



The  
Economist

Corporate  
Network

Asia Regional Strategic Forecast

## **PREPARING FOR THE PARADIGM SHIFT**

Globalisation and the Asian  
business environment

A report by The Economist Corporate Network

March 2017

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## Executive summary



**Robert Ward**  
Editorial Director,  
The Economist Intelligence Unit

The events of the past decade or so leave little doubt that the world has entered a prolonged period of instability. If 2008 saw a financial upheaval that upended the post-1945 economic settlement, 2016 produced political earthquakes that will reverberate well into the next decade, not least the election of Donald Trump as president of the US and the UK's decision to leave the EU. For the first time in many decades, companies are having to navigate elevated political risk throughout the rich world. This, coupled with the backlash in the US, Europe and elsewhere against globalisation and changing geopolitical risk, make for a very different global business environment from that which prevailed in the 1990s and 2000s.

But increased volatility does not mean reduced opportunity. Asia remains the world's fastest-growing region by a considerable margin, with the Association of South-East Asian Nations (ASEAN) and India showing particularly robust expansion, and of course China continues its shift towards becoming a consumption-driven economy, which will increasingly have benefits both for the region and for the global economy. I hope you find this report a helpful tool for planning for the coming year and that you enjoy the accompanying Regional Strategic Forecast event. Please do not hesitate to let me or any of my team know if you would like to know more about how The Economist Corporate Network or The Economist Intelligence Unit can support your business.

# Global outlook

Two political earthquakes reverberated around the world in 2016: Donald Trump's victory in the US presidential election and the UK's decision to leave the EU. In 2017, as business leaders around the world have started to grapple with the consequences of these seismic events, three key questions have emerged. Where will populism strike next? Has the era of globalisation drawn to a close? And with nationalism and protectionism on the rise, which economies are best placed to benefit?

## WHERE WILL POPULISM STRIKE NEXT?

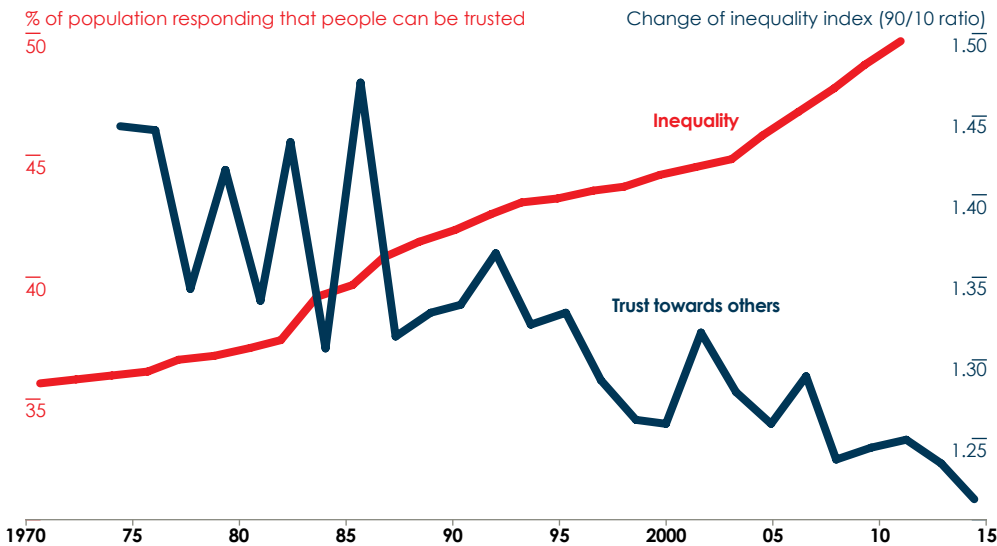
The parallels between the "Brexit" vote and the outcome of the US election are manifold. In both cases, the electorate defied the political establishment. Both votes represented a rebellion from below against out-of-touch elites. Both were the culmination of a long-term, secular trend of declining popular trust in government institutions, political parties and politicians, exacerbated by a rise in income inequality. They showed that society's marginalised and forgotten voters, often



**Joseph Lake**  
 Director of Global Forecasting

## Higher income inequality has reduced trust towards others and government

Trust and inequality in the US



Source: IMF.

## **Political systems are becoming more fragmented**

working-class and blue-collar, do not share the same values as their established political leaders and are demanding a voice of their own.

Populist politicians often do not have convincing answers to the problems they purport to address, but they nevertheless pose a challenge to the political mainstream because they are connecting with people who believe that the mainstream parties no longer speak for them. Political systems are becoming more fragmented, with national elections resulting in gridlock, making the formation of stable governments challenging.

The Brexit referendum and Mr Trump's win have boosted the anti-establishment political forces in many European countries, and the departure of other EU member states cannot be ruled out. In 2017 national elections will be held in the Netherlands, France and Germany. In all three contests populist parties will play a large role. The Economist Intelligence Unit does not expect any of these to win or gain power, as establishment forces are likely to unite against them. However, we expect further political fragmentation, with parties of the traditional centre-left and centre-right struggling to gain enough support to govern effectively. This will weaken the ability of governments to deliver coherent policy changes or undertake structural reform. The EU is already poorly placed to respond to the multiple policy and geopolitical challenges that it faces, including migration, high unemployment and fraught relations with Russia.

### **THE TIDE OF GLOBALISATION WILL RETREAT**

The victory of Mr Trump in the US presidential election could have far-reaching adverse implications for global trade. Shortly after his inauguration on January 20th this year, Mr Trump announced that the US would withdraw from the Trans-Pacific Partnership (TPP) agreement. He also reiterated a campaign pledge to renegotiate the North American Free-Trade Agreement (NAFTA) with Canada and Mexico.

Our forecast for global trade growth is rather grim. First, we assume that rising protectionism will inhibit trade. Governments around the world have introduced a slew of protectionist measures over the past year and this pattern will continue. Second, our forecast assumes that the US will not ratify any other significant trade deals over the next four years. The proposed agreement between the US and the EU, known as the Transatlantic Trade and Investment Partnership, is also dead, in the face of public opposition on both sides of the Atlantic. Third, our forecast incorporates a structural slowdown in world trade as the integration of global supply chains abates.

That said, faced with the reality of government, we expect Mr Trump's protectionist actions on trade to be largely symbolic. Renegotiation of NAFTA is more likely to tinker with the agreement, rather than see the US withdraw altogether. This may have some benefits; the agreement is 23 years old and an update could include better protections on labour standards and the environment, and a reduction in red tape for workers in new industries such as the digital economy. Similarly, rather than impose higher tariffs across all Chinese imports, Mr Trump may selectively increase tariffs on goods that will minimise the damage on US workers and consumers. For example, higher tariffs on Chinese steel or automotive parts may have symbolic value for

**Preparing for the paradigm shift**

Mr Trump's supporters, while also being less harmful to US consumers than tariffs on electrical goods, toys and clothing.

**WHAT LIES AHEAD FOR THE GLOBAL ECONOMY?**

The "sugar rush" in global markets following Mr Trump's surprise win has abated since the start of 2017. US equities have paused for breath, bond yields have fallen back and the US dollar has given back some—and, against some currencies, all—of the gains that it made in the last two months of 2016. Although the market expectation remains that Mr Trump's policies will be positive for economic growth, investors have started to pay more heed to downside risks under a Trump administration, notably those stemming from protectionist trade policies and potentially aggressive and erratic actions in the sphere of foreign and defence policy.

