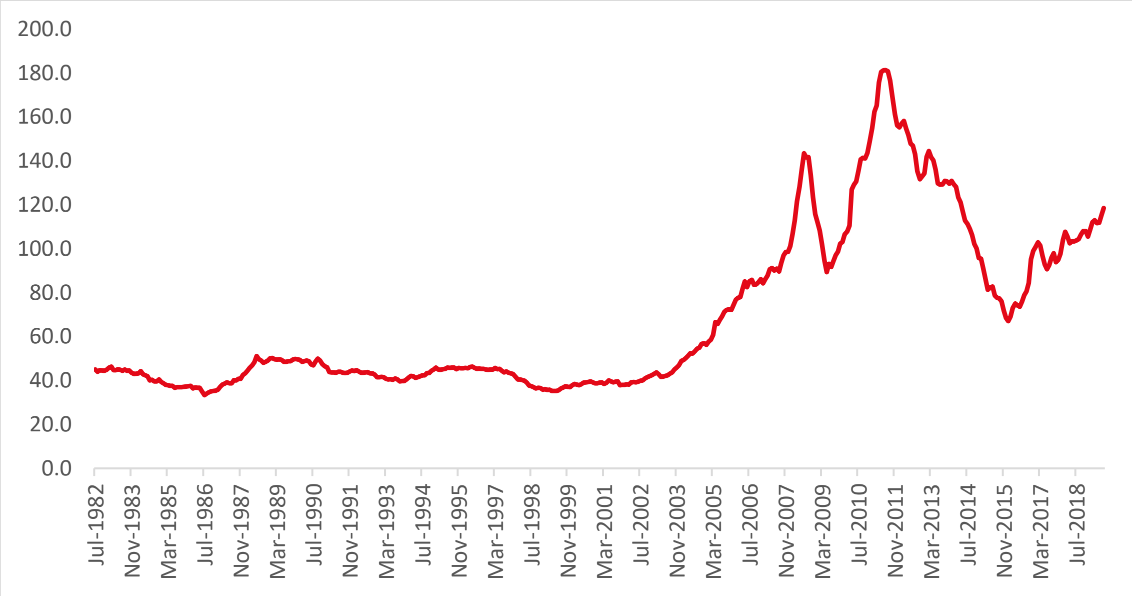
India would also have to comply with APEC standards on gender parity and social equity across rural and regional areas. But with India being a negotiating party to the Regional Comprehensive Economic Partnership (RCEP) trade deal, it is working towards eliminating trade barriers as part of those requirements.

Proponents of India's accession into APEC argue that it would keep the grouping relevant in a time of increasing strategic and economic challenges. Indian membership would also allow APEC to mature as an Indo-Pacific institution, in light of India's participation in the Regional Comprehensive Economic Partnership (RCEP) negotiations.

Commodity prices

The value of Australia's mineral and agricultural exports depends heavily on world commodity prices. Commodity prices in Australian dollar terms improved further in 2019 and have been comparable with pre-GFC levels according to the Reserve Bank's index measure. After declining from peak value in 2011, they have been recovering since early 2016, and remain high by the standards of previous decades. See Figure 3.

Figure 3: World commodity prices (2008-09 = 100)



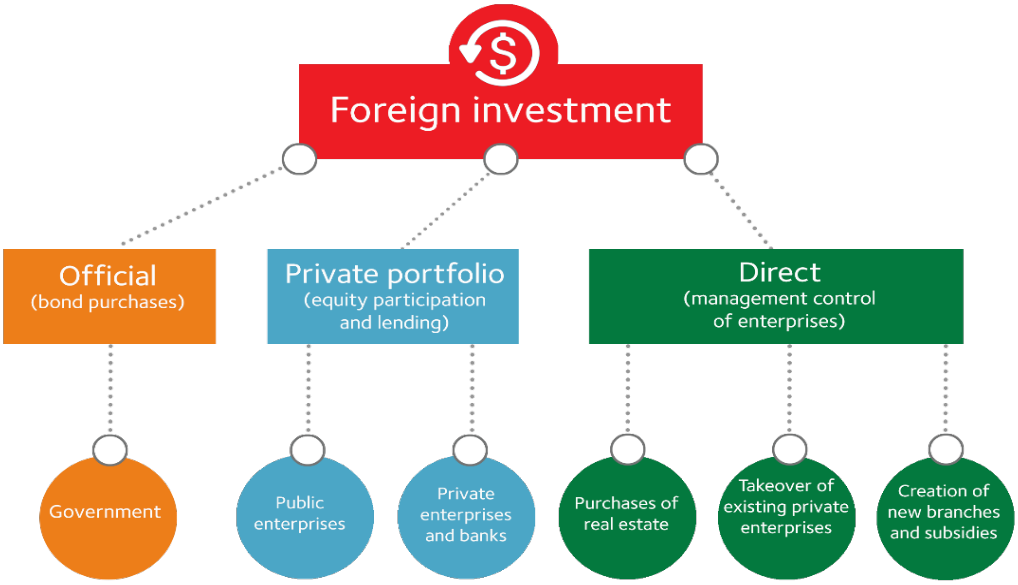
Source: Reserve Bank of Australia.[7]

