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Topics *Private manufacturing is the key to economic growth in China's interior*

China's interior has been able to sustain high levels of economic growth since the mid-2000s. Rather than government driven infrastructure development investment, the engine of growth has been investment in private sector manufacturing.

■ Growing economic traction of China's interior

While China's real GDP growth rate for the July to September quarter, 2012, was 7.4%, its lowest level in three years, examination of individual regions reveals significant differences. While the coastal regions struggle to grow, the interior regions have been able to maintain a rapid pace of growth. High levels of economic growth in the interior have been due to vigorous fixed asset investment.

This scenario of the interior's investment-led growth driving China's economy began to emerge from the mid-2000s. The interior's share of nominal GDP grew from 40.5% in 2005 to 43.8% in 2011.

For the purposes of this report, 11 eastern provinces and cities comprise the coastal regions, and 20 midwestern provinces, cities and autonomous regions, the interior.

■ Investment-led economy of the interior

In consideration of whether the interior's investment-driven high economic growth is sustainable, whether government-led infrastructure development investment is not the real engine of growth in the interior, and whether private sector firms have held off from participation in interior markets due to prohibitive transportation costs, the movement of fixed asset investment in China's midwestern regions was examined. The interior's investment-driven high economic growth was found to have the following three characteristics.

First, from the mid-2000s onwards, investment growth has been driven by the manufacturing industry. Fixed asset investment in manufacturing in the midwest expanded by 4.8 times in the period 2005 to 2010. The speed of expansion outstrips that of infrastructure development investment. Fixed asset investment in infrastructure development investment in the midwest expanded by 3.1 times in the same period. The contribution rate to fixed asset investment growth in that period was 32.5% for manufacturing investment, and 28.5% for infrastructure development investment. Incidentally, the pace of manufacturing industry investment in the east was 2.6 times over the same period, well below that of the midwest. This difference has had a significant impact on the growth of the midwest's share of nominal GDP in recent years.

In terms of the background to the rapid growth in manufacturing industry investment in the interior from the mid-2000s, first of all, low interest rates can be considered. Real interest rates in the period 2006 to 2010 were an average of 3.0%, lower than the 4.2% average for the period 2001 to 2005. This meant that new plant and equipment purchases and factory construction were able to be financed at low cost in the late 2000s.

Also, the progress of infrastructure provision must be noted. In the early 2000s, roads, railways, harbors and airports, etc., were still in an underdeveloped condition. With the progress of infrastructure development from the mid-2000s onwards, the manufacturing industry's concerns about infrastructure and logistics costs involved in participation in the interior have receded.

Second, though private sector firms are increasing their investment in coastal regions, investment in the interior is increasing even more. The midwest's share of private sector firms' fixed asset investments nationwide grew from 38.5% in 2005 to 51.7% in 2010.

Part of the reason for this has been cheaper labor costs. Examination of per capita gross regional production, which serves as a representative wage index, shows a 2011 average of $4,470 in the midwest, which is only about half of the $8,133 for the east.

Third, as a result of the rapid expansion of private sector manufacturers' fixed asset investment in the midwest, the pace of expansion of production in the interior for many industrial products is faster than that in the coastal regions. For example, the midwest's yarn production volume in the period 2005 to 2010 grew at an average pace of 17.0%, against 11.7% in the east. For light manufacturing products such as paper and cardboard, the average for the midwest was 10.8%, outstripping 9.1% for the east. And the same trend can be seen for the production of items such as refrigerators and automobiles, which require higher levels of technology. Meanwhile, production volume for almost all industrial products is still lower than that of the coastal regions, and there is much room for expansion.

Given the foregoing, it may be concluded that high levels of economic growth in the interior in recent years have been largely due to the advance of industrialization, and that the interior's investment-driven growth is comparatively sound.

