



## EXECUTIVE SUMMARY

The year 2018 has been an eventful period for international trade and investment. The trade protectionist rhetoric of 2017 has morphed into concrete policy actions that have triggered bilateral and sectoral trade wars. The continued blockage of the appointment of new judges to the World Trade Organization (WTO) Appellate Body has also made the binding dispute settlement mechanism almost completely ineffective in addressing the growing trade tensions or in clearing the backlog of old disputes. A number of WTO members have started to put forward reform proposals for addressing the growing concerns about the multilateral trading system and the future of WTO. Despite a show of willingness among WTO members to deal with these issues, achieving consensus will take time during which trade tensions are unlikely to weaken and may further escalate.

In that context, this year's Asia-Pacific Trade and Investment Report tracks trade and investment trends in Asia and the Pacific since 2017, i.e. trade in goods, trade in services and foreign direct investment. The report places a special focus on related policy developments and provides a forward-looking analysis of the potential impact of existing and potentially increasing trade tensions on Asia and the Pacific. Highlights from the report are summarized below.

### **The Asia-Pacific region increased its share of global merchandise trade further to 38.5%, thanks to double-digit growth in the value of both exports and imports during 2017**

The region accounted for 39.8% of global merchandise exports and 36.5% of global merchandise imports, and remained the largest trading partner globally for trade in goods. This was achieved because the region again surpassed global trade growth and registered double-digit growth rates of 11.5% and 15% for exports and imports, respectively, in 2017. Such dynamic trade growth, leading to a further increase in the Asia-Pacific region's share of global trade, meant a break in the unprecedented five-year period of trade contraction prior to 2017. However, there is no great optimism that such dynamic growth can be sustained beyond 2018.

### **Higher prices helped to keep trade value growth above 10% in 2018, despite a trade volume growth slowdown**

In the second half of 2018, trade growth decelerated significantly, which could be attributed to higher production costs and risks associated with rising fuel prices and increasing trade tensions between large economies, especially the United States and China. The increase in trade tensions has damaged trade and investment climates, thus raising uncertainties and volatilities in the global markets. Therefore, merchandise trade value in 2018 is expected to record slower growth than in 2017, although still at a double-digit rate. The growth was driven more by increased prices of goods than growth in trade volume. The value of regional exports is expected to grow by 10% in 2018, while imports may increase in value by 12%. However, in terms of volume, export and import growth rates for the year are expected to stand at only about 3.8% and 5.5%, respectively.

### **A further trade slowdown to 2%-3% growth in real terms is expected in 2019, unless trade tensions ease**

The region's trade performance in 2019 is expected to worsen if trade tensions between the United States and China, and possibly other economies, remain or deepen. ESCAP anticipates that the export volume of the Asia-Pacific region may slow to 2.3% in 2019, while import growth may drop to 3.5%. China may see

its real exports stagnate in 2019. Other countries integrated with China through international manufacturing supply chains may also expect their export growth to soften further in 2019. Rising economic uncertainty may also delay foreign direct investment (FDI) and other capital investments that have been important drivers of global demand recovery thus far.

## **Trade in commercial services has experienced strong recovery since 2017**

Commercial services trade recovered in 2017, with the value of exports and imports growing by 7.9% and 6.3%, respectively. Exports by all service sectors in 2017 grew above their long-term trends. Construction services and services linked to intellectual property rights protection recorded the most dynamic export performance in 2017. A major factor in the outstanding performance of construction services trade was the implementation of infrastructure projects in developing countries, including projects associated with the Belt and Road Initiative. The rapid expansion of intellectual property rights protection services is an indication of the expansion of digital and innovative economy.

## **Services export growth is driven by a handful of economies, especially China and India**

The Asia-Pacific region has outperformed the rest of the world with higher growth of commercial services exports and imports. The share of world exports in commercial services captured by the Asia-Pacific region increased from 22% in 2005 to 28% in 2017, while its share of world imports grew from 28% to 32%. The positive services trade performance was driven mainly by the rapidly growing roles of China and India. These two economies, together with Japan and Singapore, accounted for more than half of the services trade in the region. More than 80% of services trade in the region was concentrated in only 10 economies.

## **Services export growth is likely to ease to 4%-5% in 2019, while import growth is expected to rebound slightly from 2018 to exceed 6% in 2019**

As global demand both for goods and services decelerated during the second half of 2018, ESCAP estimates that the growth in value of commercial services exports will stand at 5%-6% in 2018. Growth in services imports may also ease to about 4% in 2018. In 2019, export growth is expected to soften further to 4%-5%. In contrast, services import growth may rebound slightly to above 6% in 2019, mainly because of intraregional demand for services for supporting digital economy expansion.