Foreign investment

Economists generally agree that increasing international trade in goods and services improves an economy's performance. Less well recognised, however, is that enhancing foreign investment flows can bolster economic development by at least as much, perhaps more, as increased international trade in goods and services. In essence, the macroeconomic benefits of foreign investment stem from capital moving to places where it can be used most productively.[8]

Figure 4 illustrates the different forms foreign investment can take. There is an important distinction between foreign *direct* investment (FDI), which includes real estate acquisitions, and foreign *portfolio* investment that reflects foreign purchases of locally issued equities and debt instruments for portfolio investment purposes.[9]

Figure 4: Forms of foreign investment



Source: Makin.[10]

FDI, which entails the takeover of domestic firms or establishment of subsidiaries of foreign multinationals, can generate the largest economic benefits through the transfer of technology and product development. Furthermore, domestic employees of foreign-owned firms are exposed to international management practices and the presence of new entrants in domestic markets stimulates imitative behaviour and acts as a spur to greater competition. In turn, higher labour productivity allows domestic wages to be higher than they would be with a smaller capital stock.

As a general rule, the greater the international trade in assets, the greater the potential economic gains. Yet, if the sum of exports and imports as a share of GDP (a measure of trade openness) is compared to the sum of FDI inflows and outflows as a share of GDP (a measure of investment openness), without exception, trade flows continue to dominate FDI flows in all Asia-Pacific economies by a large margin.[11]

The bulk of foreign investment flows into and out of Australia are portfolio flows. Inward portfolio investment was 1.8 trillion dollars in 2017, nearly twice as high as inward direct investment of almost 850 billion in 2017. Outward direct foreign investment was under 300 billion dollars that year. Whereas China is Australia's top two-way trading partner, the US is Australia's top two-way investment partner, followed by the United Kingdom, Japan, Belgium and China. Table 2 shows the top five investment partners ranked according to total two-way investment flows.

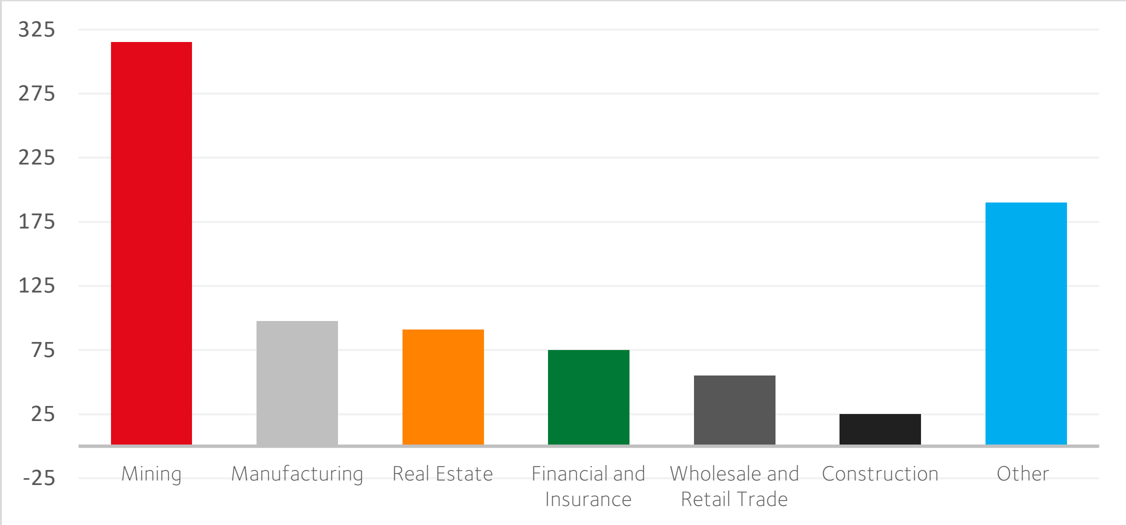
Table 2: Australia's top 5 foreign investment partners, 2017