<Fixed asset investment in China's interior>

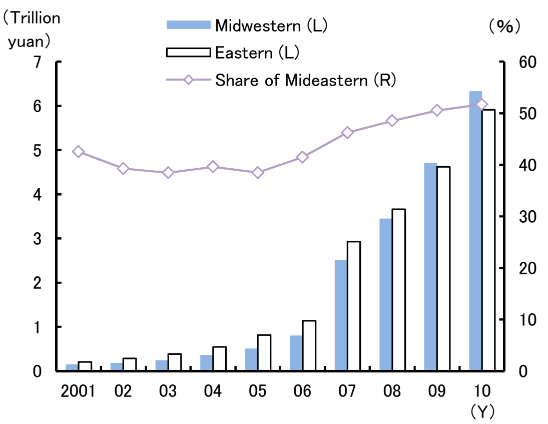
	2005 billion yuan	2010 billion yuan	rate of increase times	contribution rate %
1 Agriculture, Forestry, Animal Husbandry and Fishery	144	550	3.8	4.0
2 Mining	232	819	3.5	5.7
3 Manufacturing	872	4,190	4.8	32.5
4 Production and Supply of Electricity, Gas and Water	409	949	2.3	5.3
5 Construction	44	191	4.3	1.4
6 Transport, Storage and Post	449	1,349	3.0	8.8
7 Information Transmission, Computer Services and Software	78	116	1.5	0.4
8 Wholesale and Retail Trades	81	294	3.6	2.1
9 Hotels and Cataring Services	40	163	4.1	1.2
10 Financial Intermediation	5	21	4.1	0.2
11 Real Estate	715	2,935	4.1	21.7
12 Leasing and Business Services	19	92	4.8	0.7
13 Scientific Research, Technical Services, and Geological Prospecting	20	60	2.9	0.4
14 Management of Water Conservancy, Environment and Public Facilities	303	1,319	4.3	9.9
15 Services to Households and Other Services	20	47	2.3	0.3
16 Education	107	256	2.4	1.5
17 Health, Social Securities and Social Welfare	33	126	3.8	0.9
18 Culture, Sports and Entertainment	39	134	3.4	0.9
19 Public Management and Social Organizations	116	335	2.9	2.1
Total	3,727	13,947	3.7	100.0
Manufactureing	872	4,190	4.8	32.5
Infrastructure development (4+6+14+16+17+19)	1,417	4,335	3.1	28.5

Source: The Japan Research Institute, Ltd., based on the data of the National Bureau of Statistics of China

■ Prospects and challenges

Looking forwards, the indications are that investment-driven growth in the interior will be sustained for the time being. The progress of infrastructure development, plenty of room to expand capital equipment ratios, cheaper labor costs in comparison with coastal regions, and the interior's growing appeal as a potential market, may all be considered contributory factors behind the private sector manufacturing industry's expanded investment in the interior.

<Investment of Private Sector>



Source: The Japan Research Institute, Ltd., based on the data of the National Bureau of Statistics of China

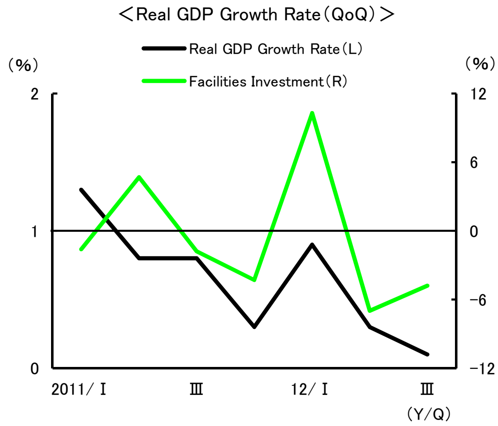
On the other hand, given the interior's strong nature as a manufacturing base for domestic markets, rather than an export production base, care needs to be taken to avoid excessive investment-driven growth. Though the problem is unlikely to become apparent as China's economy continues to post high growth levels, if a temporary lull in the spread of durable consumer goods leads to a drop in plant and equipment utilization rates, fixed asset investment could very well become an inhibitor of economic growth in the mid to long term. Given the importance of maintaining a balance between the pace of expansion in investment and consumption to sustaining economic growth, much attention will be on how the authorities steer future policy.