We remain sceptical about the reflation story. The US economy is running close to capacity. Fiscal stimulus could push up inflation, but, in that case, the Federal Reserve (the US central bank) would raise its policy interest rate more quickly, curbing any gains in output. Moreover, small-government Republicans will oppose a big public-spending programme on infrastructure unless it is fiscally neutral. We therefore maintain our US growth forecast of 2.3% in 2017: the economy is in good shape, buoyed by rapid employment growth, rising wages and strong consumer spending. We forecast that Europe's muted recovery will be consolidated over the forecast period (2017-21), although political risk will remain high. For Japan, we forecast growth averaging just 0.7% a year in 2017-21.

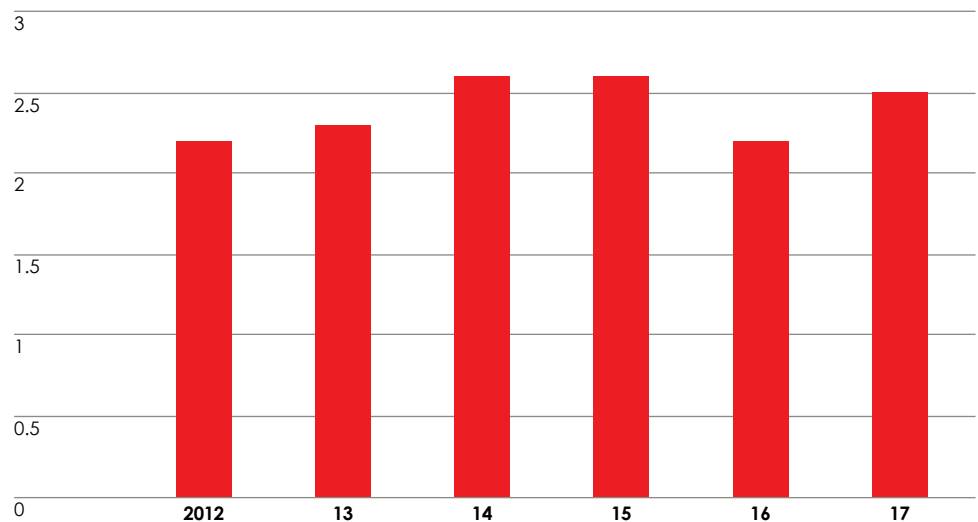
On the assumption that Mr Trump makes only modest adjustments to US trade policy, the outlook for emerging markets in 2017 is reasonable, with growth quickening to 4.5%, from 4% in 2016. Brazil and Russia, the third- and fourth-largest emerging economies, will both emerge from lengthy recessions. Overall, emerging markets will benefit from the upturn in commodity prices. Furthermore, we expect financing conditions to remain relatively benign, albeit subject to occasional episodes of volatility.

In China, the build-up in debt, particularly in the corporate sector, is unsustainable. We think that once the president, Xi Jinping, has consolidated his power at

**As the integration of global supply chains abates, expect a structural slowdown in global trade**

**Global growth will accelerate in 2017**

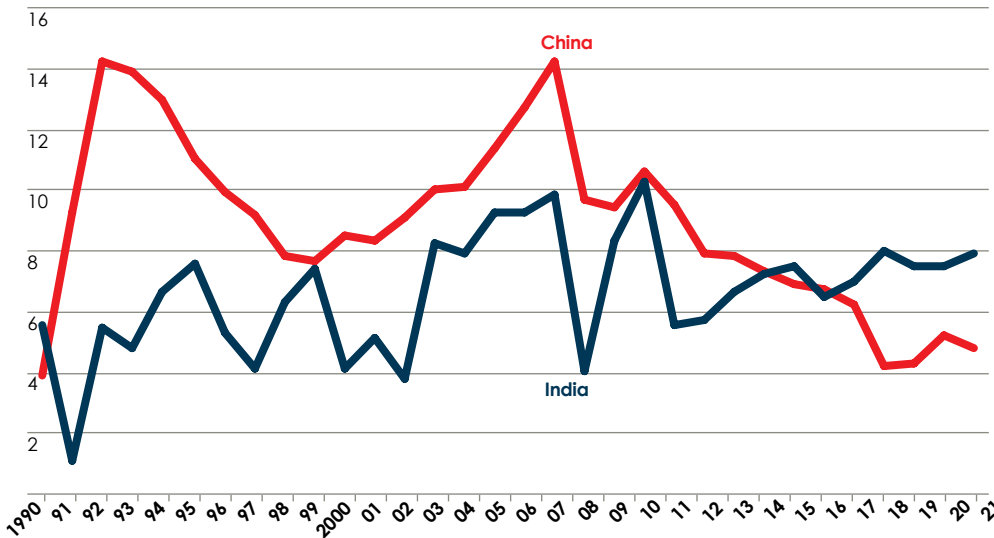
Global GDP growth (%)



Source: The Economist Intelligence Unit.

**India is world's fastest-growing economy**

Real GDP growth (%)



Source: The Economist Intelligence Unit.

the Chinese Communist Party (CCP) congress towards the end of 2017, he will sanction policies to rein in credit. Firms in the construction and real-estate sectors will be hit hardest. As a result of these policies, we forecast that real GDP growth will slow sharply in 2018, to 4.2%, from 6.2% in 2017.

India will be Asia's (and the world's) fastest-growing large economy over the next five years, expanding at an average annual rate of 7.6% and supported by the growing formal economy and infrastructure spending. The government is also promoting reforms, albeit at a sometimes

frustratingly slow pace. Key among these will be the introduction of a goods and services tax (GST) later in 2017, which, despite its overcomplexity, will bring India closer to becoming a genuinely single market.

However, the Indian economy is also going through a painful period. A lending spree has saddled state-owned banks with bad loans and created excess capacity in heavy industry. Meanwhile, a demonetisation campaign announced in late 2016 has proven extremely disruptive, causing a severe cash shortage during the wedding, harvest, festival and tourist seasons.

Taken together, the outlook for developed economies and emerging markets means that we expect global economic growth to pick up to 2.5% in 2017, from an estimated 2.2% in 2016. The risk to our economic forecast is greater than usual, however, as an unpredictable policymaker has taken the helm of the largest economy in the world. Much rests on what direction Mr Trump chooses to steer the US, and how effective he is at setting his course.

**Growth in emerging markets will quicken from 4% in 2016 to 4.5% in 2017**

**Implications for business**

- Business should more clearly communicate a commitment to corporate citizenship as a means of countering populist and anti-globalisation sentiment.
- Companies should develop their political antennae. Economic policy in the US, the EU and China will become increasingly politicised and unpredictable.
- Has sufficient thought been given to the implications of China's coming slowdown?

## Regional outlook

**In turbulent times, businesses in Asia can at least hold on to one constant: the region remains the world's most exciting growth market. The region's economy as a whole is set to expand by 4% in 2017, roughly the same pace as last year, with marginally faster growth in the Association of South-East Asian Nations (ASEAN), Japan, Australasia and South Asia being offset by slower expansion in China. Yet, short-term risks are rising.**

The election of Mr Trump to the US presidency has already seen the demise of the TPP, the landmark 21st-century trade deal that the outgoing administration of Barack Obama had wanted to use as the cornerstone of a system of strategic alliances in Asia. In place of the TPP carrot, the Trump team has brought out sticks, with which it has threatened both allies and competitors alike. Although the outline of Mr Trump's Asia policy is becoming clearer, the volatile nature of the new president and the presence of some vocal ideologues among his close advisers mean that risk scenarios will need to be considered carefully as we try to gauge the outlook for the region in 2017 and beyond.

