Pacific Economic Outlook 1993–94

SUMMARY

Background

This report presents the fifth annual Pacific Economic Outlook (PEO). During this time, the PEO has earned a reputation for the accuracy of its predictions of real economic growth in the vast and diverse Pacific region. The first four forecasts have come well within a half percentage point of actual growth. This record of accuracy — and the economic understanding that makes it possible — reflects the work of economic forecasters from each of the seventeen economies whose data are presented here.

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Economic Recovery in the Region in 1992

As forecast last year, economic growth picked up in the Pacific region in 1992. The rise in the weighted average growth rate of the region from 2.6 per cent to 3.3 per cent was somewhat less than forecast. The shortfall was the result of the disappointing economic performance of Japan which suffered three quarters of actual decline in Gross Domestic Product (GDP), its worst outcome since the first oil crisis. Actually, an equal number of economies had a moderation of their growth as had an acceleration, but the four industrial countries that suffered declines in output in 1991 all had expansions in 1992. The greatest turnaround was accomplished by New Zealand and the United States. This points out one of the characteristics of the recession, namely that it was not synchronized in the region as Japan and Korea only experienced deceleration in 1992.

The two star performers in 1992 were China and Chile. China managed to grow 12 per cent without the obvious imbalances that marked rapid economic growth in the mid-1980s. This suggests that China's structural reforms are working to create a more flexible and responsive economy. In the case of Chile, growth accelerated to 10.4 per cent in the midst of successful efforts to reduce the inflation from 18.7 to 12.7 per cent. This is clear evidence that rapid growth can be made consistent with the restoration of price stability. Some moderation of growth is expected in both of these countries in order to maintain internal and external balance.

With the exception of Korea, high rates of economic growth were sustained in the Asian Newly Industrialized Economies (NIEs), Indonesia, Malaysia, and Thailand. For the latter three economies, some progress was made in reducing their balance-of-payments deficits on current account as a share of GDP. This was achieved despite the anticipated softening of raw material prices in world markets in 1992. Indeed, all three economies are much less dependent on raw material production than in the past and are now larger producers and exporters of manufactures than of commodities.

There are two troubled economies in the region, the Philippines which experienced no growth, and Peru which suffered a contraction of output in 1992. In both cases, internal security problems combined with political uncertainty were the root causes of poor economic performance. While both economies forecast GDP growth in 1993, they are conditioned by an assumption of more stable political conditions.

Changing Pattern of Growth and International Trade

It is somewhat surprising that the economy of the region performed so well in 1992 given the recession in Japan and the less-than-robust recovery in the United States, the two supposed engines of growth in the region. One reason for this respectable performance was the continuation of import growth by the United States despite the lackluster economy, but primarily it was because some economies in the region are less export-led than they used to be, and others are finding different and rapidly growing markets in which to sell their exports. For example, the economies of Korea and Chinese Taipei are being stimulated more by consumption and domestic investment in housing and social overhead facilities than by exports. And the double-digit growth of imports by China, Mexico, Chile, Indonesia, Peru, and Chinese Taipei more than made up for the small decline in imports by Japan.

The picture of the region that is emerging is somewhat different than the one that is usually portrayed. As is usually recognized, the region is becoming more interdependent and driven by such variables as intra-regional trade, direct investment, and tourism. Rather than being dominated by just two economies, however, a complex pattern of relationships is developing with multiple sources of stimuli. For example, ASEAN as a group and China are rapidly growing markets, and the NIEs are now sources of foreign direct investment as well as recipients. The experience of the last two years suggests that the multiplicity of growth centers is creating greater dynamism and greater stability in the region.

Faster Growth in 1993 and 1994

Thirteen of the seventeen economies of the region are forecasting faster growth in 1993 than in 1992, and the higher level is expected to be sustained in 1994. The exceptions are the super-growth countries — China, Chile, and Malaysia — plus Mexico, which is still struggling with inflation. The average growth rate in 1993 is expected to reach 4.2 per cent which means greater acceleration than occurred in 1992. Growth is forecast to be led by personal consumption expenditures and gross private domestic investment. The acceleration in 1993 is greater than in 1992 because Japan and Korea are expected to contribute to the rise rather than detract from it. The forecast for 1994 differs from 1993 in that Japan is expecting a further increase in growth while the expansion in the United States is expected to be moderate as the new Administration's fiscal policy is increasingly dominated by deficit reduction.