(Shinichi Seki)

Korea Concerns over prolonged investment slump

■ GDP down to 0.1% in July to September, 2012

South Korea's real quarter to quarter GDP for the July to September quarter, 2012, was 0.1% (revised 0.1% point down from flash report), down from 0.3% in the previous period (the year on year comparison was 1.5%, also down from 2.3% in the April to June quarter). While export growth was 2.8% up, facilities investment continued to grow negatively (minus 4.8%) following the previous quarter, and private consumption growth was a wafer thin 0.7%. Construction investment also struggled, due to the sluggish real estate market, and could only manage 0.1% growth.



Source: The Bank of Korea, *Economic Statistics System*

In terms of recent developments, exports and consumption are showing signs of improvement. Exports (customs cleared basis) in November grew 3.8%, compared to the same period in the previous year, continuing positive year on year growth, following October's 1.1% improvement. ASEAN – destined exports grew strongly, and exports to China are staging a recovery. Also, as economic measures (lower interest rates, reduced private consumption tax rates on automobiles and large household appliances) begin to kick in, consumption is showing signs of a gentle comeback, with automobile sales (including imported vehicles) growing 4.9% in October, and 13.9% in November.

Meanwhile, there is a possibility that investments will continue to languish for the time being. The private sector machinery orders received amount (excluding vessels), which serves as an indicator of the future performance of facilities investment, appears to have bottomed out, but the Federation of Korean Industries' business environment survey (surveying 600 large corporations), announced in November, has revealed that many corporations expect the business environment in 2013 to be "tougher" than 2012, or at least about the same, and some are planning to keep investment levels at the same as those in 2012, or cut them back.

■ Future of "economic democratization" is also a cause for concern

The presidential elections held on December 19 (new administration to be inaugurated in February, 2013), became a de-facto two horse race between the ruling Saenuri Party candidate, Park Geun-hye, and the opposition Democratic United Party candidate, Moon Jae-in. The central topic of these elections has been "economic democratization", focusing on tougher controls on the chaebol and greater support for small and medium sized enterprises, for example, and much attention will be on the direction of the new administration.

Candidate Moon has promised to revive the total investment limit system, and to eliminate cyclical investment within three years. The aim is to get to grips with the heart of the investment structure and reform S. Korea's chaebol-centric economic structure. In contrast, Ms. Park has not promised to revive the total investment limit system, and her policy with regard to cyclical investment will be to "prohibit new investment". However, there are strong calls for the fulfillment of social responsibility and to halt the abuse of power by the chaebol through the implementation of measures to protect local shopping centers and small business, and promote fairness in transactions between large corporations and small and medium sized enterprises.

Having been criticized by the people for favoring big business, the Lee Myung-bak administration has been promoting the creation of systems to facilitate the sharing of profits among large corporations and small and medium sized enterprises since 2011. From the start of 2012, there have been restrictions imposed on large discount stores and franchises, limiting the opening of new branches. It is likely that this direction will be continued in the years to come, but there is a danger that chaebol reform policies could work to inhibit investments to some degree. Future developments will need to be watched carefully.

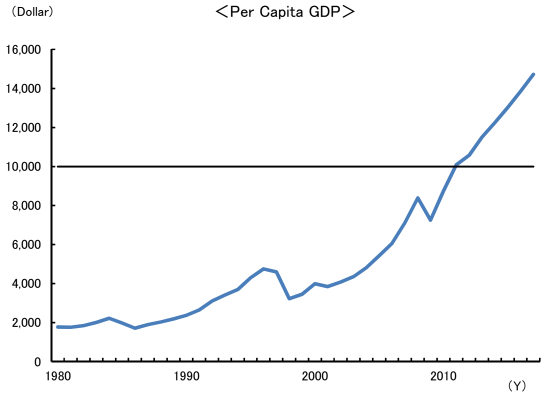
(Hidehiko Mukoyama)

Malaysia Solid private consumption drives economy

■ Per capita GDP passes $10,000

Malaysia's real GDP growth rate for the July to September quarter in 2012, was 5.2%, against a backdrop of minus 6.8% growth in exports due to economic stagnation in the developed nations, but supported by 12.0% growth in domestic demand. Growth for the whole year is expected to be over 5%. This will bring Malaysia's GDP certainly over the $10,000 level, the 3rd highest level among ASEAN, after Singapore and Brunei.