### PROSPECTS FOR TRADE

Three issues are likely to loom particularly large for Asia in the year ahead: trade, partnerships and prices. Of these, trade is likely to be the most important by some margin. In the short term, the demise of the TPP has prompted much speculation about the outlook for trade deals. There has been much talk about whether China might be able to steal the lead in pushing forward multilateral free-trade agreements (FTAs), basing a deal around the Regional Comprehensive Economic Partnership (RCEP), which, unlike the TPP, includes China.

Such speculation is mostly misguided. RCEP is a very different deal from the TPP, seeking to align existing trade agreements between its members rather than to break new ground. It also has an old-fashioned focus on issues such as tariff barriers. This is not to say that RCEP will not be useful. Tariff barriers are still high in most emerging markets and many of these economies remain advocates for trade liberalisation. So-called south-south deals could become a new driver for trade liberalisation. Nevertheless, caution is necessary: RCEP has faced its own problems. Deadlines have been repeatedly missed, and we are not optimistic that its members will be able to reach agreement on a deal before 2020.

For more developed markets, trade talks will increasingly shift towards bilateral

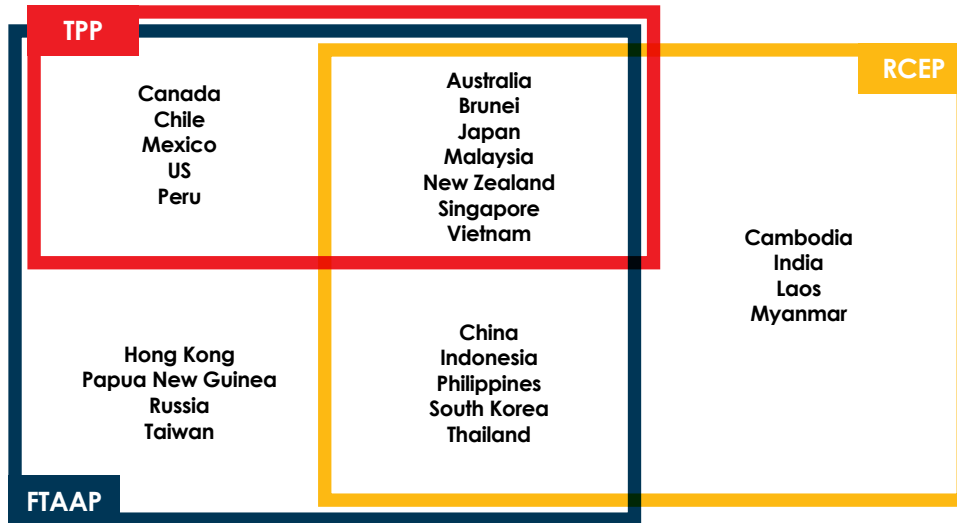


**Duncan Innes-Ker**

Regional Director, Country  
Publishing, Asia

## Overlapping and overdue

Proposed Asia-Pacific trade agreements



Source: *The Economist*.

arrangements. Mr Trump has already reached out to Japan over a possible bilateral FTA, and Japan is also working to secure one with the EU. The work done in putting together the TPP will not have been wasted, as much of its content will probably be rolled into these deals between advanced economies.

Still, those talking with the US will find it a tough negotiating partner. Mr Trump appears to take his cue on trade policy from a close adviser, Peter Navarro, whose negative views on the subject suggest that the US administration will take

a hardline stance in trade negotiations. The Trump administration is likely to take a transactional approach when it comes to FTAs, downplaying the significance of trade as a tool for strengthening US strategic alliances in Asia.

Any trade talks will also take place against a background of shifts in global supply chains and potentially destabilising lurches in US tax policy. Mr Trump's arrival is likely to accelerate the shift of manufacturing supply chains closer to end-consumer markets. This had already been making headway as rising costs in China forced some manufacturers to relocate.

The process of supply-chain movement could be turbo-charged if a broad trade war erupted between China and the US, or if the "destination-based cashflow tax" proposals currently being debated in the US Congress imposed a border-adjustment tax (BAT). The latter would serve not only to dampen US imports from Asia, but by pushing up the value of the US dollar could also spell problems for countries with large volumes of US-dollar-denominated debt, such as Malaysia and Indonesia. Neither option forms part of our core forecast. US firms that export to their home market from China will probably help to ensure that the Trump administration's moves to reduce China's trade surplus with the US take the shape of targeted anti-dumping measures rather than sweeping tariffs. Entrenched interests are also likely to stymie efforts to transform the US tax code. Nevertheless, both issues will bear close watching, given Mr Trump's unpredictable nature.

### PRAGMATIC PARTNERSHIPS?

On partnerships, the key question for most Asian countries is likely to be: the US or China? For many years, countries ranging from Australia to Singapore have sought

**Trade,  
partnerships and  
prices will loom  
large in Asia  
in 2017**

## Preparing for the paradigm shift

to answer: both. That approach is becoming harder to maintain. Our forecast, based on the make-up of the Trump team and their past and recent statements on China, is that Sino-US tensions will escalate significantly in the next few years.

Against this backdrop, other countries will inevitably face increased pressure from the two great powers. Singapore had an early taste of this when its armoured vehicles were seized in Hong Kong on the way back from military exercises in Taiwan, a way of China attempting to force the city state to distance itself from Taiwan. Countries with a strong economic dependency on China but close political links to the US, such as South Korea and Taiwan, will find this climate particularly tough. With South Korea's next president set to come from the liberal opposition, ties with the US are likely to fray in the coming years. By contrast, Vietnam and the Philippines may feint towards China for economic reasons, but the US should have no difficulty strengthening political and military links with the two countries—provided relations are handled sensitively.

Although we do not rule out the potential for the US and China to come to a mutually acceptable deal on trade, our core forecast is that this will not happen. Instead, trade friction will aggravate other disputes, adding to the risk of a military clash between the world's two leading nuclear powers. Taiwan is likely to be the most dangerous hotspot in the near future. Mr Trump's team contains long-time advocates for stronger US support of Taiwan. Coupled with mainland-Chinese antagonism towards the island's new Democratic Progressive Party (DPP) government—the DPP has traditionally favoured independence—this could set the stage for a confrontation. There is also a danger of incidents occurring in either the East China Sea or the South China Sea, if the US navy or airforce chooses to challenge China's assertions of sovereignty. Meanwhile, North Korea, as ever, remains a wildcard.

The US-China dynamic will also be in play in South Asia. China has clearly thrown its weight behind Pakistan, most obviously through the massive China-Pakistan Economic Corridor investment initiative. The Trump administration's concerns about Islamic extremism will ensure that it remains deeply suspicious of Pakistan, even as the scaling-back of the US's military presence in Afghanistan reduces the need for Pakistani support. This, in theory, offers fertile ground for a strengthening of US-India ties, but this is not high on Mr Trump's agenda, and tighter US visa restrictions will serve as an irritant for the Indian side.

