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Topics *India concerned over protracted slowdown after abolition of high denomination banknotes*

After India abolished some high denomination banknotes in November, 2016, the negative effects are spreading not only in private sector consumption, but also in the corporate sector.

■ Sudden abolition of high denomination banknotes

In India, on November 8, 2016, Prime Minister Modi announced the abolition of the 500 rupee and 1,000 rupee banknotes. These banknotes would become demonetized on November 9, and people would have up until the end of December to deposit them into bank accounts, or to exchange them for new notes at bank counters. However, there was considerable turmoil, with the supply of new banknotes not being able to keep up with demand, a 4,000 rupee limit set on the initial amount that could be exchanged at bank counters, an upper limit of something like 20,000 rupees on the amount that could be withdrawn from bank deposits in a single week, and long lines being formed at the banks. In India over 90% of settlement is done in cash, and the two banknotes that were abolished accounted for about 85% of cash distribution, and the effects have already become pronounced, particularly in private sector consumption.

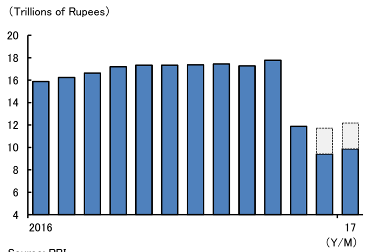
Below, having first confirmed the most recent cash distribution condition, this report will examine the effects on the household and corporate sectors.

■ Cash distribution volume greatly reduced since November

Examination of the recent cash distribution volume shows a decline of 23.6%, compared to the same period in the previous year (and the same hereafter), followed by 40.0% in December, a massive decrease on the previous year. Since all of the banknotes that were not deposited or exchanged at the banks by the end of December would have become worthless, it is assumed that they were absorbed, for the time being, into bank deposits.

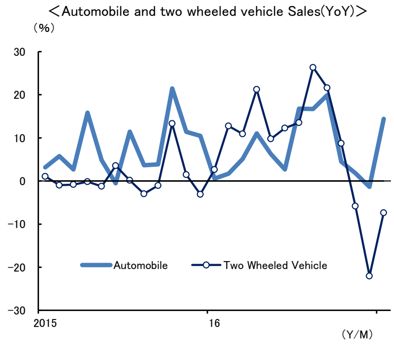
A comparison of the cash distribution volume in October, before the demonetarization of the old banknotes, and bank deposit totals shows that, while the cash distribution volume in November shrank by 5.9 trillion rupees, bank deposits increased by 6.1 trillion rupees, so it would seem that the cash distribution was largely converted into bank deposits. In contrast, the cash distribution volume as of December, by when deposits and exchanges of old banknotes had to be completed, had shrunk by 8.4 trillion rupees, whereas the increase in deposits stayed more or less flat from the previous month at 6.1 trillion rupees, and the assumption is that the difference of 2.3 trillion rupees is the amount of the old banknotes that could not be exchanged in time and therefore became worthless.

＜Cash Distribution Volume＞



Source: RBI
Note: Cash Distribution uses money supply statistics : Currency in Circulation. And the dotted line is the volume substracting the decrease in cash distribution amount from October to December from the increase in bank deposit during same period. These are the banknotes that were not brought into the bank and were invalidated.

＜Automobile and two wheeled vehicle Sales(YoY)＞



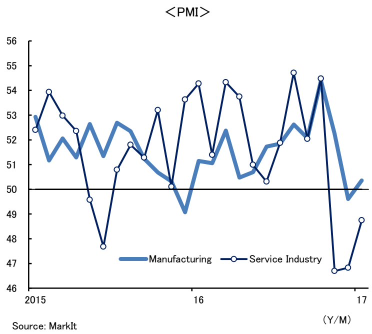
Source: Society of Indian Automobile Manufacturers

The contraction in cash distribution first of all had an impact on individual consumption. In particular, there has been a noticeably negative impact on sales of automobiles and two wheeled vehicles, two representative high value consumption items. Automobile sales mainly in the cities have been able to maintain their growth momentum somehow, but sales of two wheeled vehicles in mainly rural areas have fallen below the previous year's figures for three straight months. In agricultural communities, the ratio of cash settlement is even higher than in the cities, and alternative settlement methods, bank loans and other forms of borrowing are not common, so the abolition of the high denomination banknotes appears to have had a more serious impact.