Rank	Country	Foreign investment $ billion
1	United States	1,561
2	United Kingdom	815
3	Japan	344
4	Belgium	310
5	Hong Kong, China	164

Source: Department of Foreign Affairs and Trade.[12]

The main industries attracting inward foreign direct investment in recent years have been mining, easily commanding the biggest share, manufacturing, real estate, financial and insurance and wholesale and retail trade and construction. See Figure 5.

Figure 5: Inward foreign direct investment by industry, 2017 ($ billion)



Source: Based on data from the Department of Foreign Affairs and Trade.[13]

Meanwhile, the value of Australia's foreign investment abroad is considerably less than its inward investment and has recently been directed mainly to the finance and insurance sector, followed by manufacturing, mining, real estate and construction in a diverse set of overseas countries.

Major risks to the outlook

The biggest risks to the economic outlook for the region are rising protectionism, further economic slowdown in China, and high debt levels.

Rising protectionism

The tariffs levied by the US on Chinese goods and the retaliatory tariffs China has imposed on US goods in response, have contributed to slower merchandise trade growth in the Asia-Pacific region. Total export growth fell from around 6 per cent in 2017 to near 4 per cent last year, while import growth fell from near 8 per cent to around 5 per cent. Meanwhile, there was only a slight improvement in services trade.

Across the region, new policy measures that have restricted international trade have outweighed measures that have facilitated trade every year for the past three years, as illustrated in Figure 6.

While rising protectionism is dampening multilateral trade, dispute resolution and multilateral negotiations under the auspices of the World Trade Organization (WTO) have been slow. FTAs involving much fewer country participants have provided a faster way of opening up new commercial opportunities. The big question is whether proliferating FTAs are delivering sufficient economic benefits to offset the costs arising from increasing protectionism more broadly.

The China-US "Trade War"

The China-US dispute over their trade imbalance has soured economic relations between the two economic superpowers for more than a decade. The CNY/$US exchange rate has also been a major point of contention given the strong influence exchange rates have on international competitiveness and trade flows. The demise of US manufacturing firms unable to compete against low-priced Chinese imports has repeatedly sparked calls for retaliatory action by Washington against Beijing, stretching back to concerns raised by the Bush and Obama administrations.

President Trump has been the first US president to take direct action and has justified imposing tariffs up to 25 per cent on a wide range of imports from China—with more possibly to come—as a means of reducing the persistent China-US trade imbalance and in turn provoking retaliatory tariffs by China on US imports. Economic questions that arise about China-US trade tensions are: is the bilateral trade imbalance per se a problem? And what should be done about unfair trade practices?

Trade imbalances are not necessarily harmful, although important assumptions that underpin a benign view of them are violated in the China-US case. For instance, China has not moved to full capital account convertibility, so capital mobility is not as high as in OECD economies. In addition, China has over recent decades significantly undervalued its exchange rate, distorting capital flows from China to the US.[14]

By running sizeable trade and current account surpluses since the turn of the century, China's undervalued exchange rate against the US dollar enabled its central bank, the People's Bank of China, to accumulate huge foreign exchange reserves. These peaked at close to $4 trillion in 2014, falling to around $3.0 trillion more recently, the highest $US reserves of any economy in the world. China's $US foreign exchange reserves have been used to buy US government bonds issued to fund large US budget deficits, and to acquire other foreign assets.

