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New Hope for Trade to Revive, but Productivity Growth Remains Slow

Following much pessimism about the prospects for globalisation and free trade in 2016 due to 'Brexit' and the election of Donald Trump as United States (US) President, 2017 has seen greater optimism with the Netherlands, France, and Austria electing leaders who are positively disposed towards free trade and globalisation. Expected cooperation between Angela Merkel, Emmanuel Macron, and Mark Rutte means the integration process in the European Union (EU) is likely to continue and the platform of free trade will be preserved.

Such renewed optimism was also evident at the G20 summit held on 7 and 8 July 2017 in Hamburg, Germany, where the leaders of the world's 20 biggest economies emphasised the need to share the benefits of globalisation. In their summit declaration, the G20 leaders expressed their resolve to support free trade and open markets to help the global economy recover from the Great Recession, the sharp decline in economic activity during the late 2000s. Another indication of the fight against protectionism was the political agreement on a strategic partnership reached between the EU and Japan just before the G20 summit.

While the recent more positive sentiment towards free trade and globalisation is a welcoming sign for the global economy, this sentiment is due in part to the cyclical recovery underway since Q4-2016 and Q1-2017 as China, the EU, and the US have seen robust growth in trade (Table 1). It is also a result of the continuous decline in the unemployment rate in the EU from its peak of 11.3% in Q1-2013 to 8.2% in Q1-2017 (Figure 1).

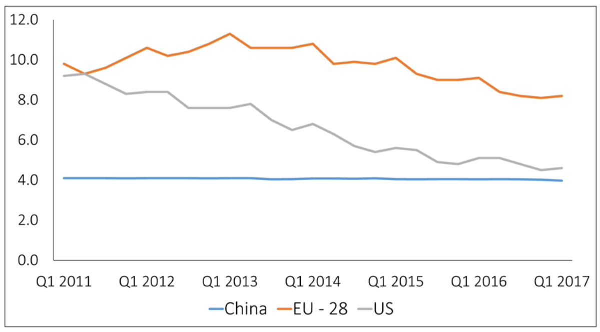
Despite such indications of a global economic recovery, it can only be sustained if the world's major economies manage to improve their productivity growth, which has been lacking in the past 3 years (Figure 2). To do so, they need to raise investment in physical capital, human capital, and research and development.

Table 1. China, EU, and US Trade Portion over GDP and Trade Growth (%)

	European Union (28)		United States		China	
	Trade/GDP	Trade Growth	Trade/GDP	Trade Growth	Trade/GDP	Trade Growth
Q1 2015	84.6	6.4	28.7	-1.5	37.4	-6.4
Q2 2015	85.3	7.6	28.4	-3.5	36.0	-7.4
Q3 2015	84.4	5.4	27.8	-4.4	36.8	-9.7
Q4 2015	83.0	5.4	27.1	-6.4	34.8	-8.1
Q1 2016	82.8	-0.1	26.6	-4.8	32.5	-11.3
Q2 2016	84.5	0.6	26.6	-3.8	33.4	-5.4
Q3 2016	84.5	-0.2	26.8	-0.6	34.0	-5.8
Q4 2016	85.8	2.7	26.9	2.6	33.2	-2.1
Q1 2017	88.8	9.0	27.3	6.9	34.3	12.2

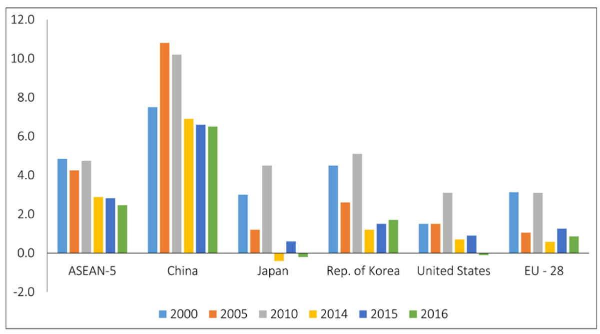
Source: China General Administration of Customs, Eurostat, and US Bureau of Economic Analysis, 2017.

Figure 1. China, EU, and US Unemployment Rate (%)



Source: China Ministry of Human Resource, Eurostat, and US Bureau of Labor Statistics, 2017.

