

Regional Defence Economic Outlook 2021

Asia and Oceania

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This memo complements Defence Economic Outlook 2020 (DEO 2020), which assessed the global power balance focusing on the major world powers, with a regional outlook on Asia and Oceania. The memo aims to provide a regional perspective not contained within DEO 2020. Similar to DEO 2020, the regional power balance in this memo is described in terms of military expenditure and macroeconomic trends during the period 2010-2019, focusing on the five largest military spenders. Furthermore, the memo provides a description of the defence industrial capabilities of these countries, as well as the regional security environment.

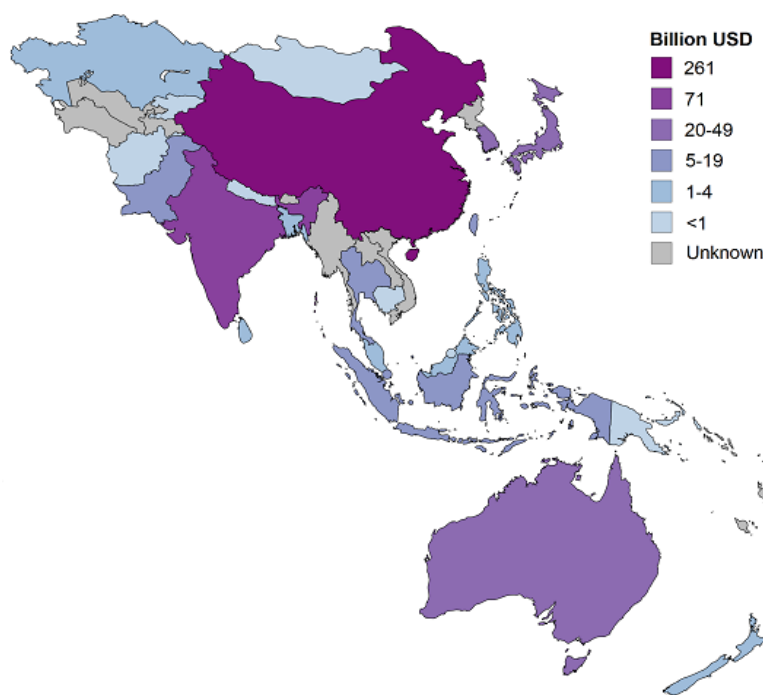


Figure 1: Asian Military Expenditure, 2019 (current prices). Source: SIPRI (2020)

Military Expenditure

The Asia and Oceania region is currently home to four of the world's ten largest military spenders and has seen a steady rise in military expenditure during the past decade. The region has increased its global share of military spending from 19.2 percent in 2010 to 27.7 percent in 2019. A

significant part of this increase can be attributed to just one country, China.

The People's Republic of China is the world's second largest military spender and the largest in the Asia and Oceania region by far, see Table 1. In 2019, China spent USD 261 billion on its military,

which is more than half the regional total and exceeds the spending of the next four regional powers combined. During the past decade, China has increased its military spending by an average of 7.1 percent annually, made possible by the country's rapid economic growth. Both China's military spending and economic growth rates have slowed in recent years, but are still substantial and higher than most other countries in the region.

Table 1: Top 5 Military Spenders in Asia and Oceania, 2019.
Source: SIPRI (2020).

Country	Billion USD (current prices)	Share of region (%)	Share of GDP (%)	Average change 2010-19 (%)	Average change 2017-19 (%)
China	261.1	50.5	1.9	+7.1	+5.7
India	71.1	13.8	2.4	+3.6	+4.7
Japan	47.6	9.2	0.9	+0.2	+0.0
South Korea	43.9	8.5	2.7	+3.5	+6.3
Australia	25.9	5.0	1.9	+2.4	-0.2

Meanwhile, India has increased its military expenditure to become the region's second largest spender and third in the world, accounting for USD 71 billion in 2019. Although its spending levels have been virtually stagnant during the past decade, Japan is still the third largest military spender in the region. South Korea has increased its military expenditure steadily during the same period, an increase that has accelerated in the last few years. Australia is the fifth largest spender in the Asia and Oceania region, having increased military expenditure during the past decade but decreased somewhat in the last few years.