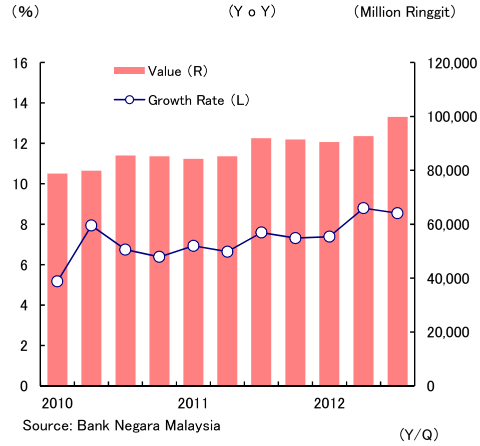
＜Per Capita GDP＞



Note: Numbers after 2012 are projections
Source: IMF, *World Economic Outlook Database*, October 2012

In recent years, private consumption has been able to maintain high levels of growth, thanks to a healthy employment environment and increased disposable income, as well as expanded lending to low income earners, and raised wages and salaries for civil servants. The Malaysian government expects that private consumption will continue to be the driver of economic growth throughout 2013, and is forecasting year on year growth of 5.7%.

＜Real Private Consumption＞



Source: Bank Negara Malaysia

Motorbike sales in the period January to September grew 8.9% compared to the same period in the previous year, to 420,000 vehicles. The value of consumer goods imports in the July to September quarter grew 11.4%, similarly, and retail turnover growth was a robust 6.0%.

■ Kuala Lumpur as an international shopping center

This solid private consumption growth is due to the fact that Malaysia's consumption structure is akin to that of the industrialized nations. Certainly, the number of mobile telephone subscriptions has risen to 39.8 million, 1.3 times the population (29.6 million). The landscape of Malaysia's biggest consumer market, Kuala Lumpur, is no different than that of the industrialized nations. In recent years, Internet shopping and suburban shopping malls have increased, and Japanese enterprises have embarked upon full participation in these markets.

＜Global Shopper Index＞

	City	Score
1	Hong Kong	68.5
2	Kuala Lumpur	65.1
3	Shanghai	63.1
4	Beijing	60.7
5	Singapore	60.2
6	Sydney	58.4
7	Bangkok	57.1
8	Tokyo	56.4
9	Seoul	54.8
10	Delhi	52.8

Source: globalshopperindex.com

In addition, Kuala Lumpur is transforming itself into an international shopping center. In the Globe Shopper Index, jointly developed by the UK's Economist Intelligence Unit (EIU) and a Swiss travel company, Kuala Lumpur ranked 2nd, after Hong Kong, out of 25 Asian cities. The number of tourists visiting Malaysia in 2010 was 25 million, surpassing Thailand's 19 million.

Nevertheless, the solid expansion in private sector consumption that Malaysia has witnessed over recent years is due in large part to the effects of economic stimulus measures implemented since the Lehman Brothers' collapse. From the standpoint of redressing income disparity, eligibility for the payment of subsidies has been widened and, with a general election likely for the spring of 2013, this trend is accelerating. The budget for fiscal 2013 has been prepared in anticipation of a fiscal deficit equivalent to 4% of GDP, but the public debt to GDP ratio has increased from 41.3% at the end of 2008 to 52.4% in September, 2012, and it needs to be noted that fiscal flexibility is being compromised.