## **FDI inflows to Asia and the Pacific are expected to drop by 4% in 2018, a downward trend that is likely to continue into 2019**

Since 2017, FDI inflows have fallen, both globally and in the Asia-Pacific region. While global FDI inflows dropped by 23% in 2017, the drop was only 2% in the region. However, greenfield FDI inflows, suffered a sharp drop by 40% in the region, compared to 13% worldwide. FDI inflows to the region are expected to witness a further decline by 4% in 2018, a trend that is likely to continue into 2019.

## **Globally, the Asia-Pacific region remained the most important destination and source of FDI, led by China and ASEAN**

The region attracted 39% of global FDI inflows in 2017. China and Hong Kong, China accounted for 43% of total FDI inflows to the region. For greenfield FDI, ASEAN and China together attracted more than 50% of the total inflow. The Asia-Pacific region is also a major source of FDI, making up 36% of global FDI outflows. Intraregional greenfield investment accounted for nearly half of the greenfield FDI inflows to the region in 2017. Japan, China and Hong Kong, China were the three largest investors in the region. Compared with East and North-East Asia, and South-East Asia, FDI inflows to other subregions have been limited due to disadvantages related to geography, substandard business environment and limited participation in global value chains (GVCs).

## Policy and structural factors both contributed to weakening investment

Policy changes are a major factor in explaining the drop in FDI. The repatriation of foreign earnings in response to tax reforms in the United States is one of the factors responsible for the weakening of FDI. China, the major investor country in the Asia-Pacific region, also implemented more restrictive policies concerning outward FDI in order to maintain the levels of foreign exchange reserves and value of its currency. Policy uncertainties associated with the ongoing trade tensions have also increased risks for investors. As for structural factors, a key trend has been a shift of FDI to intraregional sources. The slowdown of intraregional investment flows, particularly from China, was one of the factors contributing to the drop in FDI inflows in 2017. Some of the fastest-growing sectors are also digital economy-related sectors, which require fewer physical assets such as e-commerce business.

## Further escalation of the United States-China trade war is possible in 2019

This year has been marked by rising trade tensions between the United States and other economies, particularly China. In the first half of 2018, the world's largest economy initiated a number of trade remedy procedures, unilaterally raising United States tariffs on targeted products, especially steel (25%) and aluminium (10%) products. More recently, on grounds of unfair trade practices, the United States also imposed higher 10% tariffs on a large number of Chinese imports. China and other affected economies, including Canada, India, the European Union, Mexico and Turkey filed WTO disputes against the United States and some retaliated by imposing higher tariffs on selected imports from the United States. The threat to include all imports from China on the increased tariff lists has made the escalation of the bilateral conflict between the world's two largest economies a real possibility in 2019. However, the 90-day truce agreed between President Trump and President Xi Jinping on the side of the G20 summit in December provides some hope of a compromise.

## The protectionism trend is broad and not limited to bilateral or sectoral trade conflicts

The trend towards increasing trade and investment protectionism across the board is evident. Policy changes from 2017 to 2018 point to an accelerated imposition of restrictions on trade in goods, increasing restrictiveness of trade in services and more reservations on FDI. At the global level, the number of new discriminatory measures reached a record figure (88 per month) and largely exceeded the number of new liberalizing measures (32 per month) implemented in the same period. Similarly, in Asia and the Pacific, the number of new discriminatory measures introduced by economies of the region (33 per month) was more than double the number of liberalizing measures. Several Asia-Pacific economies raised the restrictiveness of trade in services, which could make their engagement in Industry 4.0 more difficult.

## Asia-Pacific economies are not only a target, but are also active users of discriminatory trade measures

Asia and the Pacific are an important target as well as contributor of discriminatory trade measures, in part because the region is a major exporter of some of the products and sectors subject to trade conflicts. More than 30% of the newly implemented discriminatory measures affected the Asia-Pacific region. Notably, about a third of these measures were introduced by countries in the region. India, China, Indonesia and Australia contributed more than 70% of them. While the share of intraregional discriminatory measures decreased in 2018, it was only because of the more rapid growth in protectionism outside the region.

## Tariffs are just a small part of a whole array of protectionist actions

Contrary to the global worries about the increase of bilateral tariffs, other forms of trade distortion measures have been much more often used than tariffs. Alleged subsidies provided to producers and exporters collectively represented more than 40% of trade distortion measures introduced in 2018. In contrast, import

tariffs accounted for only 17% of newly implemented measures, while contingent trade-protective measures represented about 15%. Non-tariff measures (NTMs) have also grown rapidly. In particular, about 2,400 new technical barriers to trade (TBT) and sanitary and phytosanitary (SPS) measures have been implemented every year since 2013. While SPS and TBT measures often have legitimate non-trade (public) policy objectives, evidence exists that they are sometimes used as protectionist tools. The trend in the Asia-Pacific region has been similar to the global trend.

