Imagine the “unimaginable”

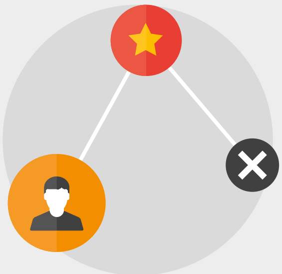
New risks and their potential impacts on the Australian economy

We live in interesting times. Rapidly evolving technologies, tectonic geopolitical shifts and dynamic global markets are entirely reshaping the world’s economic stage.

In this new and changing environment, businesses and governments must be as adaptive as ever to both take advantage of the opportunities presented and protect against the downside risks.

For Australia, we see several key risks on the horizon:

The failure of the Australian government to respond to US corporate tax reform



Deterioration of Australia’s relations with China

Economy-wide damage caused by major cyber attack

Not so long ago, many of these risks would have been considered ‘unimaginable’. Now, they are very distinct possibilities.

To help business leaders and policymakers better understand and respond to these risks in context, PwC has assessed the potential impact on jobs and economic growth if the ‘possible’ turns into fact.

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Risk

Australia fails to act in response to US tax reform

Potential Cost

$3.3 billion in GDP ($70 billion by 2030) and 29,000 jobs

It's been less than three months since President Trump signed into law the most business-friendly tax reform package in recent US history and already it's having positive economic impacts.

Some of the country's biggest employers, including Walmart and Home Depot, have announced wage increases or bonuses for employees, providing a well-needed boost to the hip pocket of many US workers.

On top of this, large volumes of capital are beginning to flow back into the US economy as American businesses repatriate a large proportion of the estimated US$2.6 trillion in offshore earnings that's been sitting overseas waiting for the arrival of domestic tax breaks, such as those just passed.

Tax reform is making the US, which now tops the list of 'growth markets' according to the world's CEOs, an even more attractive place to invest.

Australia's government and business leaders should be concerned. The US is our largest foreign direct investor ($860 billion annually) – almost twice that of the UK ($515 billion) and ten times more than China ($87.2 billion). Also, Australia has recently dropped out of the top 10 countries as a destination for global capital (we're now #11) *(PwC's Global CEO Survey)*.

For every 5% fall in foreign and domestic investment in Australia (excluding investment in mining and property) in 2018:

- GDP will decline by $3.3billion
- 29,000 jobs will disappear

As a consequence of these economic shocks, the 5% decline in investment would increase the Commonwealth Budget deficit by $1.475 billion in the first year.

Tax reform is no longer an option for Australia

Australia's prosperity is dependent on foreign capital. Our savings don't meet our investment needs and we have been a net importer of capital in nearly every year since Federation. As a player in the global market, Australia, which already has one of the highest corporate tax rates in the OECD, must respond. 'Doing nothing' is no longer a viable option if we want to continue to be a place where businesses want to invest.

The proposed drop in the Australian company tax rate to 25% over a ten year period, while now more critical than ever, is not enough.

While the headline company rate cut in the US gets a lot of attention, the reform package goes way beyond a rate cut - it contains a wide-ranging set of incentives designed to boost economic growth by encouraging on-shore manufacturing and innovation.

Given Australia's current weaknesses – anaemic wage and productivity growth, one of the highest corporate tax rates in the OECD, comparatively high energy prices and a challenging industrial relations regime, Australia's growth prospects are in jeopardy. We have to find new ways to increase GDP.

The alternative is to 'tax our way to growth'. This means reforming the tax system to create the conditions that encourage long-term business investment, with the aim of driving growth in productivity, as well as, ultimately, jobs, wages and the size of Australia's taxation base.

If Australia continues with its current tax and policy settings, we should expect a continued slowing of investment flows as organisations prioritise investment in the US.

Risk

China responds to growing tensions through 'economic retreat'