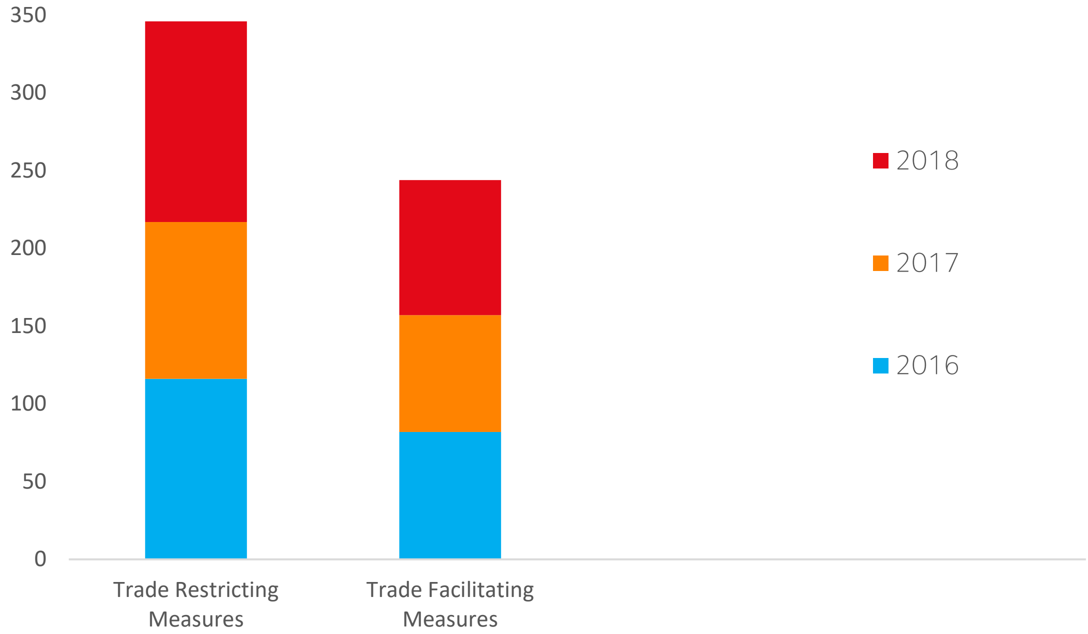
Bilateral trade in goods dominates trade in services and attracts the most attention. US merchandise imports from China, mainly in the form of computers, phones, electronics, other electrical equipment, machinery, metals, furniture, apparel and footwear, are over three times the value of US merchandise exports to China, mainly commercial aircraft, electronics, chemicals, oil and gas, soybeans and motor vehicles.

By increasing the cost of consumer goods and of inputs to production, this ongoing trade war has worsened economic welfare in both countries and is the most noteworthy feature of rising trade protectionism globally.

Protectionist measures are ineffective in reducing the bilateral trade imbalance and negatively affect macroeconomic welfare, broadly defined, in both countries. Meanwhile, real exchange rate adjustment, increased Chinese private consumption and relaxation by China of restrictions on US foreign investment would all contribute to balancing the external accounts.

Higher Chinese private consumption of US goods and services, and lower Chinese savings, would reduce the trade imbalance and unambiguously improve macroeconomic welfare in both countries as a win-win outcome. As would more US FDI in China, subject to improved safeguards to protect intellectual property rights.

Figure 6: Trade-related policy measures in APEC economies, 2016-18



Source: APEC [15] *and WTO.* [16]

Australia currently has eleven FTAs in operation that have lowered tariffs, behind the border restrictions on Australian exports, expanded markets for services, and improved rules governing foreign investment. The *Indonesia-Australia Comprehensive Economic Partnership Agreement* that was finalised in March 2019 is not yet in force and several other FTAs are under negotiation. Indonesia is expected by some to be the world's fifth largest economy by 2030, suggesting significant future potential for Australian goods and services producers.

The largest agreed regional FTA to date, the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), also known as the TP11, between Australia, Brunei Darussalam, Canada, Chile, Japan, Malaysia, Mexico, Peru, New Zealand, Singapore and Vietnam, was signed by the 11 countries in March 2018 in Santiago, Chile. It aims to deliver lasting benefits to small and medium-sized enterprises (SMEs) trying to tap into new export markets in partner countries.

Meanwhile, negotiations are progressing on the RCEP trade agreement which is likely to have less rules affecting intellectual property, the environment and state-owned enterprises compared to the CPTPP. Whether the macroeconomic gains accruing to Asia-Pacific economies from these FTAs exceed the losses arising from a broader creeping protectionism worldwide is ultimately an empirical question yet to be answered. Nonetheless, given the scale and reach of the FTAs in place and in prospect, there are grounds for optimism that they will.