## **Asia and the Pacific accelerated their economic integration intra- and interregionally**

Asian and the Pacific economies have signed 18 new free trade agreements (FTAs) since 2017, including the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP), a mega-regional agreement involving 11 economies, seven of which are in the Asia-Pacific region. In addition, negotiations of another mega-regional agreement between 16 regional economies, the Regional Comprehensive Economic Partnership (RCEP), have also gathered pace with signature expected in 2019. Negotiations between such a large group of different economies has been difficult, but trade tensions as well as uncertainties about the future of the multilateral trading system have given new impetus to this and other regional integration initiatives. China and other Asian economies appear to be keen to speed up the negotiation and implementation of trade deals with each other. At the same time, they are also seeking new partners outside the region as a means of diversifying and strengthening economic resilience within a regional trade architecture dominated by the United States and China. A highlight in 2018 in this regard was the signing of the European Union-Japan Economic Partnership Agreement. The agreement has become one of the largest and most comprehensive FTAs, covering approximately 30% of the world GDP and 40% of world trade.

## **Escalating tariff wars may reduce global GDP by more than \$200 billion**

ESCAP estimates, based on computable general equilibrium (CGE) simulations, reveal that the current trade war will have detrimental impacts globally and regionally. Global and regional trade flows are set to slow, particularly in the short term, as ongoing United States-China tensions disrupt existing supply chains and dampen investor confidence. While China and the United States experience economic losses under all scenarios, Asia-Pacific economies are affected by a significant loss of demand for intermediate products and commodities from China. ESCAP estimates that global GDP could fall by nearly \$215 billion if the tariffs threatened in 2018 materialize in 2019. In the Asia-Pacific region, the adverse impacts on China could drive the regional GDP down by about \$60 billion. In the case of a prolonged trade war in which investor confidence declines significantly, the cost of adverse impacts increases to about \$400 billion at the global level.

## **As trade frictions reshape GVCs, winners and losers are likely to emerge, with South-East Asia well positioned to benefit in the medium term**

In the medium term, trade frictions could significantly affect the configuration of GVCs, particularly if those frictions remain essentially bilateral. As importers in the United States and China look for alternative suppliers, new opportunities will open up for economies that can leverage their competitiveness to attract the redirected trade and investment. Although the relocation of production will not be completed overnight, and will cause short-term pains in all economies involved in GVCs, ESCAP estimates that ASEAN members are some of the largest potential beneficiaries, especially Viet Nam. The retaliatory tariffs imposed by China and other economies on the United States' exports of agricultural and industrial commodities could also increase export opportunities for some commodity-based economies. However, GVC redirection and trade flows induced by trade tensions are not optimal – nor stable. Policy distortions affecting decisions of multinational enterprises to relocate may create inefficiency-related losses as production moves to second-best locations. Trade tensions may also lead investors to postpone investments until policy uncertainties decrease.

## **The Asia-Pacific region may weather worsening trade tensions and global policy uncertainties through continued regional integration**

Deepening market integration in the region is an effective strategy for minimizing the adverse consequences of rising global trade tensions. ESCAP simulations suggest that, for the region as a whole, regional integration could more than offset the impacts of the ongoing trade war. Implementation of mega-regional deals (RCEP, CPTPP and the European Union-Japan) could boost regional exports by 1.3% to 2.9%, depending on the severity of global trade tensions. With regional integration, even with the “doomsday” trade war scenario, regional employment could actually increase by more than 3.5 million jobs, while still falling globally. Asia-Pacific economies that are not involved in regional trade integration efforts are found to be losers when global trade tensions increase. These results show that regional cooperation has become a vital means for Asia and the Pacific to increase economic resilience and mitigate adverse impacts from external trade policy shocks.

## **As trade tensions and regional integration lead to resource reallocation, both within and across borders, complementary policies will, more than ever, become necessary**

The computable general equilibrium simulations of alternative trade war scenarios highlight the fact that discriminatory trade policies may have potentially serious impacts on resource allocation, efficiency and the environment in the region. The trade conflict will push production to more expensive locations, reducing resource efficiency globally. Some of the production activities may, for example, shift from China to economies with lower environmental standards, leading to higher global emissions. Importantly, as many of the main export industries in the region are relatively labour-intensive, a contraction of exports could spell at least temporary hardship for many workers as GVCs are redrawn. ESCAP estimates that, at a minimum, Asia and the Pacific will see a net loss of 2.7 million jobs if the trade tensions are not resolved. Employment losses will be 66% higher for unskilled workers, compared with those for skilled workers. As production shifts take place and resources are reallocated across sectors and borders, tens of millions of workers will see their jobs displaced and be forced to seek new employment. Those with lower skill sets or who are less mobile – often women – will face higher risk of unemployment. Regional integration, accompanied by efforts to simplify and digitalize trade as well as improve the business environment, will be an important factor in creating new economic opportunities. However, other complementary policies, such as social protection, labour and education policies to support people negatively affected by trade frictions and integration efforts, must also be placed high on the policymakers’ agenda if the region is to continue its progress towards the Sustainable Development Goals.