### INFLATIONARY PRESSURES

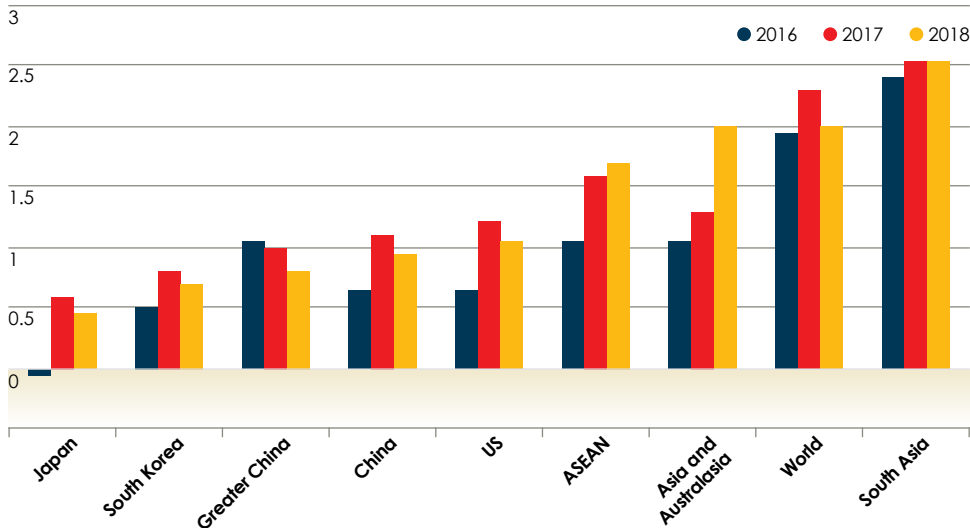
The last of the three key issues for Asia in 2017, prices, is less related to Mr Trump. Our forecast that inflation will pick up across most of the region this year is largely a reflection of the higher trend in commodity prices, most notably for oil. Stronger demand conditions in the US and EU will support the upward drift in global price pressures. The trend is likely to be short-lived, as an economic slowdown in China in 2018 and the US in 2019 will dampen global inflation, but its impact on monetary policy and exchange rates in 2017 could be marked for many Asian economies.

Higher inflation will limit the room for countries in the region to cut policy interest rates further, and some are likely to begin tightening monetary policy to head off upward

**Inflation will  
pick up across  
most of the  
region this year**

**Inflation is set to pick up this year**

Consumer price inflation (% change)



Source: The Economist Intelligence Unit.

price momentum. Meanwhile, as US interest rates begin to rise, the authorities in economies with current-account deficits may have to offer higher interest rates in order to attract the capital inflows that they need to balance their external accounts, or else risk seeing their exchange rates weaken sharply. Where current-account deficits are matched with fiscal shortfalls, strains will multiply.

Sri Lanka, Mongolia and Pakistan look most vulnerable to sudden currency weakening or interest-rate increases. India and Indonesia are also somewhat exposed, as both

have twin deficits on their current and fiscal accounts. However, the two countries have made significant progress on the reform front in recent years that should be enough to shore up investor support. Arguably the most worrying case is China, where existing downward pressures on the renminbi are likely to build as US interest rates rise. We nonetheless expect the authorities there to manage only a gradual weakening of the currency, which will depreciate by 5.6% against the US dollar on average in 2017.

The year ahead is thus likely to be a challenging one for Asia, despite the relatively robust long-term economic outlook. It is likely that economic developments in 2017 will expose some governments that were relying on loose liquidity conditions to lift GDP growth. Yet the bigger concern remains political. Governments across the region will stay focused on the potential impact of the Trump administration, both in terms of its domestic tax reform agenda and its policy towards China. Most will be hoping that the changes in US policy towards Asia are less dramatic than they currently promise to be.

**Despite a robust long-term outlook, 2017 will be a challenging year for Asia**

**Implications for business**

- Current volatility and uncertainty aside, Asia's underlying growth story remains solid. Is this reflected in investment strategy?
- Diversification, risk-mapping and monitoring of global supply chains are required to reduce the fallout from geopolitical risk events.
- Trade friction between the US and China raises supply-chain risk for multinational companies operating in the region. Watch especially for the politicisation of supply chains.

## Risk scenarios

Each month The Economist Intelligence Unit's Global Outlook team seeks to identify the top ten threats to global business operations—ranging across the economic, political and security spheres. With a focus on the business operating environment over the coming two years, each scenario provides the context and potential timing of events, and concludes with a discussion of how each of these occurrences would play out for the rest of the world.

Supplementing this analytical approach, we evaluate the scenarios according to the probability of their occurrence and the potential impact on business profitability—an approach that combines to give each scenario an “intensity” score and, ultimately, their ranking.

For Asia, we have identified three risk scenarios especially relevant for the region in 2017-18. Unsurprisingly, the new Trump administration in the US features, but it is the sustainability of China's economic performance that remains our top concern.

### **RISK SCENARIOS (METHODOLOGY)**

Very high risk = greater than 40% probability that the scenario will occur over the next two years; high = 31-40%; moderate = 21-30%; low = 11-20%; very low = 0-10%.

Very high impact = change to global annual GDP compared with the baseline forecast of 2% or more (increase in GDP for positive scenarios, decrease for negative scenarios); high = 1-1.9%; moderate = 0.5-0.9%; low = 0.2-0.4%; very low = 0-0.1%.

Risk intensity is a product of probability and impact, on a 25-point scale.



**Robert Powell**

Director, Risk Briefing

### **NEGATIVE SCENARIO—CHINA SUFFERS A DISORDERLY AND PROLONGED ECONOMIC SLUMP**

#### **HIGH RISK; VERY HIGH IMPACT; RISK INTENSITY = 20**

We expect China to experience a sharp economic slowdown in 2018, with real GDP growth slowing to 4.2%, from 6.2% in the previous year. The political reshuffle in the upper echelons of the CCP scheduled for late 2017 will enable the president, Mr Xi, to alter economic policy in 2018. The primary focus of this policy shift will be to slow the rapid growth in credit that has been a feature of government policy since the 2008-09 global financial crisis and has caused the country's debt stock to surge to over 210% of GDP. Despite the scale of the economic slowdown, we anticipate that it will be policy-induced and therefore easier for the authorities to manage (reflecting in part the state's deep integration with China's banking system). As a consequence, we do not expect it to result in a rise in unemployment and social unrest on a scale that would threaten the established order. However, there are substantial risks to this outlook. The bursting of credit bubbles elsewhere has usually been associated with sharper decelerations in economic growth, and, if accompanied by a slump in house prices, the government may struggle to maintain control of the economy—especially if a slew of China's small and medium-sized banks (which are more reliant on wholesale funding) hit the wall. If the Chinese government is unable to prevent a disorderly downward economic spiral, this would lead to lower global commodity prices, particularly for metals. This would have a detrimental effect on the Latin American, Middle Eastern and Sub-Saharan African economies that had benefited from the earlier Chinese-driven boom in commodity prices. In addition, given the growing dependence of Western manufacturers and retailers on demand in China and other emerging markets, a prolonged deceleration in Chinese growth would have a severe global impact—far more than would have been the case in previous decades.

### **NEGATIVE SCENARIO—CHINESE EXPANSIONISM LEADS TO A CLASH OF ARMS IN THE SOUTH CHINA SEA**

#### **MODERATE RISK; HIGH IMPACT; RISK INTENSITY = 12**

Competing territorial claims in the South China Sea—which have intensified in recent years as China has sought to turn uninhabited reefs, atolls and rocks into artificial islands (and, in some instances, military bases)—could take an unpredictable and dangerous turn following the election of Mr Trump in November. Notably, his rhetorical baiting on Twitter of China (which he has accused of, among other things, currency manipulation) and his ambivalence towards the One China policy on Taiwan, could destabilise the delicate diplomatic balance within the region. In response, there is a risk that China may take an even more aggressive approach to exerting its claimed historical rights to the sea areas demarcated by its so-called nine-dashed line, which encompasses around 85% of the South China Sea. This could include an acceleration of its island reclamation measures or declaring a no-fly zone over the disputed region. Although this might not necessarily result in a military confrontation—China's bilateral tensions with the Philippines,

## Preparing for the paradigm shift

for example, have eased since the election of Rodrigo Duterte to the Philippine presidency—it is worth noting that China remains mired in multiple island disputes elsewhere, including with South Korea and Japan. As a result, there is a risk that any Chinese military build-up in the region will raise the danger of an accident or miscalculation that might lead to a wider military escalation. Any worsening of the row could undermine intra-regional economic ties, interrupt global trade flows and depress global economic sentiment more broadly.