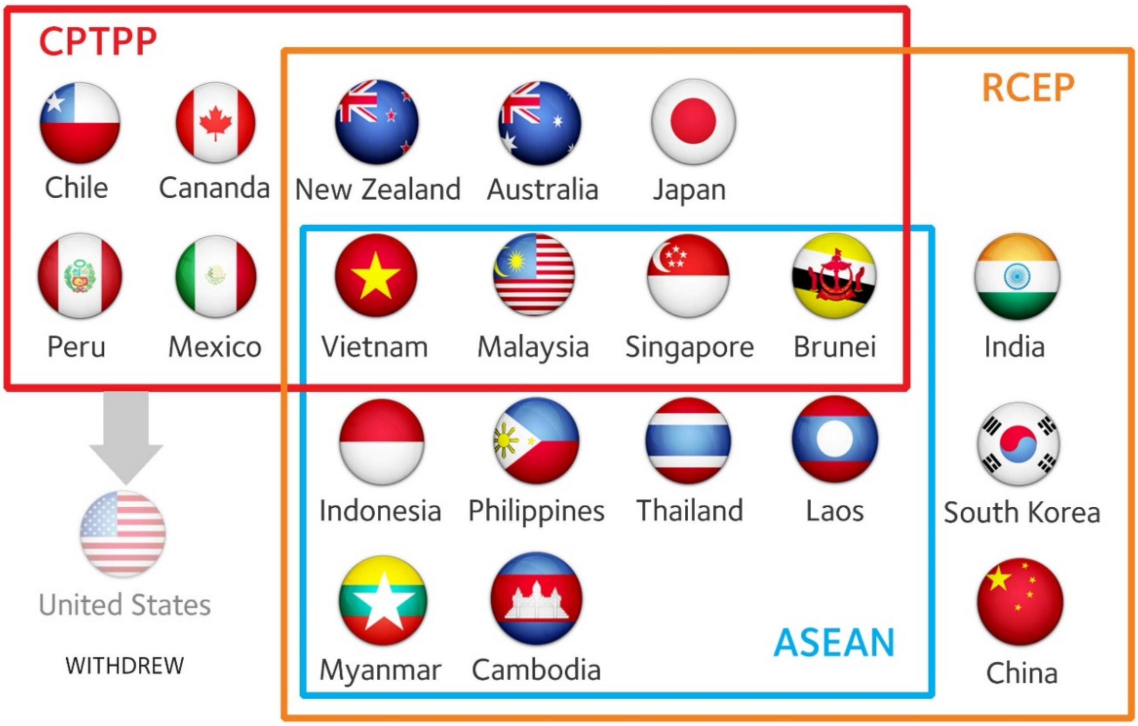
The Regional Comprehensive Economic Partnership (RCEP)

RCEP is an ASEAN centred regional free trade agreement (FTA) that emerged from the sidelines of the November 2012 East Asia Summit in Phnom Penh. RCEP negotiators consist of the 10 ASEAN members and ASEAN's FTA partners India, China, Australia, New Zealand, South Korea and Japan. Negotiations first began in 2013 but have accelerated this year in response to the US-China "trade war". The 16 leaders have committed to 'conclude a modern, comprehensive, high quality, and mutually beneficial' RCEP by the end of 2019.[17]

Market access remains a sensitive issue for developing countries. India for example has long been resistant to removing agricultural tariffs, citing the detrimental impact it would have on domestic industries and the country's poorer workers. Some analysts have also noted that RCEP could further worsen India's large and growing trade deficit with China—however, India remains keen to offer its pool of information technology talent to the region's labour markets. Market access, intellectual property protection and environmental and labour clauses remain the thorniest issues still under negotiation.

RCEP, once formed, will be the world's largest trading bloc with the participating countries accounting for almost half of the world's population, over 30 percent of global GDP and over a quarter of world exports. The economic outcomes are expected to be substantial.