International trade is forecast to continue its strategic role as facilitator of growth in the region. In every year the growth of trade volume is expected to be significantly greater than the growth of output. While fears of trade protectionism continue to be a concern, there is no evidence yet that it is having a noticeable impact on the volume of trade.

Progress Made against Inflation

Significant progress was made in reducing the rise of consumer prices in 1992. The weighted average increase of the consumer price index (CPI) for the region was almost 2 per cent less than in 1991. No doubt the improvement was helped along by the weakness in commodity prices and by the usual productivity spurt that comes in the first year of an economic recovery, but it was also due to determined efforts of governments in economies such as Chile, Mexico, Indonesia, and Korea to deal with the problem.

TABLE 1
Forecast of Real Economic Growth and Increase of Consumer Prices of Seventeen Economies, 1993–94
(Percentages)

	Real GDP/GNP			*CPI*		
	1992	*1993*	*1994*	*1992*	*1993*	*1994*
Australia	1.8	2.4	3.0	1.0	2.2	2.2
Canada	0.9	3.7	3.6	1.5	2.4	2.5
Chile	10.4	6.0	6.0	12.7	11.0	10.0
China	12.0	10.1	9.5	5.3	6.5	7.2
Hong Kong	5.0	5.4	5.5	9.4	10.2	9.7
Indonesia	5.8	6.3	6.5	4.9	9.5	6.8
Japan	1.3	2.3	3.2	1.8	0.9	0.9
Korea	4.4	6.4	7.6	6.5	5.0	5.0
Malaysia	8.0	7.6	7.5	4.7	4.0	4.2
Mexico	2.7	2.1	3.5	11.9	9.0	8.0
New Zealand	2.2	3.0	2.8	1.0	1.8	1.6
Peru	–3.0	3.5	4.5	56.7	27.0	15.0
Philippines	0.0	3.3	6.7	8.9	7.5	7.0
Singapore	5.8	6.0	6.1	2.3	2.3	2.4
Chinese Taipei	6.1	6.7	6.9	4.5	4.8	5.1
Thailand	7.5	7.9	8.4	4.1	5.3	5.4
United States	2.1	3.2	2.3	3.0	3.1	3.9
Weighted Average ('89–'91)	3.3	4.2	4.2	3.8	3.7	3.9
Wt. Avg. excl. U.S. and Japan	4.9	5.6	5.9	5.2	5.4	5.2
Wt. Avg. excl. Chile, Mexico and Peru	3.2	4.2	4.2	3.4	3.5	3.7
Weighted Average ('87–'89)	3.1	4.1	4.1	3.7	3.6	3.8
Wt. Avg. excl. U.S. and Japan	4.6	5.5	5.8	5.1	5.3	5.1
Wt. Avg. excl. Chile, Mexico and Peru	3.1	4.1	4.2	3.3	3.3	3.6

NOTE: The weighted average is based on the respective economies' exports during the period indicated.

Inflation was reduced in fourteen of the seventeen economies in the region. The success that Australia, Canada, and New Zealand had in reducing inflation to about 1 per cent was quite striking.

Some Inflation Problems Remain

The three economies in which inflation rose were China, Malaysia, and Chinese Taipei. Should inflation be a major concern in these three economies, or elsewhere? Inflation is not forecast to rise for the region as a whole. Gauged by its historical standard, a stable average inflation rate of about 4 per cent constitutes adequate price stability. Nevertheless, inflation is expected to increase in China, Hong Kong, and Chinese Taipei. If this problem is not addressed promptly, then governments in these economies will be forced to restrain real growth in order to keep inflation from getting out of hand.

Inflation also continues to be a simmering problem in Indonesia. It arises from structural, or cost push, factors as well as from excess demand. Although contained in 1992, the imbalances in the real economy, such as inadequate infrastructure and incomplete deregulation, will lead to higher inflation when growth accelerates. Indonesia is poised to advance to a still higher level of growth, but this will not be possible unless these problems are addressed.

