

# ASIA MONTHLY

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**Topics** *The transformation of China's economic development model is urgent*

As evidenced by recent developments such as hazardous air pollution and a decline in the working age population, the transformation of China's economic development model has become a matter of urgency. The Xi Jinping administration has been entrusted with the task of guiding China at this historic juncture.

■ **Hazardous air pollution affects one third of mainland China**

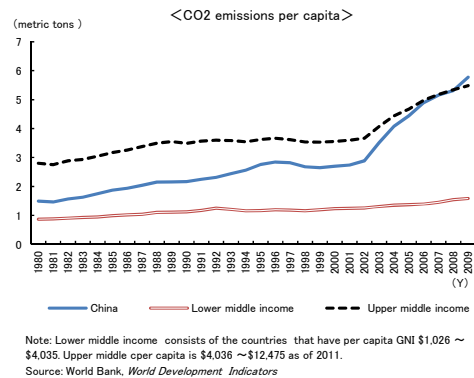
In China, the transformation of the economic development model has become a matter of urgency. From the reports of the 18th Party Congress and the 12th Five Year Plan, the transformation of China's economic development model may be characterized by 1) the switch from an investment and export driven model of economic growth to a consumption led model, 2) the switch from a resource wasting economy to a resource saving and recycling oriented economy, 3) increased contribution to innovation and human capital growth, 4) the promotion of modern service industries and strategic emerging industries, and 5) improved social stability through efforts to redress the wealth inequality between urban and rural communities.

The transformation of China's economic development model is not a question of the speed of economic growth, but refers to policies to enhance sustainability. The importance of transforming China's economic development model was stressed under the leadership of Hu Jintao, so it is by no means a new topic of discussion. However, that administration was noted for having put off the reforms required to achieve such transformation, and there were no successes to that end in any field. The repercussions of that are becoming painfully obvious under the Xi Jinping administration. The challenges are diverse, but here a cue can be taken from two recent news items that put the focus on the switch from a resource wasting economy to a resource saving and recycling oriented economy, and increased contribution to innovation and human capital growth, as the challenges that face China looking forward.

There has been renewed awareness of the importance of converting from a resource wasting economy to a resource saving and recycling oriented economy in the wake of the recent hazardous air pollution levels. The hazardous smog that has appeared in Beijing and much of the Huabei region has spread to cover roughly one third of the Chinese mainland, and is having a serious impact on the lives of the people. Environmental pollution has been one factor leading to protest demonstrations, euphemistically termed "group events", but until now these have been limited to local demonstrations by citizens' groups squaring off against corporations or local government. Recent smog levels have heightened public awareness of environmental pollution issues, and there is a danger that the nature of the conflict could become one of "the people vs. the central government".

For example, China's per capita CO2 (carbon dioxide) output levels can be compared with the average figures for lower middle income countries and upper middle income countries. China's per capita GNI (gross national income) as of 2011 was \$4,940, just making it into the upper middle income group. Nevertheless, China's CO2 output levels are above the levels for that group. While the Hu Jintao administration may be said to have started to apply the brakes to China's excessive energy consumption, this correction has now become a most pressing issue.

Beijing city introduced tougher automobile exhaust regulations in February, and it has been announced that some 200 companies found to be emitting hazardous gases will be closed within the year, with some 1,200 scheduled for closure by 2015. However, given the burden that it means for businesses, it would be very difficult to impose the same measures and restrictions as in Beijing across the whole country at once. Also, given the fact that it is possible that the toxic gas reduction effect of the measures introduced in Beijing will be largely cancelled out by the increase in the number of automobiles and the relocation of factories, and that energy, from development to retail, is under the control of central government run businesses, from which a vigorous reaction can be expected, it is very unlikely that the problem of hazardous air pollution will be cleared up overnight.