### **NEGATIVE SCENARIO—THE US INTRODUCES THE BORDER-ADJUSTMENT TAX**

#### **LOW RISK; VERY HIGH IMPACT; RISK INTENSITY = 10**

In the US, the Republican Party (which has a majority in both houses of Congress) is working to pass the largest programme of tax reform in more than three decades. It wants to eliminate the 35% federal corporate income tax and replace it with a 20% destination-based cashflow tax. Central to this reform is the introduction of the BAT, under which US exports would not be subject to the tax but imports would, and imported raw materials would not be tax-deductible. Overall, tax would be levied on goods and services where they are sold rather than where they are produced. Supporters of the BAT argue that destination-based taxation is better suited to the modern economy, where patents and software represent a growing share of assets and can be moved across borders to avoid taxes. Such a big change, however, comes with a great deal of risk. A tax on imports would raise the price of petrol, clothes and food in the US, and this inflation would hurt those who are economically vulnerable. Advocates maintain, however, that the US dollar would appreciate to offset the BAT, and this would prevent an increase in imported inflation. However, an appreciating US dollar would have significant consequences for the rest of the world. The US dollar surged against most currencies in the weeks following the presidential election in November 2016, reaching a 14-year high on a trade-weighted basis. Some studies project that the BAT would lead to a further appreciation, of 20-25%. This would increase the cost of servicing US-dollar-denominated debt and could trigger financial instability, particularly in emerging markets. In addition, it is possible that the BAT would run afoul of World Trade Organisation rules. It could also incite retaliatory measures by the most affected countries (such as Mexico and China), which could spiral into a trade war.

# China

## Risk management or crisis management?



**Mary Boyd**  
Director, Corporate Network,  
Shanghai

**China's prospects in 2017 point to a still-high level of economic growth, although The Economist Intelligence Unit's forecast of 6.2% GDP growth for the year is below the government's target of an average annual rate of 6.5% for the 13th five-year plan period (covering 2016-20).**

However, beneath these impressive figures there are a number of serious challenges that will test the country's risk-management capabilities. The first factor that will influence developments in China this year is the country's political calendar, which will be dominated by the 19th CCP congress, expected to be convened towards the end of the year. This is a five-yearly political gathering, and it will mark the end of the first term of the Xi administration and the commencement of his second five-year term. Five of the seven members of the standing committee (the CCP's top decision-making body) will retire, giving Mr Xi the opportunity to make key personnel appointments. His choices will be instrumental in shaping China's economic and social development in the next five years, and so the stakes could not be higher.

The leadership transition will preoccupy the country's political elite, leaving everyone else to speculate about what is being decided behind closed doors. Throughout this period, the government's emphasis will be on projecting an image of stability and continuity for the domestic as well as global audience. Several multi-year themes and targets have already been articulated in numerous government documents, notably the "centennial goals" to mark the 100th anniversary of the CCP's formation in 2021, and "China 2025", a programme to upgrade and digitise industrial sectors. China's preference would be to keep to such prescribed policies throughout the year, but this will be very difficult given geopolitical volatility, especially in China's relationship with the US.

Relations between Mr Xi and Mr Trump have yet to be tested, but punitive measures against China featured prominently in the latter's election campaign rhetoric, and China has been preparing defensive retaliatory measures should Mr Trump deliver on his election promises to raise tariffs on or bar Chinese imports. This would be destabilising, both for companies involved in direct bilateral trade as well as for manufacturers reliant on China's supply chains. Other economic worries arise from homegrown causes. China's debt has grown to over 210% of GDP. This has placed the country's conventional banking system under considerable strain and pushed "shadow banking" activities to ever-riskier heights. New total social

**2017 will be dominated by the 19th CCP congress**

**Preparing for the paradigm shift**

financing (the China-specific terminology used to describe shadow-banking activities) grew to Rmb17.8trn (US\$2.7trn) in 2016. Although it will be mindful that China's debt addiction is increasingly harmful, the government will still be relying on stimulus spending to deliver stable economic growth in 2017. This will mean continued government spending on major infrastructure projects, such as the high-speed train network. Government funding will also support key industrial objectives, such as incentives for electric-vehicle manufacturing and robotics, in line with "China 2025" targets.

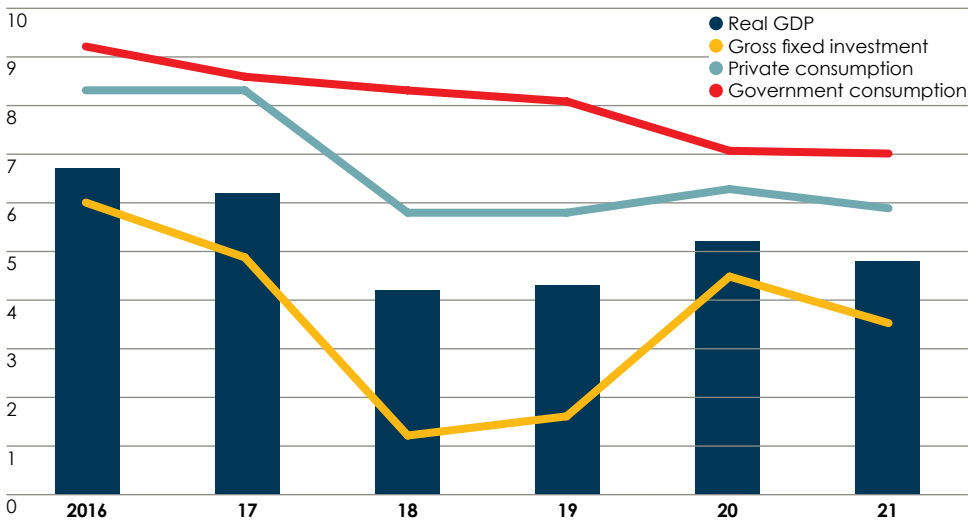
**China's government will rely on stimulus spending to deliver stable growth in 2017**

**GROWING APART**

Balancing credit growth with economic stability is likely to mean more micromanaging of financial risk within the conventional financial sector, and cracking down on shadow-banking schemes that are egregiously risky, such as peer-to-peer lending. Stricter "window guidance" for bank lending, and tightened regulations for foreign-exchange approvals and overseas direct investment, will result in tougher operational challenges for business, as will rising producer prices and overall credit costs.

Economic policy discussions in China are currently focused on "supply-side structural reform", which encompasses squeezing out overcapacity (in heavy-industry sectors as well as destocking housing inventory) and deleveraging. The government has been exploring mixed-ownership experiments, debt-for-equity swaps and some reduction in industrial capacity, but this has been offset by consolidation and mergers within state-owned enterprises.

**Economic growth in China**  
(% change)



Note. 2016 figures are estimates. All others are forecasts.

Source: The Economist Intelligence Unit.

Risk management in international affairs will be even trickier. The Trump administration's isolationism offers leadership opportunities for China, but these must be carefully weighed. Mr Xi's appearance at the World Economic Forum in Davos in early 2017 underscored China's stake in economic globalisation, but it also exposed the country's own record of protectionist policies towards foreign companies. Similarly, Mr Trump's abandonment of the TPP leaves open the question of what new trade architecture will be most favourable for China. So far, China has equivocated on whether it prefers the RCEP or the Free-Trade Area of the Asia-Pacific (FTAAP) option, and it may well choose to pursue bilateral trade pacts or advance its own "One Belt, One Road" initiative instead.