Peru, Chile, and Mexico still have the highest rates of inflation in the region. All three forecast progress in reducing the rise in the CPI. In the case of Mexico, the target of reducing inflation to a single digit is expected to be achieved in 1993. It is critical for the future health of these economies that the fight against inflation be continued until a sustainable level is reached.

Unusual Current Account Surplus in 1992: Deficits in 1993 and 1994

The Pacific region experienced another surplus ($4.6 billion) in the current account of its aggregate balance-of-payments in 1992. While less than the $27.6 billion surplus recorded in 1991 when the United States received income transfers in conjunction with the Gulf War, the fact that it was in surplus at all was unusual as the region tends to borrow capital from the rest of the world. A surplus was recorded because the $59 billion rise in the U.S. deficit coming from its economic recovery was counter-balanced by a $43 billion increase in the Japanese surplus reflecting its economic recession.

The forecast for 1993 and 1994 indicates a return to an aggregate deficit of $20 billion for the region as a whole which is similar to levels recorded in the 1980s. Assuming that world capital markets continue to function properly, there is no reason to believe that this level of deficit cannot be financed. While the aggregate deficit may not constitute a problem, the structure of imbalances within the region (U.S. deficit and Japanese surplus) is a matter of great concern.

Risks in the Forecast: Imbalances

The usual amount of uncertainty clouds the outlook, and this constitutes a risk to the forecast. Five specific risks can be discerned. The first risk comes from the imbalance of trade and payments between Japan and the United States already noted. The Japanese forecast indicates declining imports in 1993 and slow growth in 1994. Combining this with average growth of exports, the Japanese trade and current account surplus is expected to grow in absolute amount and remain above 3 per cent of its GNP. Meanwhile the U.S. deficit in current prices is forecast to worsen in 1993 and 1994, both absolutely and in relation to its GDP. Growth of import volume exceeds that of exports in 1993 before partially reversing in 1994.

While not inherently unsustainable, the situation could be elevated to a crisis by the Clinton administration if it demands that something actually be done to reduce the imbalance. The Japanese government could respond constructively by stimulating its own economy, resulting in more domestic absorption, and by opening its economy further to imports from abroad. It is unclear, however, whether the Japanese government is strong enough to conceive and implement such a policy after having been weakened by political scandals.

If a crisis should occur, it could take two forms. It could lead to interferences in trade by either the United States or Japan that could constitute major distortions to the market. Alternatively, it could lead to forced appreciation of the yen in the foreign exchange market. If a correction in the imbalance was to be effected only through exchange rates, the appreciation of the yen would surely have to overshoot its longer-run equilibrium and the move might have to be sustained through a period of apparently perverse response (a J-Curve effect), which could be difficult.

Risk Two: Conflicts over Trade Policy

It is clear that imbalances can lead to a trade conflict if trade practices are not done cooperatively, but rather lead to a tit-for-tat pattern of retaliation. Another event that could touch off a trade conflict would be a declared failure of the Uruguay Round of trade negotiations under the General Agreement on Tariffs and Trade (GATT). Such a failure could trigger recriminations and conceivably end in a trade conflict between the European Community, the United States, and others.

Even if a partial success is scored in GATT, the agreement maybe too weak to head off an expansion of new non-tariff barriers (NTBs). Historically, protectionism surfaces at the end of trade negotiations. While this would not constitute a trade war, it could sour the atmosphere for trade expansion. While the economies in the area could prevent this from happening in the Pacific region, it would require a regional dialogue on trade that is of higher quality than currently takes place.

Risk Three: Financial Fragility

It is generally accepted that economic progress depends in part on efficient capital markets which in turn require liberalization from restrictive government regulations. Nevertheless, financial deregulation is fraught with danger if prudential regulations and oversight procedures are not in place when deregulation occurs. Failures in deregulation led to the savings and loan debacle in the United States and the bubble economy in Japan. Indeed the Pacific region may be prone to financial bubbles as they have occurred in Chinese Taipei, Korea, Thailand, and may even be present in China.