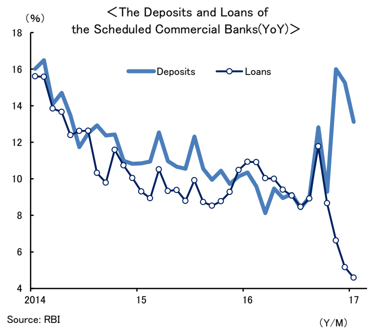
State Bank of India and others have expressed the view that the cash supply shortage situation will return to normal by the end of February, but given the fact that in addition to the absolute contraction in the distribution volume caused by the amount that became invalid, the increase in January's currency distribution volume was slight at best. Thus, it is thought likely that it will take some considerable time for the currency distribution volume to return to the levels it was at prior to the currency demonetization. Given these circumstances, while it is expected that the consumption of consumer goods necessary for daily living will gradually recover from the January to March quarter onwards, as the cash distribution volume recovers, there is a very high probability that a recovery in discretionary consumption, such as durable consumer goods, will be modest at best. There are concerns that in the agricultural communities, where the recovery in incomes is slower than in the cities, the stagnation of future consumption may be a protracted one.

■ Attention needs to be paid to the impact on the corporate sector

In addition, the negative impact on the corporate sector is widening. Examination of the corporate sector's PMI (purchasing managers' index) shows that the service industry has suffered a significant slump since November. The background to this is that, in addition to industries, such as retail, that suffer a direct impact from the lack of cash, there are signs of slumps in entertainment related industries. Added to this, signs are beginning to emerge that the number of land sales and purchases has decreased in the real estate industry, in which cash is the main settlement mode. Also, in manufacturing, though the performance indicator for January was over 50, the benchmark, the level was still low in comparison with the months of October and before, suggesting that the recovery in manufactured goods transactions is not making any progress.



In addition, there have been changes in the activities of the financial institutions that are the principal source of corporate capital procurement. Examination of the deposit and loan totals of the scheduled commercial banks reveals that, although deposit totals have increased by huge margins as a result of the banknote deposits, loan growth is stagnating at its lowest level since the start of 2000. India's banks were already cautious in their approach to lending, in order to suppress any new occurrence of non-performing loans, under pressure as they are to comply with measures to deal with non-performing loans, led by Reserve Bank of India. Under these circumstances, according to a Reserve Bank industry outlook survey, the corporate capital procurement situation appears to be worsening, and there is a possibility that, triggered by the demonetization of high denomination banknotes, banks will adopt an even stricter stance with regard to lending. Production adjustment as a result of a cooling of economic activity, and falling demand for capital due to growing uncertainty about the future, seem to have played a part, but if corporate earnings decrease in the wake of slowing consumption, deteriorating cash flow is expected to result in bankruptcies and other business difficulties. The repercussions on the corporate sector are expected to be significant in terms of the recovery in plant and equipment investment, which is recently continuing to struggle for growth, and there will be a need to keep an eye on the likely risk of downward pressure on the Indian economy.



■ Fears of a longer than expected state of confusion

The impact of the demonetization of the old banknotes is effectively the same as that of monetary tightening, and there is a possibility that the impact on private sector consumption and corporate plant and equipment investment will not be just a short term one. In terms of the government's response also, the initial view was that confusion would quickly settle down. However, as a result of repeated changes in the deposit withdrawal upper limit and an insufficient supply of new banknotes, then the raising of the deposit reserve ratio and its subsequent re-withdrawal, there is an undeniable sense of confusion with regard to the policy response, and there is now a real feeling that the situation could become a protracted one.

Taking a long term view, the demonetization of high denomination banknotes has many positive aspects, such as increasing tax revenue by cracking down on the use of "black money" and creating a foundation for the spread of e-money. However, if the economic slump becomes a protracted one, the Modi administration, which has been pushing ahead with reforms, may experience a decline in its cohesive force. To the extent that there is a possibility that it may prove difficult to maintain the high levels of growth enjoyed thus far, attention needs to be paid to whether cash distribution can recover as hoped.