■ China’s first falling working age population

Another issue that is set to become more pronounced during the Xi Jinping administration is the increased contribution to innovation and human capital growth. Under the Hu Jintao administration, the slogans were all about changing from a “population superpower” to a “human capital superpower”, and successes were achieved in spreading compulsory education (elementary and secondary) to a near complete level, as well as greatly increasing opportunities for advancement to higher education. However, in recent years, the difficulties that university graduates face in finding work has become a serious social issue, while the phenomenon of the shortage of unskilled labor is starting to become the norm. Given these circumstances, it may also be said that the government’s education and human capital development policies did not always match the needs of the labor market.

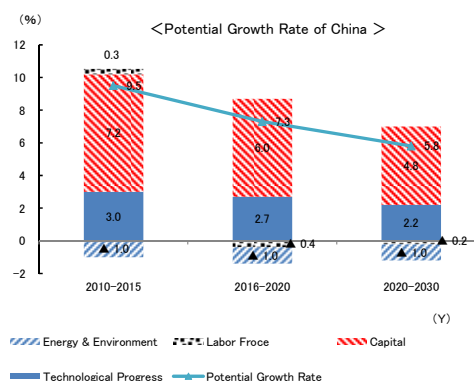
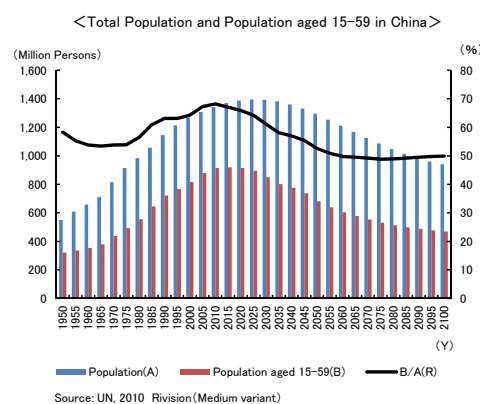
That China was able to achieve high levels of economic growth despite this demand and supply mismatch was due to the growth in investments and the expanding labor input volume. However, the growth equation of the Hu administration will not work under the Xi administration. This is because China already has noticeably low investment efficiency (see JRI Research Focus “Chinese economy’s investment efficiency continues to fall”), meaning that there is little prospect of an increase in the labor force. In January, 2013, the National Statistics Bureau announced that the 15 to 59 year old working age population was 937.27 million, down 3.45 million from the previous year. This is the first time in China’s history that the working age population has fallen while the total population continues to grow.

China has long had a single child policy, and warnings about the drop in the working age population have been sounded for some time now. The upper right figure shows UN estimates regarding the long term growth of China’s population and working age population. The forecast was that China’s working age population would be found to have peaked at 68.2% of the total population in 2010, gradually declining from then on. The forecast was found to have been correct in 2012.

The lower right figure shows a government think tank’s trial calculations of China’s potential economic growth rate. The potential economic growth rate refers to the growth rate that could be achieved if the existing factors of production are utilized to the full, and is calculated based on a forecast of what changes are likely to occur in the factors of, principally, capital stock, labor force, and productivity. The forecast is that the potential growth rate will fall to the 7% range from 2016 onwards. This is because, in addition to the fact that labor force issues will join energy and environmental impacts as growth inhibitors, the contribution of investment, which has hitherto been the main driver of economic growth, will become weaker.

The administration of Xi Jinping will not have the same luxury as the previous administration of allowing the “transformation of China’s economic development model” to become just another slogan. The Xi administration will need to bring a sense of crisis to the challenge that has been entrusted to it, of guiding the Chinese economy at this moment of historic transition, and exercise determined leadership based on that awareness. As symbolized by exhaust gas emission restrictions, transforming the Chinese economy’s economic development model will involve considerable cost, and there is strong opposition from vested interest groups. However, the International Monetary Fund (IMF) believes that there is a surplus labor force in the agricultural communities, and that by reforming the household registration system, the urban labor force can be increased by 2020 to 2025, so that reforms could make it possible to raise the level of potential growth ten or 20 years hence.

(Yuji Miura)



## Korea Economic environment likely to remain tough

### ■ Economic growth 0.4% in Q4, quarter on quarter

South Korea's real GDP growth rate (quarter on quarter) for the October to December quarter was 0.4%, up from 0.1% in the July to September quarter.