Regional Security

The security environment in the Asia and Oceania region has for the past decades been dominated by the growing power of China. The rapid and sustained increase of the Asian giant's military spending has enabled an extensive modernisation of its armed forces. China has also become increasingly assertive in advancing its territorial claims in the region, which includes Taiwan, the Senkaku/Diaoyu Islands and more than 80 percent

of the South China Sea. The latter claim has been physically fortified with the extensive construction of artificial islands together with military installations and dual-purpose infrastructure. These actions have led to growing concerns among maritime neighbours and rival claimants, some of which, e.g. Vietnam, have responded with fortifications of their own.

In the East China Sea, both China and Japan claim the Senkaku/Diaoyu islands, under Japanese administration, which from time to time has sparked tensions between the two nations. Japan views the continuation of activities in the area by the Chinese Navy and Air Force as an attempt to change the status quo through coercion, although not through direct force. China's growing strength and increased assertiveness have also accelerated the US security policy shift towards Asia. Among several conflicting issues, US support for Taiwan is of greatest concern for China, which views the island as a runaway province. It is the stated goal by the Chinese Communist Party to take control over Taiwan by 2049, by military means or otherwise.

North Korea, more specifically its nuclear and ballistic missile programmes, is another focal point of regional security in East Asia. Since the meeting between former US President Donald Trump and North Korean Chairman Kim Jong-un in June 2018, negotiations regarding denuclearisation of the Korean Peninsula have stalled. North Korean missile tests have been resumed and conducted on a number of occasions, albeit not featuring long-range ballistic missiles. North Korean officials indicate that a security guarantee would be a prerequisite for denuclearisation, in addition to the recurring demands of UN sanctions relief. However, given that the North Korean regime see nuclear weapons as the only hard guarantee against invasion, the actual likelihood of voluntary denuclearisation is debatable.

The increased tensions in East Asia have resulted in deepened military ties between the US and its regional allies and partners, such as Japan, Australia and India. Other countries, such as the

Philippines under President Rodrigo Duterte, have taken a more China friendly and US sceptic stance, even though continued territorial disputes in the South China Sea might obstruct the deepening of ties with China. Thailand, under the current military leadership, has also sought to balance its traditionally close relationship with the US with closer ties to China. Thailand has for instance signed deals for Chinese tanks and submarines.

Since July 2019, South Korea and Japan have been embroiled in a trade dispute, partly linked to what South Korea views as unresolved historical injustices. The direction of this dispute is unclear, but there has been some spill-over on seemingly unrelated areas, such as the South Korea threat to leave a military intelligence-sharing pact, a threat later withdrawn. There is also the unresolved dispute over the Dokdo/Takeshima islands, claimed by both countries but administered by South Korea, contributing to strains in bilateral relations. The relationship between South Korea and Japan should also be viewed in the context of each country's bilateral alliance with the US, which the two countries have to balance with their respective economic relationship with China.

Meanwhile, Japan is in the midst of discussing revisions of its constitution connected to security concerns related to China and North Korea. Recent developments include a reinterpretation of the Constitution, referred to as pacifist, which took effect in 2016. The change enables Japan's Self-Defense Forces to engage in collective self-defence, which entails the lending of military support to its allies, i.e. the US, in defensive purposes. These measures are currently limited to scenarios which are deemed to pose an existential threat to Japan's security. Prime Minister Yoshihide Suga has stated that he intends to continue the efforts of his predecessor, Shinzo Abe, who sought to revise the constitution in order to consolidate constitutional support for the Self-Defense Forces and for the right of collective self-defence. Prime Minister Suga's party, the Liberal Democratic Party (LDP),

has strived to amend the constitution since the party was founded in 1955, but has thus far failed to achieve the necessary consensus in parliament.

India has traditionally prioritised its army over other military branches. This in large part due to the country's historical border conflicts with Pakistan and China, as well as the need to control internal insurgencies. However, an increased priority of air and sea capabilities has come amid India's growing concerns about China's growing power and presence in and around the Indian Ocean. In June 2020, tensions with China saw its first casualties in several decades when a border clash resulted in 20 Indian, and a claimed number of 4 Chinese, soldiers killed. The clash has brought the relationship between the two Asian giants to a new low. Meanwhile, border tensions between India and Pakistan along the Line of Control in the Kashmir region remain. Tensions over continued terrorist activities continue to haunt the Indo-Pakistani relationship, but recent developments between the nuclear powers also include mutual airstrikes, carried out in February 2019. In October 2019, the Indian state of Jammu and Kashmir was converted into two separate Union Territories, Jammu and Kashmir as well as Ladakh. This reorganisation means decreased self-governance and greater centralisation of power and control to the federal government.