Figure 2. Selected Countries' Productivity[1] Growth (%)



Note: ASEAN-5 consists of Indonesia, Malaysia, Philippines, Singapore, and Thailand. Productivity growth is the simple average of each country's productivity growth.
Source: Economist Intelligence Unit and Eurostat, 2017.

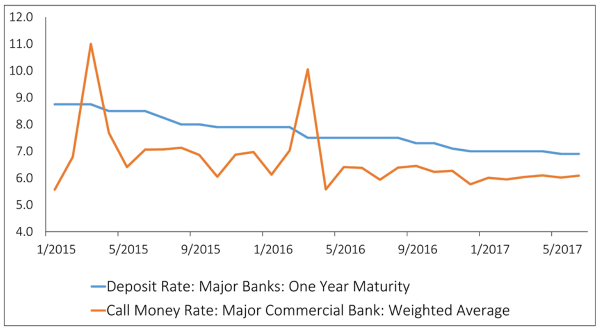
[1]Productivity is measured by output (in each respective currency) per hour of labour work

INDIA
Difficult Reform Underway

Prime Minister Narendra Modi is having a hard time delivering on his campaign promise of reforming India as one of his signature programmes, demonetisation, has produced mixed results. On the positive side, demonetisation has attracted liquidity into the banking system as indicated by a fall in the deposit rate, one of many indicators of bank liquidity, amongst major banks from 7.9% in January 2016 to 6.9% in July 2017 (Figure 3). However, only US$20 billion in demonetised notes was scrapped from the economy, far below the government prediction that roughly US$44 billion would be scrapped as a result of the effort to eliminate black money from the financial system at the end of 2016. Further, the adverse impact of the demonetisation on the real sector was also apparent, as growth in the industry sector remained low in Q1-2017, especially due to a very poorly performing construction sector (Figure 4).

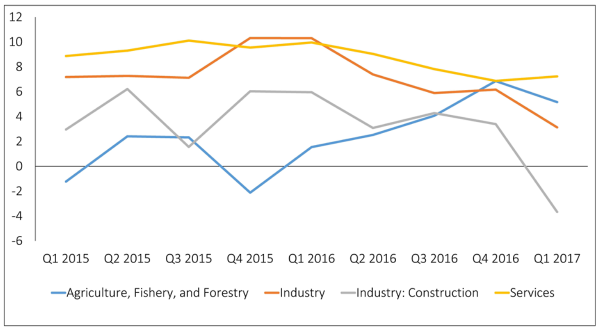
The second significant measure taken by the Modi administration is the implementation of a comprehensive multiple Goods and Services Tax (GST) that replaced the complex multiple indirect tax structure on 1 July 2017; it aims to improve competitiveness, increase transparency, and improve tax collection. Following the implementation of the GST, India has seven separate tax rates: 5%, 12%, 18%, and 28%, plus a 0% rate for basic items (food, grains, cereal, and fresh milk), a luxury tax (43% and higher) on high-end consumer items, and a 3% tax on gold. The implementation of the GST will be a big challenge for Modi's administration as it is a multidimensional tax policy that will take time to bear fruit. On the positive side, the reform is expected to improve the ease of doing business as it brings India a step closer to a One Country–One Tax system that will facilitate the movement of goods between states. On the down side, the implementation of the GST is likely to be another blow to Indian economic growth in the short term as small and medium-sized enterprises may not have sufficient capacity to understand and utilise the new tax system.

Figure 3. India Interest Rate Movement (%)



Source: Reserve Bank of India, 2017.

Figure 4. India GDP Growth by Sector (%)



Source: Central Statistics Office, India, 2017.

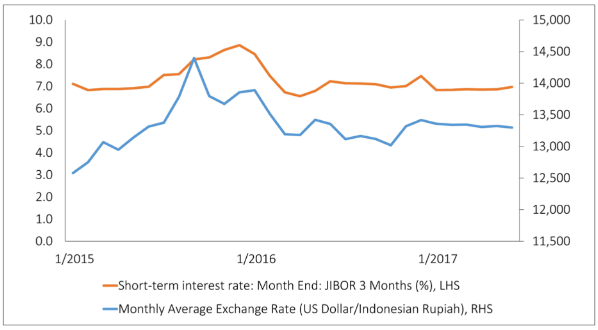
ASEAN Keeps Interest Rates Steady amid US Monetary Tightening

The three biggest economies of the Association of Southeast Nations (ASEAN) – Indonesia, Malaysia, and Thailand – have maintained healthy growth driven by robust export earnings in 2017. Monetary conditions have also stabilised as domestic liquidity is maintained as manifested in stable short-term interest rates and stable currency performances in the first half of 2017. Indonesia, Malaysia, and Thailand maintained their interest rates at 4.75%, 3%, and 1.5%, respectively, in July 2017 despite an increase in the Effective Fed Funds Rate from 0.7% on 3 January 2017 to 1.2% on 17 July 2017.