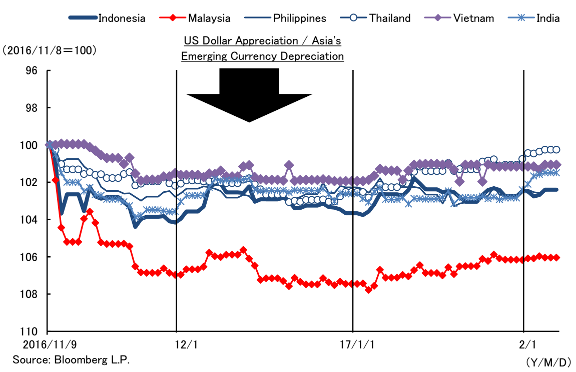
(Kentaro Matsuda)

Malaysia *Central Bank to introduce new exchange control measures*

■ Ringgit slides heavily up to end of 2016

In response to Donald Trump's victory in the US presidential election of November 8, 2016, US long-term interest rates surged upwards in anticipation of an upswing in the US economy as a result of expanded fiscal expenditure. This stimulated a reflux of capital back into the US, and depreciation of the currencies of the Asian emerging economies. In particular, Malaysia's ringgit weakened considerably against the dollar, falling 7.5% by the end of 2016.

＜The Exchange Rate Against the US Dollar in Asia's Emerging Economies＞



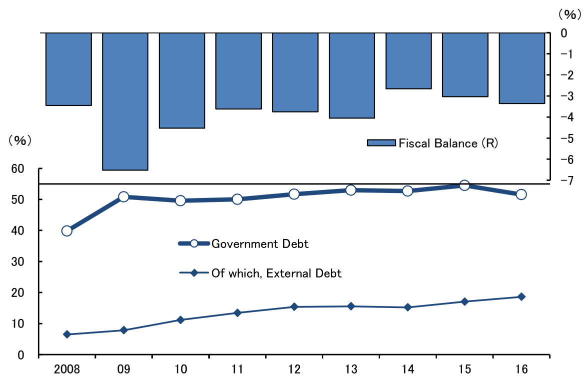
Source: Bloomberg L.P.

Under these circumstances, Central Bank of Malaysia announced new exchange control measures on December 2, 2016 (effective from December 5). The main provisions are 1) an obligation on exporters to convert 75% of their export earnings into ringgit, 2) an obligation for domestic goods and services transactions to be settled in ringgit, and 3) restricting exchange risk hedging without the backing of actual demand to 6 million ringgit per company per bank. Central Bank maintains that the purpose of the measures is to ensure the smooth circulation of foreign currency, but their actual purpose is believed to be to protect the ringgit.

■ Urgent fiscal and economic reform

The ringgit showed a gradual appreciation from the start of 2017, but given the fact that other Asian emerging economies' currencies are largely behaving in the same way, and that markets overall are waiting and watching to see the direction of the new Trump administration, the new measures cannot really be said to have had the desired effect in protecting the ringgit. In fact, the new measures may end up having an adverse effect on the country's mid to long term development by increasing corporate administrative costs and exchange risk, and suppressing direct inward investment.

＜Fiscal Balance and Government Debt Against Nominal GDP＞



Source: Bank Negara Malaysia, Department of Statistics Malaysia, IMF
Note 1: Nominal GDP is 2005 base in 2008～09, 2010 base after 2010.
Note 2: Fiscal Balance in 2016 is IMF estimation. Government Debt is the number at the end of September 2016.

In the first place, part of the reason that the ringgit depreciated so heavily against the dollar in comparison with other Asian emerging economies is the fragility of Malaysia's financial and economic structure. In addition to the on-going deficit in the fiscal balance, government debt is approaching the statutory upper limit of 55%. Also, in terms of the export structure, Malaysia has yet to find a clear path to break away from its dependence on raw materials and primary products, and its dependence on China, issues that have been outstanding for some time. In addition, there are persistent allegations of corruption against Prime Minister Najib, and the growing risk of political turmoil is one factor that damages the credibility of Malaysia's currency.