The rapidly changing power dynamics in the Asia and Oceania region will likely complicate efforts to improve bilateral relationships in the near future. Given the conflicting goals, both regionally and globally, tensions between the US and China are likely to increase and shape the security environment in the Asia and Oceania region in the coming decade. Various countries in the region seek to balance their military alliance with the US with their economic relationship to China. Meanwhile, China's increasing economic and military influence in the region, including the Belt and Road Initiative launched in 2013, might further strain relations with nations dependent on secure sea lines of communications in

the region, such as India, Japan, South Korea, Australia and the US. The power balance of the Asia and Oceania region will also depend on the future development of other relationships between major actors in and outside of the region, such as the aforementioned US relationships to various countries as well as the Sino-Russian relationship.

Macroeconomic Trends

The economy of the Asia and Oceania region, and the region's contribution to global economic growth, has increased steadily for decades. This development can largely be attributed to China and India, as the two countries have experienced average growth rates of 5 to 8 percent during the ten years preceding the coronavirus pandemic.

However, Chinese growth rates have slowed steadily during the past decade, from double digit in the decade prior to the 2008 financial crisis to about 7 percent up until the coronavirus pandemic in 2019. The pandemic hit the Chinese economy hard in 2020. IMF estimates real economic growth of merely 2.3 percent that year, followed by a rebound of around 8.1 percent in 2021. In the long term, the gradually slowing growth is likely to continue. This trend cannot easily be attributable to one single factor. Current growth rate partly results from the backlash of the massive stimulus package launched after the global financial crisis in 2009. It can also be seen as a consequence of the conscious efforts by the Chinese government to shift focus from high-speed investment and manufacturing-led growth to high quality growth with a more equally distributed, efficient and balanced economy. This economic rebalancing has seen a relatively higher contribution to growth by the service sector and domestic consumption, sectors where productivity gains are more difficult to achieve. However, the decreasing marginal returns from previous growth models coupled with continued lack of comprehensive reforms to increase productivity among state-owned enterprises (SOEs) also weigh on the economy.

Since the financial crisis the Chinese economy has been supported by public spending and credit expansion from state-controlled banks as well as shadow lenders. This has caused non-financial sector debt to surge, exceeding 280 percent of GDP in 2020, high for an emerging economy. Meanwhile, government debt was a more manageable 53 percent of GDP, which could act as a stabiliser during a potential debt crisis. On top of high debt levels, China has been embroiled in a trade war with the US since 2018. At the outset, the Trump administration imposed tariffs on about half of all Chinese exports to the US, accusing China of unfair trade practices. China in turn imposed retaliatory tariffs. In January 2020, the US and China signed a "phase one" trade deal, which entailed some US tariff concessions, as well as Chinese promises concerning US intellectual property and technology transfer protection, among other things. It remains to be seen to what degree the Biden administration will rescind US-China trade policies put in place by the previous administration, but preliminary statements indicate that immediate de-escalation is not in sight. However, the Biden administration has stated that it will put greater emphasis on coordination with US allies when dealing with China compared to the previous administration.

India has experienced high economic growth rates of between 5 to 8 percent during the past decade, even though there has been a downward trend the past few years up until the coronavirus pandemic. While Indian growth has primarily been driven by the service sector, Prime Minister Narendra Modi's government has hoped to strengthen the manufacturing sector through the 'Make in India' initiative. Results have been mixed. Although industrial production has grown steadily in recent years, manufacturing as share of GDP has decreased slightly during the past decade. A standardised goods and services tax was introduced in 2017 with the aim to encourage economic activity and increase tax revenue. Following the coronavirus pandemic, the

economic growth projected by the IMF for the Indian economy will have been a contraction of 8 percent in 2020, followed by a rebound of around 11 percent in 2021.

The Japanese economy is arguably the most advanced and mature in the region. While Japan has experienced low growth rates during the past decades, former Prime Minister Abe sought to stimulate economic growth, tackle deflation and lower the country's high levels of public debt. As with other countries in the region, the coronavirus pandemic adversely impacted the Japanese economy. IMF's projections indicate an economic contraction of 5 percent in 2020, followed by 3 percent growth in 2021. The public debt level was projected to reach over 260 percent of GDP in 2020.