(Keiichiro Oizumi)

Philippines High growth led by domestic demand

■ Q3 real GDP growth 7.1%

The Philippines' real GDP growth rate slowed to 3.9% in 2011, due to poor export growth and a construction slump caused by slow progress in public works projects, but has clearly improved since the start of 2012, against a backdrop of policy interest rate reductions and expanded government spending. GDP growth for the July to September quarter was 7.1% compared to the same period in the previous year, well above the expected approximately 5.4%, and the highest level since 7.3% in the July to September quarter, 2010. The rate for the period January to September was 6.5% and it is more or less certain that the government's target of between 5.0% and 6.0% for the whole year will be achieved. The fact that private consumption accounts for a large proportion of GDP and that the Philippines has a relatively low dependence on exports are also seen as factors contributing to the economy's robust condition. Strong domestic demand has become a driving force of the economy, and private consumption, government consumption and fixed capital formation have grown 6.2%, 12.0% and 8.7%, respectively. Exports also grew 6.2% (customs cleared basis), and the recovery trend appears to be continuing.

In terms of industrial origin, agriculture grew 4.1%, industry 8.1%, and services 7.0%. In the agricultural sector, production of rice (13.5%) and corn (11.5%) was strong despite unfavorable weather (figures in parentheses indicate growth rates). In industry, manufacturing grew 5.7%. The contributions of food manufactures (8.9%), wearing apparel (56.6%), and televisions and communication equipment (5.5%) have been significant. In the construction sector, public sector investment grew 23.7% and private sector investment 25.0%. Services also generally performed well. The largest contributor was wholesale trade (8.5%), but transport, storage and communication (9.0%) and finance (8.3), have also maintained high growth levels. Furthermore, in the real estate sector (7.8%), major real estate firms such as Ayala Land, SM Prime Holdings and Megaworld are enjoying double digit earnings growth.

■ Future prospects

The government's target GDP growth rate for 2013 is between 6.0% and 7.0%. As long as the economic deceleration in the industrialized nations and the rising inflation rate do not get any worse, there is every possibility that this target can be achieved. In the future, the improved employment situation and low inflation rate are expected to continue, and private consumption is expected to stay strong. Also, in the mid-term, it is forecast that the number of households earning $5,000 or more is expected to rise from the current 55% to 65% by 2017, and the adult population continues to grow because of the high number of young people. These factors will likely encourage consumption. In addition, with continued expanded infrastructure development by public-private-partnerships (PPP) and income transfer programs for the poor, government expenditure is likely to continue to grow. The steady implementation of infrastructure development will encourage private sector investment and is essential for the maintenance of high growth levels.

In addition to growing inflationary pressure accompanying strong domestic demand, Central Bank is being cautious about the risks of expanded bank credit and rising asset prices as a result of increased capital inflows. Given the fact that the peso's appreciation is keeping inflation under control, that global economic trends are still a risk factor, and that raising interest rates may accelerate capital inflows, the possibility of a switch to tighter monetary policy in the foreseeable future seems remote. The Philippines' sovereign ratings are expected to be raised to investment grade in the near future, and this sense of anticipation will likely to lead to a continued expansion of capital inflows into government bonds and other investment targets. Foreign direct investment is also likely to increase further, and this will probably boost further economic growth.

＜GDP Growth Rates by Industrial Origin＞

(Y o Y, %)

	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3
Real GNI	2.2	4.5	5.1	5.7	6.6
Real GDP	3.2	4.0	6.3	6.0	7.1
Agriculture, hunting, forestry and fishing	2.2	−2.5	1.0	0.6	4.1
Industry Sector	0.1	3.4	5.3	5.5	8.1
Manufacturing	2.0	3.3	6.0	4.3	5.7
Construction	−8.8	8.1	3.6	14.0	24.3
Service Sector	5.2	5.9	8.1	7.4	7.0
Transport, Storage and Communication	4.6	4.1	9.7	9.3	9.0
Financial intermediation	1.4	1.5	8.7	7.0	8.3

Source: National Statistical Coordination Board

(Satoshi Shimizu)