The immediate concern results from the implosion of the Japanese financial bubble which has undermined the health of Japanese financial institutions. Under the worst of circumstances, massive bankruptcies of financial institutions could overwhelm the management skills of the Japanese government and jeopardize the real economy. However, even under the best of circumstances, Japan's huge current account surplus requires capital markets to work well to recycle surplus back to deficit countries. In the absence of viable private financial institutions, the job must be done by governments which inevitably leads to problems. Hence the undermining of Japanese financial institutions may weaken the financial system's capacity to efficiently recycle the surplus.

Risk Four: Electoral Uncertainty

Major elections have recently taken place in Australia, Indonesia, Korea, and the United States. Even in those cases where the government candidate was elected, ministers have been changed and policies re-evaluated. When governments change, as in the United States, some period of time must pass before all policymakers are chosen and their policy preferences made known. In the interim, a period of political and policy uncertainty exists. While hopefully policy changes are improvements, they may not be, and uncertainty itself constitutes risk.

Furthermore, other economies in the region such as Canada, Mexico, and New Zealand are in a period where elections are clearly on the horizon. This is an even more uncertain time for them. In the case of Canada, the impending provincial election in Quebec could reopen the unsettled constitutional question. Economic performance may be closely linked to elections; scholars believe that they are able to discern ties between political business cycles and elections in some countries. While this may be a plus or a minus for the economy, it does constitute uncertainty, and, therefore, a risk for the forecast.

Risk Five: Political Tensions

While electoral change can be either good or bad for an economy, political tensions are different — they are usually deleterious. Two hot spots can be identified within the Pacific Basin: Hong Kong and the Korean peninsula. Concern about China's repossessing Hong Kong in 1997 has already had its economic impact, which has been essentially benign. The process has been clouded. China has been unwilling to accept new changes proposed by the current British Governor of Hong Kong to elect more members of the legislative council rather than having them appointed. If this comes down to a test of wills between Britain and China, the economy of Hong Kong could suffer.

The relationship between South and North Korea has changed a great deal over the last three years. Much of the change has been positive in that the two sides have begun talking to each other and have even signed certain treaties. However, a serious issue of military security has arisen in that North Korea is believed to be developing nuclear weapons and has been unwilling to let foreign inspectors determine whether that is the case or not. In March, North Korea withdrew from the Nuclear Non-Proliferation Treaty rather than submit to inspection of sites not designated by them as nuclear facilities. While outbreak of hostilities is still highly likely over this or any other issue, the prospect is greater now than it was in 1992.

A Changing and Maturing Region

Three dominant characteristics of the Pacific region are the outward orientation of government policy, the increasing integration of the region, and rapid economic growth. A process of convergence is also taking place as the developing countries consistently grow faster than the advanced countries. For this to be sustained, however, economic reform and restructuring must be an ongoing process, which turns out to be the case. In the developing economies such as China, Indonesia, Malaysia, and Thailand, high levels of industrial investment are creating new capacity to produce goods for world markets. The NIEs, feeling the pinch of labour shortages, rising wages, and loss of competitiveness in labor intensive goods, are moving up the technological ladder into alternate goods and, increasingly, into services. As a sign of their growing maturity, the share of their labour forces working in manufacturing is declining. The advanced economies are under constant pressure to improve their productivity and creativeness to produce higher valued goods and services. This is a difficult and demanding process, but offers rewards to all economies as is evident from the high rate of growth achieved by the region. Investment in infrastructure is a necessary ingredient in this process, and seems to be growing in importance throughout the region.

A Renewed Feeling of Confidence

While we were able to identify more sources of risk this year than last, we believe that the probability of an event occurring with a negative economic impact is no greater. Several facts create confidence that the reverse may be true. The Pacific region continues to open and liberalize. To strengthen this process, the PECC defined and endorsed an open Pacific region in its San Francisco Declaration. As economies recover from the recession, confidence generally rises. This is seen this year, especially in New Zealand where several years of painful adjustment now appear to be paying dividends. Also in Canada, after three years of very poor economic performance, the forecast calls for a strong recovery of growth that exceeds that of the United States and Japan. Confidence has also risen in the United States where the election has ended the previous governmental gridlock. Of course pessimism is present in both Japan and Korea, but if we cyclically correct those attitudes, they do not seem extreme. Our forecast calls for the continuation and acceleration of the economic recovery. We feel comfortable with that forecast.

SOURCE: Pacific Economic Cooperation Council Secretariat, Singapore