Exports were minus 1.2%, facilities investment minus 2.8% (negative growth for three consecutive quarters), and construction investment minus 1.3%, all posting negative growth, but private sector consumption supported economic growth overall, posting 0.8% growth in the same period. Also, on a year on year basis, growth for the quarter was 1.5%, the same as in the previous quarter, and 2.0% for the whole year.

In terms of recent developments, exports (customs cleared basis) went from minus 5.7% in December, compared to the same period in the previous year, to 11.8% growth in January, 2013. However, it needs to be borne in mind that this reflects a degree of upward distortion due to the different timings of the Lunar New Year (January in 2012, February in 2013).

While private sector consumption is performing solidly, it still lacks strength. The acceleration in consumption growth witnessed from the autumn of last year has been due in no small part to the effects of economic stimulus measures (lower interest rates, and lower private consumption tax rates for purchases of automobiles and large household electrical appliances) and the "severe winter effect" (healthy sales of winter clothing and heating equipment). In fact, the end of tax reduction measures at the end of 2012 has also had an effect, and automobile sales slumped from 140,000 vehicles in November and December to 110,000 vehicles in January, 2013.

Also, investments have been slowing. The private sector machinery (excluding vessels) orders total, an index of future facilities investment performance, has begun to bottom out, but recovery would seem to be still a long way away. Also, apartment prices in Seoul city fell to minus 4.7% in January, compared to the same period in the previous year (the largest drop in recent years), indicating that construction investment is still not yet out of the doldrums.

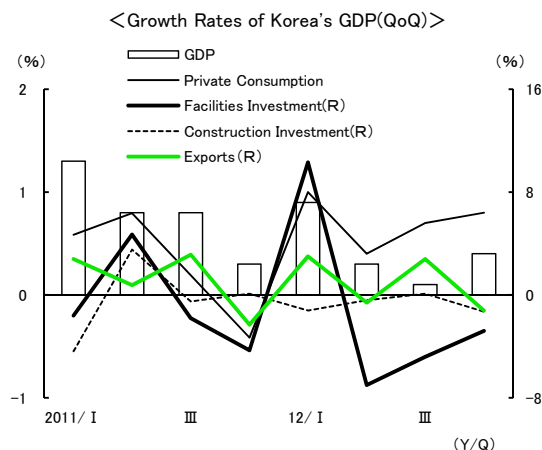
### ■ Economic situation to remain tough for the time being

As for future prospects, the economic recovery in China, S. Korea's largest export partner, is welcome news. On the other hand, the yen – won exchange rate, which was 100 yen = 1,500 won in October, 2011, saw the won strengthen against the yen to the 1,100 won range in February, 2013, and the yen has depreciated rapidly against the won since. This has brought concerns over the potential impact on exports and corporate earnings and since, as stated above, there is little prospect of investment recovery in the foreseeable future, the economic situation is thought likely to remain harsh for some time to come.

Though consumption continues to stay fairly solid, its momentum cannot increase unless the household balance sheet is improved. President-elect Park Geun-hye (who will take office from February, 25) plans to create "high quality" employment and to promote the conversion of workers from non-regular employment to regular employment, as well as working to ease the burdens of debt repayment and education costs, which have weighed heavily on household budgets. With regard to the debt repayment issue, President-elect Park has put together a plan that involves having the "National Happiness Fund" buy up the delinquent loans held by the financial institutions to allow applicants to repay their debts over a longer term (within certain limits, short term loans with interest of 20% or more will be converted to low interest long term bank loans).

President-elect Park's mettle will be tested by how well she is able to promote measures dealing with the mid to long term issues of economic democratization and the aging society, all the while paying due attention to the economy.

(Hidehiko Mukoyama)



Source: The Bank of Korea, Economic Statistics System

## Hong Kong Maiden Policy Address

### ■ Focus on soaring housing prices and welfare related issues

The Chief Executive's Policy Address was delivered before the Legislative Council on January 16. Even given the fact that this was a scheduled, once a year event, it was Chief Executive CY Leung's maiden address and, as such, there was much interest in its content, even before it had been delivered.