Under Mr Xi, China has emphasised its desire for a new "great power" relationship with the US, and initiatives such as the creation of the Asian Infrastructure Investment Bank have lent substance to this competitive vision. However, China's pursuit of territorial claims in the South China and East China seas risks alienating its regional neighbours to the point that they seek alternative counter-balancing security arrangements. China may be emerging as the natural successor to the US as the hegemonic power in the Asia-Pacific region, but it has yet to secure regional acquiescence for this outcome.

#### **Implications for business**

- Demonstrating a commitment to the local market may help to reduce any negative effects from tensions between China and the US.
- China's transition to a new, consumption-driven growth model will require a much greater focus on understanding evolving consumer demand.



# Hong Kong and Taiwan

## Politics and economics in China's shadow

**Friction with mainland China for both Hong Kong and Taiwan is set to continue but will be mitigated by vital economic ties. Hong Kong's capital markets are faring well and the territory now occupies the top spot for foreign-exchange trading in Asia, but renminbi depreciation and weakening external demand from mainland markets represent key headwinds.**

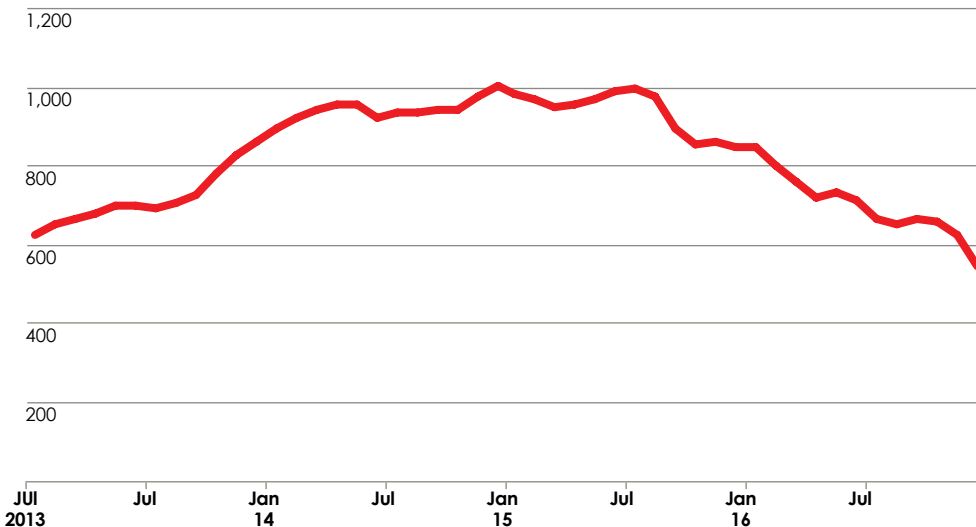
### HONG KONG

Carrie Lam, Hong Kong's former chief secretary for administration, looks set to be chosen as the special administrative region's next chief executive on March 26th, succeeding the highly unpopular current leader, Leung Chun-ying. Elections for the Legislative Council (Legco, Hong Kong's parliament) in September 2016 produced an opposition increasingly dominated by populist "localist" groups advocating greater self-determination or even independence. Although pro-government parties will dominate Legco until the next ballot in 2020, government moves to bar radical opposition members from the legislature risk undermining the body's legitimacy.



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### Renminbi deposits in Hong Kong (Rmb bn)



Sources: The Economist Intelligence Unit; Hong Kong Monetary Authority; Haver Analytics.

**HKEX to launch renminbi currency options in 2017**

## Real GDP growth set to pick up modestly in Taiwan this year

Despite political frictions, boosted by the territory's robust capital markets, economic integration between Hong Kong and the mainland continues, as does the city's prominence as a regional capital hub. Average daily turnover on foreign-exchange markets rose by nearly 60% in 2013-16, from US\$274.5bn to US\$436.6bn. Partly driven by the jump in US dollar:renminbi trading (accounting for 17.4% of transactions), especially notable is that US dollar:yen trading rose by even more (accounting for 21.2% of transactions). This has propelled Hong Kong to overtake Tokyo as a centre for foreign-exchange transactions and reduced Singapore's lead in this field.

A notable weak spot in Hong Kong's foreign-exchange picture is a slump in renminbi deposits, which fell to Rmb627.6bn (US\$94.5bn) in November 2016, from a peak of Rmb1 trn in December 2014. The People's Bank of China (the central bank) has allowed liquidity on the offshore renminbi market to tighten, pushing up the cost of borrowing offshore for bets against the currency. An accompanying decline in Hong Kong's renminbi savings is likely to be more a reflection of such actions and weaknesses in the currency itself, rather than a deterioration of the territory's market strengths. Indeed, the market infrastructure for renminbi services is expanding. The Hong Kong Stock Exchange (HKEX) will launch renminbi currency options on March 20th 2017, with US-dollar-offshore renminbi options the first such product to be traded.

### TAIWAN

We expect the DPP government, which supports a more autonomous position for Taiwan in cross-strait relations with mainland China, to control both the presidency and the Legislative Yuan (parliament) until at least 2020. Further trade and investment agreements with China will be shelved during the period owing to the Taiwanese government's refusal to recognise the basic framework for dialogue, the "1992 consensus", that the mainland authorities demand for official communications.

Taiwan's real GDP growth will pick up modestly in 2017, extending a recovery begun in the second half of 2016. Electronics, the backbone of the island's manufacturing sector, will see exports grow more strongly on the back of new product launches. Yet external demand will remain weak by recent historical standards, limiting growth in corporate investment overall. An economic "hard landing" in China in 2018, followed by a downturn in the US in 2019, will erode external demand and investment growth. With the mainland and Hong Kong markets representing the two largest destinations for Taiwanese exports (at 28.8% and 14.9% in 2016, respectively), economic pressures will provide a check against populist tendencies within Taiwan's leadership towards ratcheting up political tensions with China.

#### Questions for business leaders

- How concerned are you about growing political frictions between mainland China vis-à-vis Hong Kong and Taiwan?
- Does your company's experience with finance and treasury activities in Asia match with Hong Kong's rising importance as a capital markets hub?

# Japan and South Korea

## Political (in)stability in North Asia



Economic growth will remain sluggish in both Japan and South Korea. The Economist Intelligence Unit forecasts that Japan's economy will grow by 1% in 2017, while South Korea's will expand by 2.8%. Whereas Japan is enjoying a period of political stability—the prime minister, Shinzo Abe, is now in his fifth year in office—South Korea has been impaired by a political vacuum, resulting from the impeachment motion against the president, Park Geun-hye, and the scandal that triggered it.