There are many aspects of financial and economic structural reform, such as the strengthening of tax collection and the relaxation of various regulations related to Bumiputera policies, that are expected to be strongly opposed by the people, and with a general election slated for 2018, it will not be an easy task for the Najib administration to push ahead with planned reforms.

However, standing idly by will only delay the stabilization of Malaysia's currency and the achievement of its stable growth. The Najib administration is currently facing a moment of truth, whether it can present reforms that will win the trust of the market, and carry out these reforms while providing careful explanation in order to convince the people.

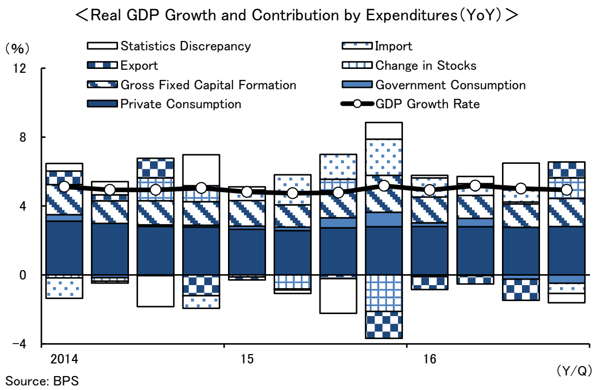
(Yuta Tsukada)

Indonesia *4.9% growth in Q4, 2016*

■ 2016 sees first acceleration in six years

Indonesia's real GDP in the October to December quarter of 2016 was 4.9%, compared to the same period in the previous year, practically unchanged from the previous quarter (5.0%, similarly). As a result, the economic growth rate for 2016 was 5.0%, a slight acceleration, and the first in six years.

In terms of demand items in the October to December quarter, it can be seen that a contraction in government consumption and increased imports helped push down the growth rate.



The background to the contraction in government spending has been the government's stance of restricting expenditure. Sri Mulyani, appointed Finance Minister in July, 2016, is prioritizing the maintaining of fiscal discipline, rather than trying to prop up the economy by expanding fiscal expenditure. Because of this, central government expenditure, excluding capital expenditure allocated to infrastructure development, etc., shrank by 5.8% in the October to November period, compared to the same period in the previous year.

On the other hand, the increase in import growth is linked to solid domestic demand and expansion in export growth. In addition to steady growth in private consumption against the backdrop of a continuing comparatively low inflation rate, gross fixed capital formation was driven by progress in infrastructure development, among other factors.

There were increases in exports of animal and vegetable oils and fats, transportation equipment, chemical products, etc., principally to China, Korea and the US.

Given these developments, though the pace of Indonesia's economic growth has stayed relatively flat, it seems reasonable to say that it is performing solidly.

■ Relaxing embargo on unprocessed ore

Against this backdrop, on January 12, 2017, the Ministry of Energy and Mineral Resources announced the relaxation of a ban on the export of unprocessed mineral ores, with some exceptions, that had been in force since January, 2014. The aim of the relaxation of the export embargo is believed to be to increase tax revenue and to expand employment.

Companies may begin to export unprocessed ore under certain conditions, such as 1) using 30% of the smelting capacity of refineries within Indonesia, 2) domestic supply exceeding demand, 3) acquiring a special business license to refine mineral resources within five years, and 4) requiring foreign capitalized firms to sell at least 51% of their shares to the Indonesian government, local government or an Indonesian private sector firm within ten years. As a result of this deregulation, exports of natural resources are expected to make a gradual recovery.

In terms of Indonesia's economic outlook for 2017, while China's economic deceleration and economic structural transformation continue to be a concern in terms of external demand, the economies of the US, Japan and the ASEAN countries are beginning to pick up, and with the expected increase in mineral exports resulting from the relaxation of the export embargoes described above, it is likely that there will be a gradual recovery. As for domestic demand, on the other hand, gross fixed capital formation is expected to show a solid performance, due to factors such as the development of infrastructure projects and expansion in private sector investment due to the effects of the lowering of interest rates from the latter half of 2016.