The Policy Address was characterized by the following two main points.

First, there will be more determined efforts to combat soaring housing prices. Though the Hong Kong government had implemented measures to try to restrain housing prices, such as increased taxation on home purchasers, other than those with permanent residency, who try to resell property in the short term, housing prices have well exceeded their post '97 sovereignty transfer peak, and there seems to be no end in sight to their rise.

Given this situation, the Policy Address states that "The top priority of the current-term Government is to tackle the housing problem." Additional measures to increase housing supply included 1) an annual supply of over 22,000 public rental housing units per annum, through new construction and the surrender of unfair using properties, and 2) the conversion of industrial and other sites for housing use.

Second is the government's involvement in social welfare issues. The Address incorporates the setting of a poverty line, and policies for the expansion of services for the elderly, etc. These initiatives are thought to have been in response to the widening income disparity within Hong Kong, and the advancing aging of society. In addition, when the government's proposed platform for discussion on the introduction of standard working hours, comprised of representatives from all sectors, is taken into account, it may be said that the government has switched from a laissez-faire approach to one that will see much more appropriate intervention in order to improve social welfare.

### ■ Content criticized, additional measures rushed through

Hong Kong residents' evaluation of the Policy Address has not been favorable. The "Hong Kong Economic Daily" of January 18 reported that, based on a public opinion poll conducted by Hong Kong University, the Address scored a satisfaction level of 12% (subtracting the percentage of "dissatisfied" responses from the percentage of "satisfied" responses), the lowest Internet based satisfaction level of any Chief Executive thus far (earlier scores: 31% points, 39% points). With regard solely to the number of new housing units to be built, in addition to the fact that there were absolutely no increases on the 15,000 units planned by former Chief Executive Donald Tsang, it seems that the failure to incorporate additional tougher measures against developers who are perceived to be instrumental in pushing up prices, has attracted some criticism.

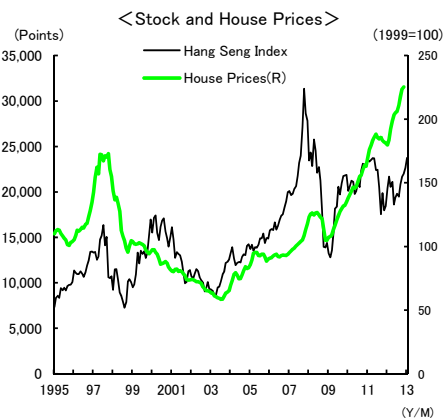
Subsequently, the government has rushed to implement new additional measures, such as revising upwards the target number of new housing units for construction, and the possibility of the introduction of a vacancy tax as a means to prevent developer hoarding. As the economy emerges from the worst of the recession and begins to show signs of gradual recovery, the Hong Kong government will be tasked with implementing effective policies to resolve the housing price issues as quickly as possible.

(Junya Sano)

<Policy Address>

Field	Main Measures
House Problem	<ul style="list-style-type: none"> <li>Supply of over 22,000 Public rental housing units per annum, through new construction and the surrender of unfair using properties</li> <li>Conversion of industrial and other sites for housing use</li> </ul>
Social Welfare Issues	<ul style="list-style-type: none"> <li>Setting of a poverty line</li> <li>Expansion of services for the elderly</li> </ul>
Others	<ul style="list-style-type: none"> <li>Composition of the deliberation framework towards introduction of the standard-labor-time system</li> </ul>

Source: Hong Kong Government



Source: Hong Kong Government, CEIC

## Malaysia Enhancing competitiveness of resource-related industries

### ■ 2012 exports drastic decrease from previous year

Malaysia's export value for the October to December quarters in 2012 grew 0.4%, \$57.9 billion, compared to the same period in the previous year. After negative growth in the April to June and July to September quarters, this was the first positive growth in three consecutive quarters. However, export growth for the whole of 2012 was 0.2%, a significant drop from the 14.0% growth posted in the previous year.