### JAPAN: ABENOMICS, INTERNALLY AND EXTERNALLY

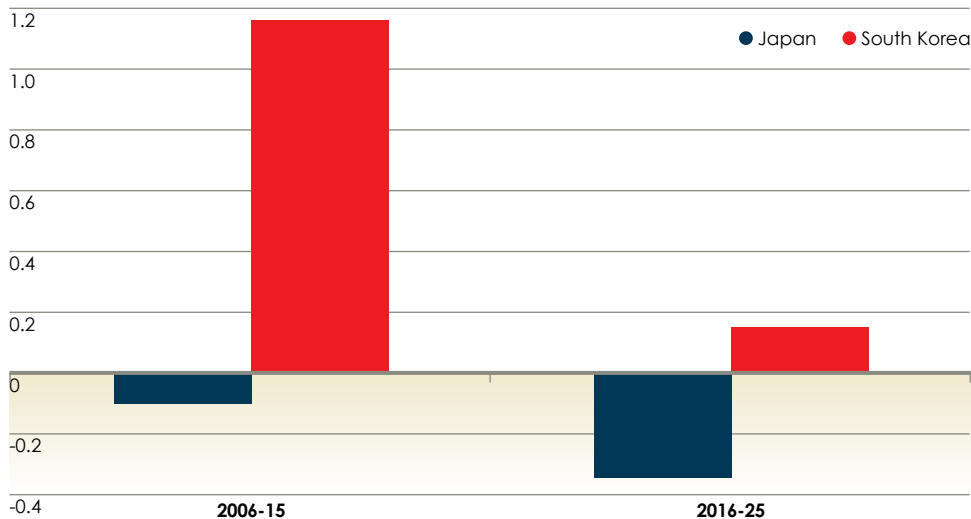
Domestically, the Japanese government will continue to pursue its economic revival policy, known as "Abenomics" after the prime minister, over the medium term. However, it will continue to fall short of its ambition to reflate the economy, failing to put it on a higher growth trajectory through the combined use of monetary, fiscal and structural reforms. Externally, the key issue for Abenomics will be the economic relationship with the US. The TPP is considered to be a key achievement for Mr Abe's trade policy agenda, and so Mr Trump's announcement that the US will withdraw from



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### Demographic challenges

Annual labour force growth (%)



Source: The Economist Intelligence Unit.

**Abenomics continues, but growth is elusive**

## Political paralysis and weak growth overshadow South Korea's prospects in 2017

the trade pact has come as a tough blow. Mr Trump's frequent criticism of Japan's economic and industrial policy has also given rise to serious concerns about the trade relationship between the two countries. After two positive meetings with Mr Trump, Mr Abe seems to have been able to allay some of these concerns, but uncertainty remains. The focus will now be on the negotiation of a bilateral trade deal. Higher import duties on Japanese products into the US represent the biggest risk. In 2016 Japan's trade surplus with the US was close to US\$69bn. Thus, clearly for Japan there is much at stake in the direction of trade with the US.

### **JAPAN: A BLEAK GROWTH OUTLOOK**

We expect real GDP growth to match the 1% recorded in 2016 (according to the latest estimates). There will be some volatility in growth in 2018-21. Concerns over global growth prospects, sparked by an anticipated hard landing in China in 2018, will cause tensions in financial markets, pushing up the value of the yen against the US dollar in that year. The exchange-rate change will act as a depressant on Japan's growth.

### **SOUTH KOREA: A DAMAGING POLITICAL VACUUM AND ECONOMIC SHIFTS**

Parliamentary fragmentation and hostile conditions will make it difficult, if not impossible, for the current South Korean administration to implement any significant policies. The current and next administrations will accord a high priority to supporting export-oriented industries, which have been affected by the prolonged weakness in global trade. The next president will be faced with the continuing need to facilitate a "paradigm shift" for the economy, in which it would be driven by innovation and creativity rather than export-oriented manufacturing. This includes curbing the influence of the *chaebol* (industrial conglomerates) and encouraging more competition in the economy.

We expect South Korea's real GDP to grow by an average of 2.3% a year in 2017-21. As the current and next governments fail to engineer a structural shift away from South Korea's export-led growth model, the fate of the economy will be tied to global trade prospects, as well as the performance of the country's exports in established and new markets. China will remain a source of both opportunity and distress. The sharp slowdown in China's economy in 2018 will have a major impact on South Korea's exports, a quarter of which are shipped to China. Yet, as a rebalancing towards more services- and consumer-driven economic growth takes place in China, opportunities for South Korea's exports of discretionary goods—such as durable goods, entertainment and leisure, apparel and motor vehicles—will rise. Trade relations with the US will also be a source of risk and uncertainty. South Korea's trade surplus with the US was close to US\$28bn in 2016.

### **JAPAN AND SOUTH KOREA: POLITICAL RISK**

Japan has been enjoying an unusually long period of political stability, with Mr Abe now in his fifth year as prime minister and few threats on the immediate domestic

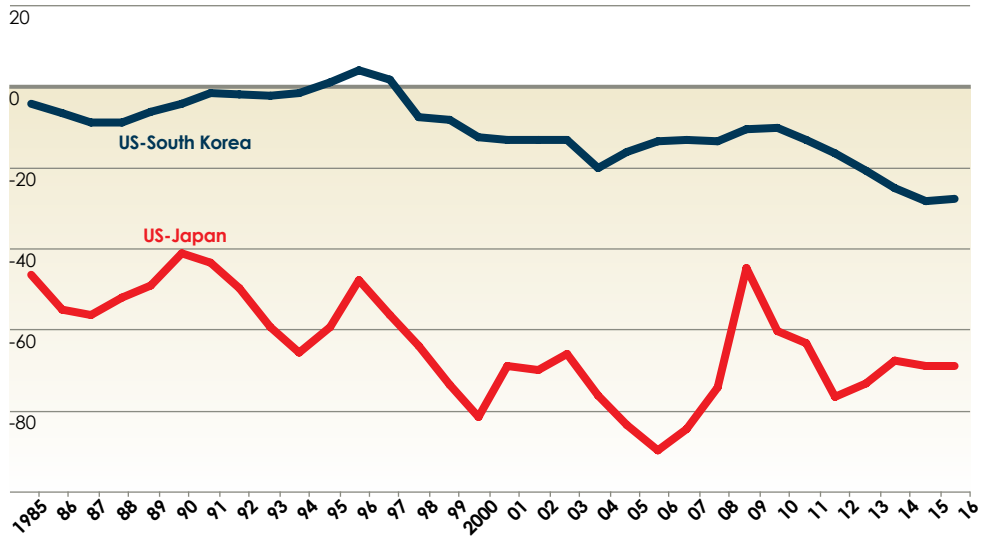
**Preparing for the paradigm shift**

political horizon. However, external political risk is high, not least stemming from the unpredictability of the Trump administration, the rising influence of China in the region and the continuing threat from North Korea. Japan is also highly vulnerable to any deterioration in relations between the US and China, especially if it is seen as a proxy for US influence in the region.

South Korea is facing political risk both domestically and externally.

In addition to the issue of trade relations, the role of the US in national and regional security in Asia is at stake. Mr Trump and his cabinet officials have recently reconfirmed their security commitment to the region, but remarks on the campaign trail, as well as questions surrounding the financial burden on the US, add uncertainty and potentially instability to the balance of power in North Asia. As for Japan and all countries in the immediate vicinity, North Korea is another key risk factor with increasing impact and intensity.

**US balance of trade in goods with South Korea and Japan**  
(US\$ bn)



Source: US Census Bureau.

**JAPAN AND SOUTH KOREA ARE BOTH AGEING AND SHRINKING**

For both Japan and South Korea, demographic factors will play a decisive role in shaping society and the economy as both countries' populations age rapidly. In Japan, in particular, demographic change will continue to act as the main constraint on potential GDP growth. Both the overall population and the workforce in Japan will continue to contract steadily in 2017-21, acting to crimp consumption as well as investor sentiment.

**Questions for business leaders**

- How well positioned is your business to deal with, or capitalise on, the changing demographic structures observed in Japan and South Korea?
- Given the geopolitical tensions in the region, are you confident that your contingency planning is robust?