Nevertheless, it would be difficult to expect any significant recovery in private consumption. This is because the weak rupiah and the rising price of crude oil have triggered rising inflationary pressure, and household purchasing power is expected to deteriorate. In fact, the inflation rate as of January, 2017, was on the rise at 3.5%

Given the foregoing, while Indonesia's economic recovery mode will likely continue, there is little hope of any major acceleration.

(Yuta Tsukada)

China *Calls for acceleration of opening up*

■ Economic growth stays relatively flat

China's most recent economic indices are generally poor, and there i s no expectation of any good news about the future of the economy.

According to the latest announced indices, retail sales during the Chinese New Year holiday period grew 11.4%, compared to the same period in the previous year, more or less the same pace (11.2%, similarly) as 2016's results. The Ministry of Commerce explains that Net services and sales of smart household appliances and new digital products were the drivers of growth. Of course, added to the fact that the structural anomaly of online sales performing strongly while store sales continue to languish is yet to be resolved, disposable income is struggling to grow recently, in consideration of which it would be difficult to expect any significant acceleration in consumption.

Also, the manufacturing industry PMI (purchasing managers' index) for January, 2017, released by the National Bureau of Statistics, was 51.3. While this is 0.1% points down from the previous month, the index has been above the benchmark 50 for six consecutive months. The various indices that make up the PMI, such as new orders received, are generally performing solidly. It may be said that, against the backdrop of expansion in public works investment, business confidence at manufacturing sites is continuing to get stronger.

■ Calls for accelerated opening up in to support growth sustainability and structural adjustment

The administration of Xi Jinping appears likely to continue to focus on providing support for the economy from the fiscal side, for example, by expanding public works investment and reducing taxes. At the same time, from the point of view of suppressing an asset bubble, there is a growing possibility that monetary policy, which has favored monetary easing thus far, may be adjusted slightly in the direction of more tightness. Under these circumstances, the government of China is emphasizing the acceleration of the opening up of markets to the outside, and has begun to revitalize activities aimed at calling for an expansion of trade and investment with China.

＜Notice About Acceleration of Foreign Opening Up（January 2017）＞

Main Targets	Match for Target Realization
Easing of Access Restriction	･An effort is made on the relaxation of foreign capital entry regulation and the opening of the market from which orders arise in service sectors
	･Abolition of foreign capital entry regulations by industries such as motorcycle production and processing of oils and fats
Fairly Competitive Environment	･Fair application of industrial policy
Increased Efforts to Attract Foreign Investment	･Implementation of the foreign capital good treatment plan admitted legally is asked from local governments as well as to move to inland areas of a foreign capital enterprise is supported politically

Source: Chinese Government Official Web Site

In January, 2017, the Chinese government issued the "Circular of the State Council on Several Measures concerning the Expansion of Opening-up and Active Use of Foreign Capital" (Guo Fa [2017] No.5). The Circular proposed three main targets: 1) the easing of access restrictions on foreign capital, 2) the development of a fair and competitive environment, and 3) increased efforts to attract foreign investment.

Part of the reason behind this is thought to be an attempt to make a clear distinction between China's stance and the protectionist trade policies being promoted by the new Trump administration in the US. However, attention needs to be paid not only to such political intentions, but also to the way in which the rapid growth of direct investment in China accelerated China's economic growth after it was accepted as a member of the WTO. Direct investments in China in 2016, with the exception of finance related investments, fell below the previous year's level for the first time in four years, albeit very slightly (-0.2%), and there may be said to be a growing sense of urgency with regard to the attracting of foreign capital in order to secure growth. If the goals expressed in the Circular can be implemented, it may be hoped that, in addition to the economic boost effect from both the demand and supply sides, it will contribute to the enhancement of China's industrial structure and economic structure through the permeation of market mechanisms and competition among businesses. At the same time, however, businesses that lack strength will be forced out of the market, so there is a danger of a growing reaction against the government. In the run-up to the National Congress of the Communist Party of China in the autumn of this year, the Xi Jinping leadership's ability to deliver will be tested as to whether they can achieve the acceleration of opening up, while keeping domestic economic turmoil to a minimum.

(Junya Sano)