The main factor behind this blunting of export growth is the economic stagnation among Malaysia's major export partners. Exports to Japan and the EU in October to December plunged to minus 10.4% and minus 12.2%, respectively, compared to the same period in the previous year, with whole year growth 3.3% and minus 14.0%, respectively, year on year. Exports to China were minus 0.9% in the October to December quarter, compared to the same period in the previous year, and minus 3.3% for the whole year, on a year on year basis. Exports to the USA were up 8.4%, similarly, with a healthy 4.9% for the whole year, compared to the previous year, and this was encouraging news. Furthermore, exports to ASEAN continue to perform solidly at 14.1%, similarly (10.0% for the whole year).

It is expected that Malaysia's economy will continue to be supported by robust domestic demand through 2013, but with the population around 30 million, Malaysia will need to expand exports in order to sustain economic growth. From this perspective, the Najib administration has been forging ahead with the signing of FTA (free trade agreements), and bilateral FTA with Japan, Pakistan, New Zealand, India, and Chile are already in force, and a new FTA with Australia (MAFTA) has started from January, 2013. Additionally, Malaysia is also participating in TPP (Trans-Pacific Strategic Economic Partnership) negotiations.

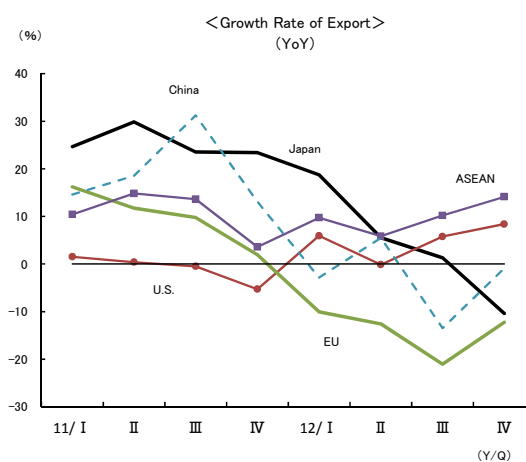
### ■ Escaping the electronic – electrical equipment dependent industrial structure

To expand export, it is necessary to develop new markets and to foster competitive export industries. Since the signing of the Plaza Accord in 1985, Malaysia has grown as an East Asian export hub for electronic and electrical equipment, by attracting investment and participation from Japanese and other foreign companies. In recent years, however, with the emergence of China as a competitor, Malaysia's position has come under heavy fire. Malaysia's share of the exports of electronic and electrical products fell from 51.1% in 2006 to 36.2% in 2012. In particular, export levels have fallen below those of the same quarter in the previous year for five consecutive quarters, since October to December, 2011. The figure for the whole of 2012 was minus 3.5%, year on year.

Given these circumstances, the Najib administration is working to nurture new competitive industries, in order to avoid the "middle income trap" (where a middle income economy loses impetus before it can become a high income economy). Among these are petrochemical related products and resource related products, such as palm oil and natural rubber. Petrochemical related product exports in 2012 were 16.9% up on the previous year, at \$32.2 billion, and their percentage of total exports grew from 9.2% in 2006 to 14.2% in 2012.

Crude oil and palm oil have always been important export items, but one characteristic feature of the Najib administration is that it has tried to enhance their added value as final products by attracting foreign investment. Foreign companies that invest in the refinery and petroleum integrated development project (RAPID) in Johor province in southern Malaysia are being rewarded with tax incentives. The government also plans to leverage foreign capital in order to improve the competitive strength of particularly Malaysian products, such as palm oil and natural rubber. Resource related industries have an important role to play in enhancing Malaysia's export competitive strength.