The South Korean economy is fundamentally strong, but still faces long-term issues in terms of adverse demographic conditions and slow growth in productivity. After experiencing an average growth of around 3 percent during the past decade, the economy contracted by 1 percent in 2020, followed by an estimated rebound to 3 percent growth in 2021. Public debt has increased from 29 to 42 percent of GDP since 2010, and the IMF estimates there will have been an additional increase during 2020 to around 48 percent of GDP.

Australia has seen an average growth rate of around 2.6 percent during the past decade. Meanwhile, the economy was expected to contract by 3 percent in 2020 followed by 3.5 percent growth in 2021. Public debt has gone from 20 to 46 percent of GDP during the past decade, and it is estimated that this ratio will increase further following the coronavirus pandemic, to around 70 percent of GDP in 2021. US-China tensions pose risks to the Australian economy, which is highly exposed to China, even though the impact thus far has been limited. Furthermore, China and Australia are also in the midst of a trade conflict of their own. In 2020, China targeted the latter with trade sanctions, in what

seems to be an attempt to coerce or punish Australia economically for actions and policies seen as adverse to China. This development should also be seen in the wider context of the US-China rivalry, in which Australia constitutes a US ally.

As trade is central for the region's economic growth, the various trade conflicts, not least the one between US and China, constitute sources of concern. The development of digitalisation and robotics presents many possibilities, but also pressures Asian economies to restructure the skill set of their labour forces. Demographics are also important to the future economic outlook of East Asia. Both Japan and South Korea are already faced with aging populations. China, with the legacy of its one-child policy faces the risk of 'growing old before growing rich' with a diminishing share of working age population, which will make it even more difficult to continue achieving high levels of economic growth. Meanwhile, in South Asian nations with large youth populations, such as India, demographic concerns are instead focused upon unemployment.

Defence Industry

China's mainly state-owned defence industry has developed significantly over the past decades, enabling the People's Liberation Army (PLA) to steadily reduce its reliance on imported equipment. This development has both supported, and been supported by, the rapid modernisation of China's armed forces. Some estimates suggest that the Chinese defence industry could very well be the second-largest arms producer in the world. However, the lack of transparency regarding arms sales makes definitive assessments about the exact size of China's defence industry difficult. Nevertheless, the industry includes large conglomerates such as aircraft producer AVIC, ground equipment and ordnance producers NORINCO and CSGC, electronics producer CETC, as well as the shipbuilder CSSC, which in November 2019 merged with China's other large shipbuilding company CSIC.

China currently produces all of its naval vessels domestically, although it still depends on imports of some key naval components. China has expanded its navy rapidly and is a global leader in commercial shipbuilding. The Chinese defence industry also provides the PLA with most of its ground weapon systems. The military aviation industry provides most, but not all, of the PLA's aircraft, some of which are imported from Russia. The aviation industry has benefitted from investments made within the commercial aircraft sector, which also comes with a decreased reliance on foreign-sourced components for military aircraft.

As part of the effort to support further military modernisation, recent years has seen an increased focus from the Chinese leadership on military-civil fusion (MCF). As of 2015, this approach has been declared a national strategy. By integrating technology development from the civil sector and the defence sector, the goal is to achieve mutual benefits such as higher rates of innovation and cost efficiency. Other steps or strategies contributing towards increased self-reliance in the defence sector include the 'Made in China 2025' strategy, with the stated aim to indigenise technology production in a variety of industries.

Despite the continued progress made in the Chinese defence industry, the country still relies on import of some key components and technologies, primarily from Russia. China could still be characterised as a 'fast follower' or a niche innovator, rather than a 'true' innovator. However, being leading in some niches may be enough for China to gain asymmetric advantages, for instance in terms of anti-ship ballistic missiles.

India was the world's second largest arms importer, after Saudi Arabia, during the period 2015 to 2019. This reflects both the increased military spending and modernisation of India's armed forces as well as some of the shortcomings within the country's domestic arms industry. India's foremost source of arms imports is Russia, but there is an ongoing policy focus towards supplier diversification, i.e. more Western suppliers. In order to

support the Indian defence industry, the government introduced new procedures in 2016 for procuring military equipment as part of the 'Make in India' initiative. The goal is to achieve increased technology transfers when procuring from foreign companies and encouraging joint ventures. If successful, this would mean a departure from past developments as India's defence industry has so far neither succeeded in meeting the needs of the country's own armed forces nor in becoming a major player on the arms export market. As part of the effort to increase domestic defence industrial capabilities, the Indian government set up two 'defence industrial corridors' in 2018. This in order to create collaborative clusters of defence companies. India also strives to facilitate increased defence exports.