Potential Cost

$2.3 billion in GDP and 20,000 jobs

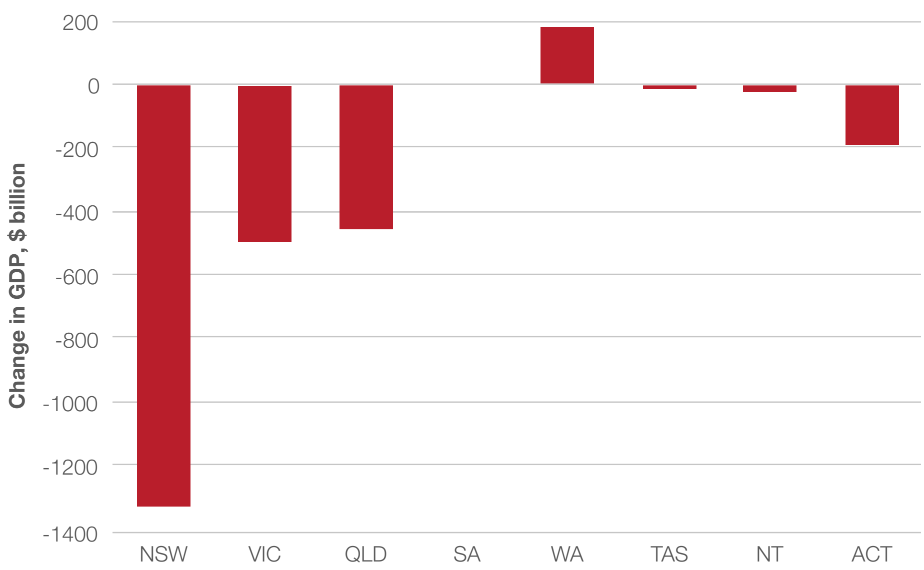
The economic ties between Australia and China run deep. China is our largest two-way trading partner ($174 billion), our largest export market ($93 billion) and our largest source of imports ($62 billion). Two-way trade between our countries, $174 billion last year, accounts for almost a quarter of our trade and is more than 2.5 times our two-way trade with Japan and the US, our next largest partners. Australia has not had a trade relationship of this significance since the 1950s when the United Kingdom was our major trading partner.

But over the last 12 months, the relationship between our two countries has shifted considerably. The Chinese Government has reacted strongly to the Australian Government's active stance on a range of issues, from territorial claims in the South China Sea to growing concerns about foreign influence in our domestic politics.

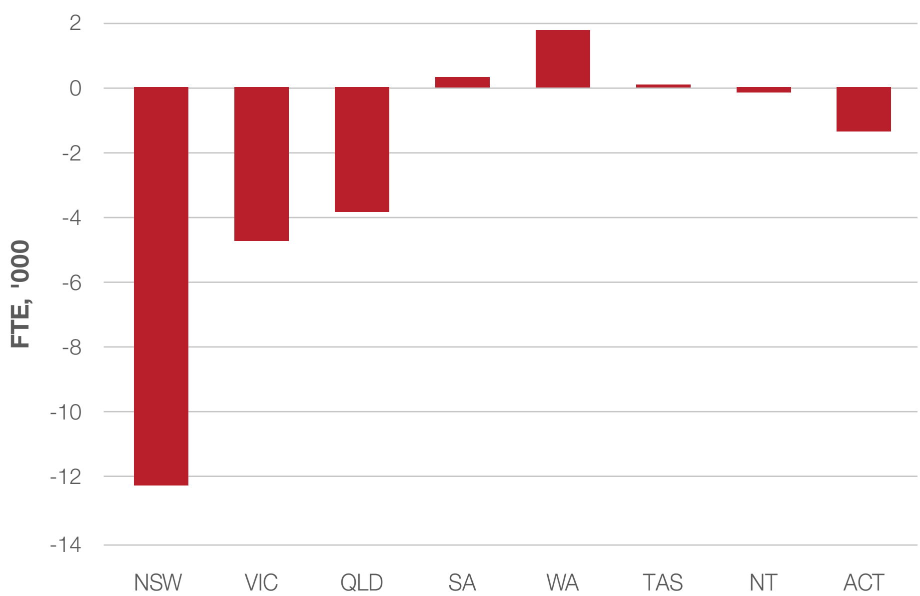
Should this come as a surprise? China has made no secret about its willingness to use its growing economic strength in the pursuit of strategic interest.

For example, when South Korea announced it would deploy a US anti-missile system, Chinese Government took a range of action that market access for a range of goods and services including entertainment, consumer products and tourism. When Taiwan elected a pro-independence Premier in 2016, the number of tourists from China fell substantially.

China withdraws: State GDP impacts in 2018



China withdraws: Employment impact 2018



In February 2018, the Chinese Ministry of Education and Chinese Embassy in Australia published an alert warning students to be vigilant about their safety while in Australia. This was widely interpreted as a first step in China pushing back against what it regards as unfriendly actions taken by the Australian Government on a number of matters and could have far reaching implications for our education system.

If the relationship between our respected Governments continues down this path – in the short term at least – there's a very real risk that the Chinese Government could express its displeasure through economic channels.

But what might that look like and what would be the impact? PwC has modelled a scenario where China limits student and tourist spending in Australia (currently about $9.2 billion) for a one year period.

The consequences of such an action would be sudden and substantial:

- GDP would fall by $2.3 billion in 2018
- 20,000 full-time equivalent jobs would disappear, many taking years to come back.

Australian business must 'step into the debate'

The idea that economic power can be leveraged to pursue national interests is not new. But the challenge for Australia is that for the first time in our history, we do not share a security alliance with our largest trading partner.