INDONESIA

Short-term interest rates and the Indonesian rupiah's exchange rate against the US dollar stabilised in the first half of 2017 due to a robust trade performance, which resulted in a surplus of US$7.6 billion in the first 6 months of 2017 (Figure 5). The challenge for the Indonesian government in navigating the economy is to maintain sound public finances amid tax collection shortages while trying to maintain its strategic goal of building infrastructure across Indonesia.

Figure 5. Indonesia Exchange Rate and Short-term Interest Rate Movement

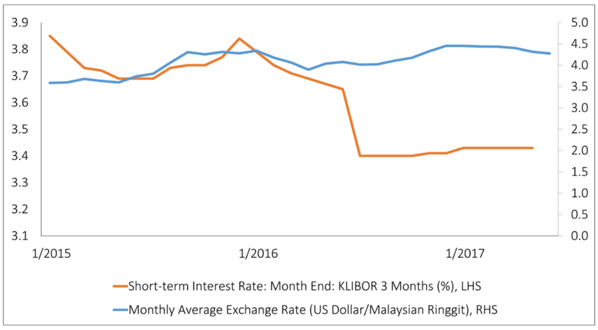


Source: Bank Indonesia, 2017.

MALAYSIA

Bank Negara Malaysia decided to maintain its benchmark interest rate at 3% in July 2017, unchanged since July 2016, to maintain an accommodative monetary policy stance that supports economic activity. Three main factors underlie Bank Negara Malaysia's decision to keep its benchmark rate unchanged. First, the Malaysian economy performed well in Q1-2017, expanding by 5.6% year-on-year due to stronger domestic demand and robust exports of US$33 billion during the first half of 2017. Second, headline inflation moderated to 3.9% in May 2017 due to a fall in domestic fuel prices from 4.4% in April 2017. Third, the domestic financial market has been resilient as the ringgit remained stable and so did liquidity in the financial system, as can be seen from the stable short-term 3-month interbank interest rate during the first 6 months of 2017 (Figure 6).

Figure 6. Malaysia Exchange Rate and Short-term Interest Rate Movement

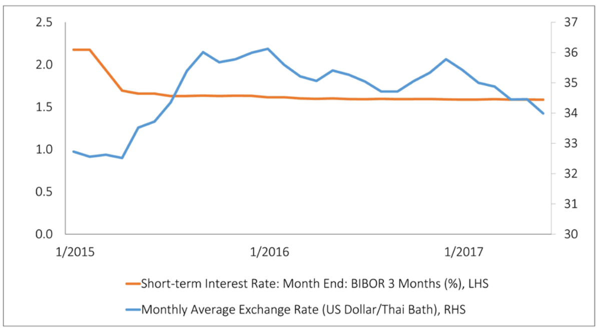


Source: Bank Negara Malaysia, 2017.

THAILAND

Bank of Thailand decided to keep its benchmark interest rate unchanged at 1.5% to maintain an accommodative monetary policy stance to support economic growth while preserving stability in the financial sector. Three main factors underlie Bank of Thailand's decision to hold its benchmark interest rate. First, although the growth outlook improved due to a robust trade performance that resulted in a US$5 billion trade surplus in the first 5 months of 2017, domestic demand growth was not yet on a sufficiently solid footing with manufacturing growth of just 1.2% and gross fixed capital investment of only 1.7% in Q1-2017. Second, as headline inflation was low at 0.7% in the first half of 2017, year-on-year, accommodative monetary policy is needed to support domestic demand to sustain inflationary pressures in the near future. Third, Bank of Thailand also needs to keep monetary policy accommodative as overall sentiment in global financial markets has improved as manifested in an appreciation of the baht and stable financial system liquidity as indicated by a stable short-term interbank interest rate during the first-half of 2017 (Figure 7).

Figure 7. Thailand Exchange Rate and Short-term Interest Rate Movement



Source: Bank of Thailand, 2017.

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