## South-east Asia Regionalism and the ASEAN way

**Growth in ASEAN is forecast to reach 4.7% in 2017, its highest rate of expansion since 2013, but economies in the region will remain vulnerable to global political volatility and economic uncertainty.**

### REFLECTIONS ON REGIONALISM

ASEAN turns 50 in 2017, under the chairmanship of one of the group's founding members, the Philippines. A golden anniversary is an opportunity for reflection and to celebrate the longevity of a relationship. Much will be made of developments over the years and of the vision of the ASEAN Economic Community (AEC) Blueprint 2025 that builds on the formation of the AEC, which was formally established at the end of 2015. Blueprint 2025 imagines a "people-centred community" in ASEAN that is "highly integrated and cohesive; competitive, innovative and dynamic; with enhanced connectivity and sectoral co-operation; and integrated with the global economy". Progress has been slow, and the so-called ASEAN way of consensus over confrontation is often identified as a key reason for this apparent glacial pace of integration. But as policymakers in the region contemplate the UK's withdrawal from what has been to date the world's most advanced regional initiative, the EU, they may conclude that slow and steady wins the race. In this sense, ASEAN's model of integration based on a bottom-up process of deepening trade and investment links offers an alternative to the top-down regionalism of the EU.

A further opportunity for reflection is presented by the fact that 2017 marks the 20th anniversary of the onset of the Asian financial crisis that ripped through the region in 1997-98, leaving collapsed currencies, economic contraction and political upheaval in its wake. As destructive as it was, the crisis pushed ASEAN to accelerate the implementation of initiatives such as the ASEAN Free-Trade Area (AFTA) in an attempt to foster deeper integration among its members and create an attractive regional market and investment destination. In the decade that followed, real GDP growth for the group averaged over 6% a year as both inward investment and intra-regional trade surged.

Will political tensions in the region prove a similar catalyst for regional integration in 2017? Perhaps, but the backdrop of US-China rivalry for regional hegemony and domestic distractions in the form of elections mean that political risk will be high this year.

### VOLATILITY ON THE HORIZON - POLITICS

There is a strong chance that Malaysia's prime minister, Najib Razak, will request an early dissolution of parliament, paving the way for a general election before the



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**Political risk will be  
high in 2017**

**Preparing for the paradigm shift**

government's term ends in 2018. Preparations for the election will dominate the political environment over the coming months. Mr Najib hopes to capitalise on a divided opposition force, which has fragmented further following the creation of a new political party led by a former prime minister, Mahathir Mohamad. An election victory, however, would offer the prime minister only a temporary reprieve and his tenure will depend on the margin of victory. Any slippage in the current seat tally of the United Malays National Organisation, the dominant party in the ruling Barisan Nasional coalition, would prompt a change in leadership, although this is not part of our central forecast.

Gubernational elections held in February 2017 in Indonesia will have a high economic and political impact on the country's significantly devolved governance structure, but it is the ongoing election for governor of the capital, Jakarta, that will present the biggest test for the archipelago's model of pluralism and tolerance. A highly publicised blasphemy case being tried against the incumbent, Basuki Tjahaja Purnama (known as Ahok), is likely to have led to voting along sectarian lines. Ahok now faces a second-round run-off election scheduled for mid-April. If he were to lose the election, it could hand an advantage to opponents of the president, Joko Widodo (known as Jokowi), ahead of the 2019 presidential election. This could hamper Jokowi's reform programme and chances of re-election in 2019, although this is not our core forecast.

Elsewhere in the region, elections are scheduled in Cambodia (commune-level), Timor-Leste (presidential and parliamentary), Singapore (presidential) and Thailand (parliamentary), although we expect the Thai ballot to be pushed back to 2018.

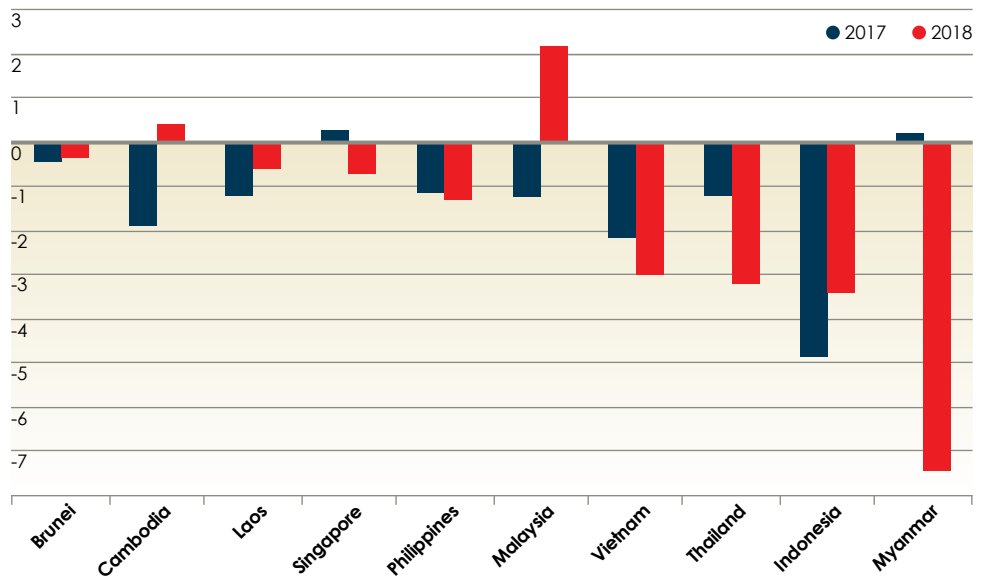
**VOLATILITY ON THE HORIZON - ECONOMICS**

Asian economies will also remain vulnerable to swings in global financial market sentiment. Markets have once again raised their expectations for rate increases by the US Federal Reserve, pushing up longer-term interest rates and causing a widespread weakening of local currencies against the US dollar. We expect to see repeated bouts of capital market volatility

**2017 will see bouts of capital market volatility**

**A strong US dollar will maintain pressure on ASEAN currencies**

Local currency unit vs US\$ (end-period)



Source: The Economist Intelligence Unit.

**Expect an early election in Malaysia this year**

**Political risk appears fairly stable but downside risks abound**

Political risk profile for ASEAN

	Current score	Previous score
<b>Brunei</b>	45	45
<b>Cambodia</b>	65	65
<b>Indonesia</b>	40	40
<b>Laos</b>	50	50
<b>Malaysia</b>	35	35
<b>Myanmar</b>	35	35
<b>Philippines</b>	50	50
<b>Singapore</b>	30	30
<b>Thailand</b>	60	65
<b>Vietnam</b>	50	50
<b>ASEAN average</b>	<b>46</b>	<b>46.5</b>

Black=Unchanged

Green=improvement

\*Compared with previous quarter

Scores range from 0 to 100, where 100 indicates most risk

Source: The Economist Intelligence Unit.

in Asia in 2017, given the uncertainties around US monetary policy, European integration and Chinese economic growth.

Despite this, our central view is that the external environment will remain broadly supportive of growth in 2017. Many commodity prices are past the bottom of the cycle, which has improved market sentiment regarding exporters such as Indonesia, even as importers like India continue to enjoy relatively cheap fuel and construction materials. The current sluggish performance of many developed economies other than the US will also ensure that monetary policy tightening in the OECD is very gradual, allowing Asian policymakers to maintain historically low interest rates.

**Questions for business leaders**

- Local currencies are forecast to decline against the US dollar. How will this affect budgets?
- Are you up to date on initiatives being progressed by the AEC process and what they mean for your business?

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