We need, therefore, to pull off a delicate balancing act when it comes to China: address legitimate matters of national-interest while continuing to develop our trade and investment relationships. These issues are inextricably entwined and cannot be managed separately.

At the moment, the debate is dominated by security matters. More than ever, our business community needs to engage with the national security community – to not only be a balancing voice for economic interests but to encourage a deeper understanding of each other's concerns.

Cyber attack takes out a major Australian 'payments system'

Risk

Potential Cost

$4.6 billion in GDP and 7,700 jobs

Digital technology has delivered many benefits for the global economy and modern life. Unfortunately, it has also delivered cybercrime.

Cybercrime is a costly and growing threat to business, governments and individuals alike. In 2016 it cost the global economy over US$450 billion and resulted in the theft of over 2 billion personal records.

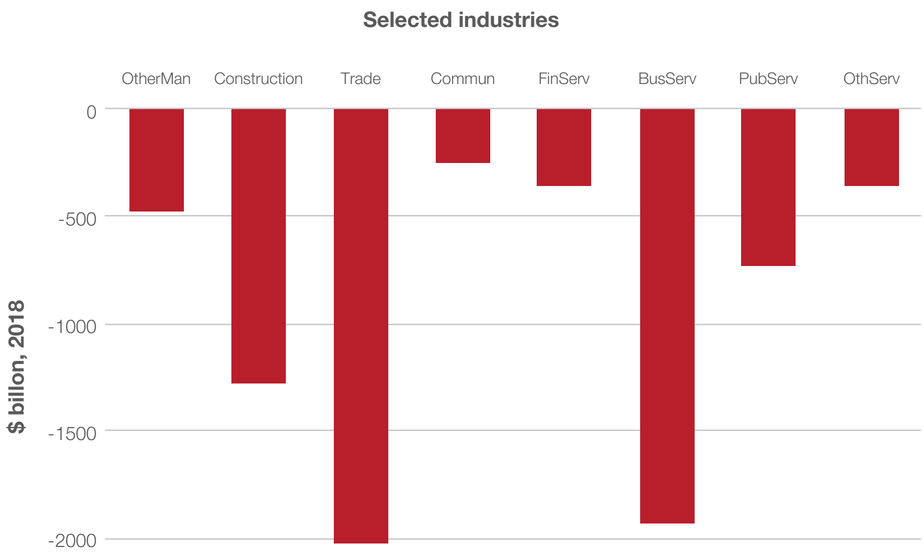
Business leaders agree: in PwC's recent global survey, Australian CEOs (89%) ranked cyber as the number one threat to their organisation's growth prospects.

Cybercrime can hit any type of organisation, regardless of size or sector. But the impact of an attack on a financial institution is particularly severe. From the sub-prime crisis to the GFC, history is littered with examples of how a loss of faith in banking systems can have a devastating effect on the wider economy.

Financial services are appealing and potentially lucrative targets. In 2016 criminals stole tens of millions of dollars from the Bank of Bangladesh by compromising the global SWIFT network, a payment order system linking more than 11,000 institutions in more than 200 countries. In 2016 hackers broke into the data systems of Equifax, one of America's three national credit bureaus, and stole data associated with over 145.5 million customers, including names, dates of birth, home addresses, tax IDs and drivers' licence details.

So what might happen in the event of a significant cyber attack on the financial sector in Australia? PwC modelled a scenario that brought down a major payments system resulting in short-term arms-length transactions being unavailable for seven days.

Payment systems crash: Industry output



The subsequent decline in productivity in the trade sector would result in:

- GDP falling by $4.6 billion in 2018
- 7,700 full-time equivalent jobs lost
- Retail, consumer and service industries hardest hit.

These impacts could almost be considered a 'best case' outcome. More than likely the loss of confidence in the financial system would cause people to hoard money or stall on payments, leading to a deterioration in spending and a rise in business distress. This, in turn, would create a domino effect on employment and the wider economy.

More investment in cyber security needed

Despite the fact that almost 90% of Australian CEOs recognise cyber as their top threat to growth, only 44% say they plan to spend more on fixing it. Plainly, businesses are not 'putting their money where their mouths are' when it comes to cyber.

The largest Australian companies – the ASX10, for example – typically invest in the order of tens of millions of dollars, if not more, in cyber security each year, which is getting close to what's needed.

But once you move down the list the investment falls away sharply. The result is a lot of major businesses significantly under-spend, and are therefore under-protected on cybercrime.

But it's not just a problem for those businesses. Because cyber attacks often come via poorly protected third-party suppliers or partners, all organisations have a responsibility to make sure their digital assets are secure and protected, so they are not an unwitting avenue for cybercrime. The world of cyber means we are all connected - we are all in the same ecosystem today.

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