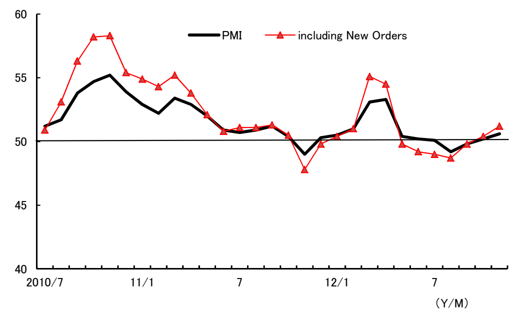
China Economic recovery picking up pace

■ Domestic demand indices show strong sense of bottoming out

Business confidence is on the upturn recently. The Purchasing Managers' Index (PMI) of the manufacturing industry for November, 2012, was 50.6, over the 50 point benchmark, which indicates a positive mood, for the second consecutive month. In particular, the index for new orders received exceeded the 50 point mark (50.4) for the first time in half a year, and the index for November was 0.8% points up on the previous month, powering the PMI upturn.

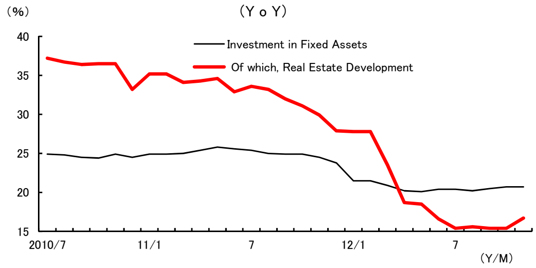
Demand item related indices also are showing clear signs of having bottomed out in recent months. Investments in fixed assets (excluding rural households) in the period January to November grew 20.7%, compared to the same period in the previous year, maintaining the performance (20.7%) for the period January to October. Bottoming out at 20.1% for the period January to May, similarly, the rate has maintained a gentle trend of recovery since then. By industry, as the implementation of economic stimulus measures advances, railroad investments have moved to positive growth, and are attracting attention. Also, year on year real total retail sales of consumer goods growth rates have generally picked up since mid-year.

＜Purchasing Manager Index of the Manufacturing Industry＞



Source: National Bureau of Statistics, CEIC

＜Investment in Fixed Assets (Excluding Rural Households)＞
(Y o Y)



Note: Figures are year-to-date. The growth rate in January is not announced. Therefore, this graph used the growth rate in January-February compared to previous period.
Source: National Bureau of Statistics

However, it can be said that the pace of recovery of external demand is not steady. Exports for November grew 2.9%, compared to the same month in the previous year, the lowest level in three months. A major factor has been the slump in exports to the developed countries, with exports to the EU becoming even more negative, and those to Japan and the US falling below the previous year's levels. While there is anticipation of a gradual recovery in the global economy, judging from the reduced orders placed at the China Import and Export Fair, for example, it would seem difficult to expect a significant increase in exports any time soon.

■ Economic policy to prioritize both economic recovery and structural adjustment

The bottoming out of the economy has also led to changes in the leadership's awareness of economic conditions. At their December 4th meeting, the Communist Party Politburo acknowledged "various challenges that should not be underestimated", and stated that "the economy is on the way to stability and positive factors are increasing". The Politburo also described the "sustainable and sound development of the economy" as a priority issue for economic management in 2013. Since the end of 2008, when speaking of the following year's policy direction, the Hu Jintao administration had always used the phrase "stable and comparatively fast economic development". In comparison with this wording, the phrase "sustainable and sound development" may be said to indicate little insistence on high growth.

In efforts to achieve policy also, there is much evidence of the administration's awareness of the need to materialize both sustainable economic growth and structural adjustment through 1) the early fostering of new growth spots for consumption, 2) promoting the stable growth of investment while restraining investment in industry sectors prone to over production, 3) the promotion of urbanization, and so on. Though many fluid aspects remain, compared to the policy lines expressed by the Chinese Communist Party at the National Congress in November, these latest statements contain many more references to the promotion of reform. There has been a perceptible shift on the part of the new Xi Jinping administration towards economic management that balances economic recovery and structural adjustment. It will be interesting to see how much power of execution they have in the months to come.

(Junya Sano)