Figure 7: Frameworks of major Asia-Pacific trade deals

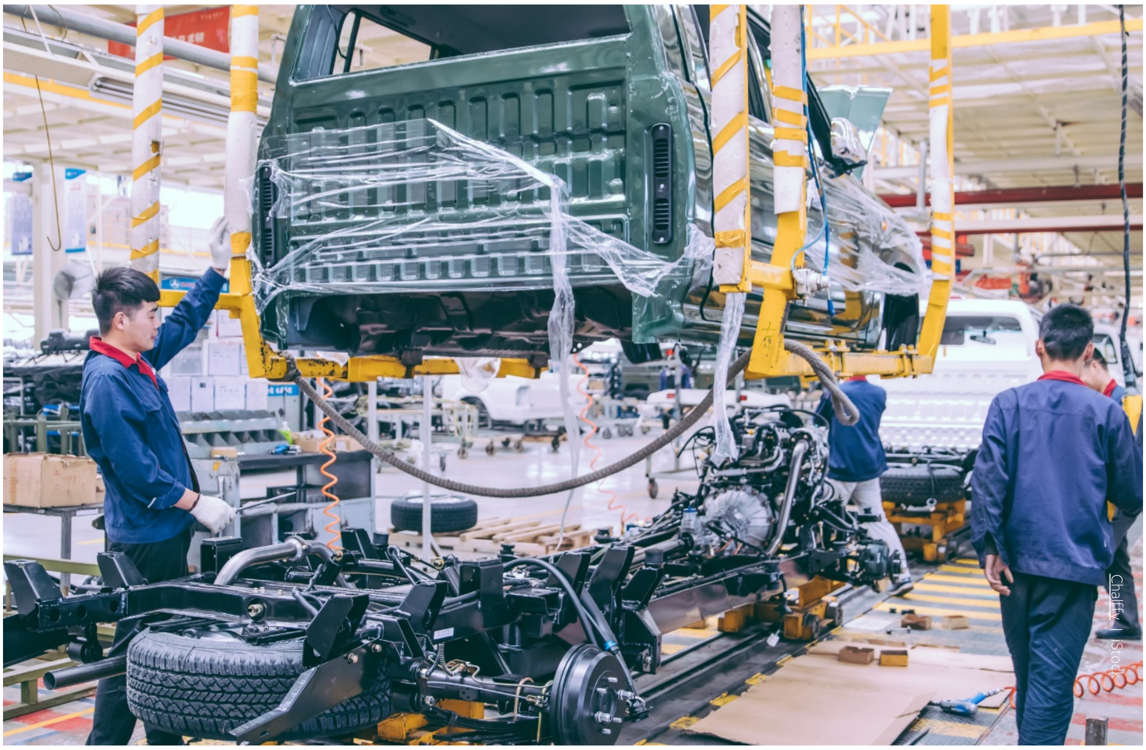


Source: Adapted from Nikkei Asian Review.[18]

A China slowdown

Over the past four decades China's economic growth and the legacy of economic reforms begun by leader Deng Xiaoping was more than three times higher than its Western trading partners. This greatly benefited commodity exporters like Australia that ship huge volumes of mineral and agricultural commodities to fuel its urbanisation and infrastructure needs and satisfy China's growing middle class.

Flourishing private and sizeable state-owned enterprises, whose role in the economy has been more strongly promoted under President Xi, substantially increased their production. In recent years, the state's role in China's economy has intensified and manifests in several ways, including acquisition of intellectual property and technology by various means and provision of subsidies to corporations.



Government subsidies to state-owned enterprises obviously tilt the playing field against China's foreign competitors, and like tariffs on imports, are undesirable from an economic welfare perspective. These subsidies, along with dissatisfaction with China's behavior towards US intellectual property, have fueled China-US trade tensions. The resultant US tariffs have dented China's growth, with the IMF estimating that tariffs could lower China's growth by 1.6 per cent, and lower growth in the Asia Pacific by 0.9 per cent, over a two-year period.[19]

Bad loans and company debt also began to escalate during the 2008-09 Global Financial Crisis. Dealing with the consequences of state-directed spending on unproductive projects funded through a heavily controlled banking system could further slow the economy.

High public debt

Since the 2008-09 Global Financial Crisis the worldwide rise in public debt has contributed significantly to the surge in total debt. Global debt, private plus public debt, stands at a record high of over 225 per cent of world GDP, some 12 per cent higher than before the crisis. Global debt is mostly owed by advanced economies that went into the GFC with already high public debt levels.

However, economies in Asia have accounted for most of the post-crisis increase, China alone being responsible for 43 per cent of the rise.[20] High public debt remains a risk as it can harm business and household confidence and create uncertainty about how it will be paid down via fiscal repair, which, if oriented more to higher taxes than cutting unproductive public spending, is inimical to private investment and durable economic growth.

Notes and references

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9 Foreign investment is classified as "direct" if at least 10 per cent of a firm's equities are owned by foreign shareholders, since this is deemed to confer a foreign management control over the operations of the enterprise.

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