(Keiichiro Oizumi)



Source: NSO, Malaysia

## Philippines Maintaining growth momentum required

### Real GDP growth rate 6.6% in 2012

The Philippines' real GDP growth rate for October to December, 2012, was 6.8%, compared to the same period in the previous year, maintaining a fairly high level of growth. This was due to continued strong domestic demand, encouraged by monetary easing and increased government spending, as well as a 10.2% increase in merchandise exports (GDP basis). As a result, growth for the whole year was 6.6%, a strong recovery from 3.9% in the previous year when growth was stifled by poor export growth and lack of progress in public works projects, and in excess of the government's target of between 5.0% and 6.0%.

Examination of domestic demand growth through the whole year shows private consumption at 6.1% and government consumption at 11.8%. Fixed capital formation grew 8.7%, of which construction investment grew 13.7% and durable equipment investment 5.7%. In the construction industry, the public sector grew 32.4% and the private sector 8.6%, but the latter half of the year saw a spurt in private sector construction growth, and private sector construction is expected to become even more active in the future. Also, export growth was 8.4%, recovering strongly from minus 6.0% in the previous year.

In terms of industrial origin, agriculture posted 2.7% growth (2.7%), industry 6.5% (2.3%) and services 7.4% (5.1%) (figures in parentheses are for the previous year). In the industry sector, manufacturing posted 5.4% growth, and construction 14.4%. In the service sector, transport, storage and communication posted the highest growth rate at 9.1% among various businesses, and wholesale and retail trade, finance, and real estate were all in the 7% range. The service industry was actually the growth driver.

### Structural reforms and measures to handle capital inflows vital to sustain high growth level

The government's target for real GDP growth in 2013 is between 6.0% and 7.0%. Mid-term elections are slated in May, and government expenditure is likely to continue to grow strongly. A range of developments lend support to expanded government expenditure, such as the full scale implementation of infrastructure development projects by public private partnerships (PPP), a contracting fiscal deficit, and reforms implemented by the Department of Budget and Management to simplify budget implementation procedures. Meanwhile, the stability of food prices, and so on, has meant that the consumer price index increase rate for 2012 was at its lowest level in the past five years at 3.2%, and it seems that monetary easing will continue. Against this backdrop, both consumer and corporate sentiment are extremely positive, and growth of around 6% seems quite possible. However, given that the average growth rate for the past ten years has been around 5%, in order to maintain growth momentum over the mid term, the steady implementation of structural reforms such as the acceleration of infrastructure development and other improvements to the investment environment, and measures to tackle poverty, will be important.

In recent times, the economy's healthy performance and the possibility that the Philippines credit rating would soon be upgraded to investment grade have been encouraging an increase in capital inflows. While it is true that increased foreign direct investment will support economic growth, there are fears that an expansion of short term capital inflows will encourage

market instability and excess liquidity, possibly leading to an asset price bubble. In addition, there are concerns that strong domestic demand will result in increased inflationary pressure. In response, the Central Bank has introduced a range of measures to combat currency and real estate speculation, such as prohibiting non-residents from making deposits into special deposit accounts. In the future, the Central Bank will find itself forced to make difficult management decisions in order to sustain high economic growth.

(Satoshi Shimizu)

<GDP Growth Rates by Industrial Origin>

	(Y o Y, %)							
	2011Q1	2011Q2	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3	2012Q4
Real GNI	3.5	2.4	2.2	4.5	5.1	5.7	7.0	5.4
Real GDP	4.9	3.6	3.2	4.0	6.3	6.0	7.2	6.8
Agriculture, hunting, forestry and fishing	4.4	8.3	2.2	-2.5	1.0	0.6	4.2	4.7
Industry Sector	7.3	-1.4	0.1	3.4	5.3	5.5	7.6	7.5
Manufacturing	8.1	5.8	2.0	3.3	6.0	4.3	5.8	5.6
Construction	4.2	-24.2	-8.8	8.1	3.6	14.0	20.6	18.4
Service Sector	3.6	5.6	5.2	5.9	8.1	7.4	7.5	6.9
Transport, Storage and Communication	4.2	4.2	4.6	4.1	9.7	9.3	9.4	8.1
Financial intermediation	6.4	11.6	1.4	1.5	8.7	7.0	8.6	7.2

Source: National Statistical Coordination Board