Due to a set of strict export rules, Japan's defence industry has relied on demand from the country's own Self-Defense Forces. The transfer of defence equipment and technology abroad was restricted in the late 1960s, followed by what was essentially an overall ban in 1976. Japan however loosened restrictions on arms exports in 2014, enabling arms transfers and international cooperation within the defence sector. Further changes in the implementation of the arms transfer principles are to be expected, in order to 'promote appropriate overseas transfer of defence equipment'. However, Japan's export ambitions may face challenges due to the defence industry's inexperience in international negotiations and expensive products compared to competitors. State initiatives to promote international defence partnerships will likely remain vital, considering the close relationship between the state and large conglomerates, which dominate the Japanese defence industry. A signature development aimed at improving domestic defence production and procurement capabilities in recent years is the establishment of the Acquisition, Technology & Logistics Agency (ATLA) in 2015. The scope of this new government agency includes tasks related to research and development (R&D), procurement and defence

exports. The Japanese Ministry of Defense and the Self-Defense Forces will also encourage technology interchange between the defence industry and the civilian sector. While continuing to increase imports of F-35 combat aircrafts from the US during the last five-year period, Japan also seems to be pushing for a domestically led development of a sixth-generation stealth fighter with assistance from US defence company Lockheed Martin.

In the past few decades, South Korea has emerged as an advanced defence industrial nation, able to serve its armed forces and expand to export markets. Increased sales during the past decade can mainly be attributed to acquisitions by the own armed forces, stemming from heightened security concerns, even though there was a slump in sales during the last couple of years. South Korea has also experienced some successes on the international defence market. While there are prospects of further exports, the South Korean defence industry still relies on US and other Western countries for many components. In fact, cooperation with Western defence industries has been one of the large success factors for the South Korean defence industry. Some regulatory changes aimed at improving the conditions for the country's defence-industrial base have been made in recent years by the South Korean Defense Acquisition Program Administration (DAPA). These changes include updating its offset policy, expanding its import substitution programme and launching a plan to support military R&D development in small and medium enterprises (SMEs).

Australia was one of the largest arms importers globally during the period 2015-2019, ranking fourth after Egypt and ahead of China. The main bulk of arms imports were derived from the US. Even though Australia still relies on imports for the majority of its key defence equipment, the Australian defence industry is also growing. ASC Shipbuilding and Austal are its foremost shipbuilding companies. Austal, which has its main production facilities located in the US, also provides vessels for the US Navy.

Summary

Asia and Oceania's regional share of global military spending has increased during the past decade, largely, if not solely, due to China's steady military modernisation and expansion.

Recent developments in regional security are largely shaped by the rise of China, even though ongoing regional conflicts and disputes also have historical causes, dating back to World War II and its aftermath. This includes issues such as territorial disputes, the political status of Taiwan, the division of the Korean Peninsula, and border conflicts in South Asia. The increased US policy focus towards the region, as well as China's growing economic strength and military capabilities are likely to remain key factors in shaping regional developments in the years to come.

Economic growth in the Asia and Oceania region has continued to reshape the global economy during the past decade, with China and India as obvious front-runners. The covid-19 pandemic, originated in Wuhan, China, has left its marks on the economies in the region. However, some countries, including China itself, are estimated to have pulled through relatively unscathed compared to other parts the world. Even though swift economic rebounds are expected across the region, the long-term consequences of the pandemic remain to be seen. The future direction of ongoing trade disputes are likely to affect regional economic growth at least in the short term, whereas low birth-rates and aging populations, especially in East Asia, are examples of long-term challenges.

In terms of defence industrial developments, the trend in the region is clearly towards a higher degree of national self-reliance. India, and to a lesser extent China, are still dependent on imports of equipment and components, especially from Russia. Meanwhile, Japan, South Korea and Australia also still depend on foreign sources, mainly Western and primarily the US, for their defence equipment. However, these countries are making efforts towards increased domestic defence industrial capabilities. ■

