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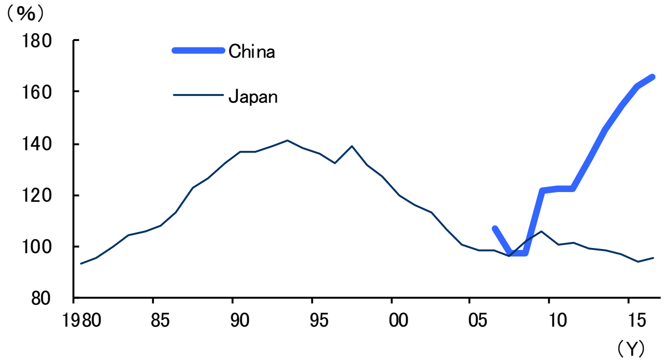
Topics China's burgeoning corporate financial asset investment growth

In China, both corporate debt and financial assets are growing rapidly. While it is easy to focus on the real estate bubble as a risk faced by the Chinese economy, attention also needs to be paid to corporate financial asset investment growth, which may well lead to a deceleration in economic growth.

■ Rapid growth in both corporate debt and financial assets

In recent years, China's corporate debt has expanded at a rapid pace. According to the Bank for International Settlements, the rate of debt outstanding for non-financial corporations to GDP at the end of 2016 was 166%, higher than that of Japan during the years of the bubble economy.

<Non-financial Corporation's Debt total Ratio to GDP>



Source: The Japan Research Institute, Ltd, based on the data of BIS, "total credit statistics", National Bureau of Statistics of China, Department of National Accounts Economic and Social Research Institute Cabinet Office of Japan.

One factor behind the expansion in corporate debt has been the excess of fixed asset investments. Much of the capital that was raised by local governments through local government financing vehicles as a result of the four trillion yuan of economic stimulus measures introduced in the wake of the Lehman shock was invested in inefficient and unprofitable infrastructure construction and real estate development. Also, large scale monetary easing measures brought down the cost of capital procurement, leading to increased new plant and equipment investment in manufacturing sectors such as steel, cement and solar panels. Examination of the closing balance sheet accounts of non-financial corporations shows that net fixed assets increased from 50.9 trillion yuan at the end of 2008 to 79.2 trillion yuan at the end of 2012, which is the latest available figure.

One other point of note is the increase in financial asset investment. Massive amounts of money freed up by the large scale monetary easing measures introduced since 2008 have flowed into financial assets. In fact, the financial assets of non-financial corporations increased from 35.7 trillion yuan at the end of 2008 to 88.8 trillion yuan at the end of 2012. Also, the percentage of end of period total assets increased from 30% to 39%, similarly. From this, it may be estimated that, even in recent times, at least 40% of the outstanding debt of non-financial corporations is finding its way into financial asset investments.

Furthermore, if the financial assets of non-financial corporations are divided into low risk cash and deposits and other financial assets with higher risk, it can be seen that the latter has grown at a very fast pace, from 21.2 trillion yuan to 57.6 trillion yuan over the same period. Although these statistics are no longer being made available, judging from the development of the "entrusted loans" described below, the probability is strong that corporate financial asset investments have continued to grow further since then.

■ Entrusted loans growing in popularity

Companies are investing in a variety of financial assets, and the entrusted loan is a large scale, high risk and very simple method of doing that.

The entrusted loan is where a company lends money to another company, with a bank acting as an intermediary. In China, it is illegal for companies to lend to or borrow from each other directly. Therefore, the entrusted loan, in which high returns can be gained even though the banks must be paid an intermediary fee, is growing in popularity.

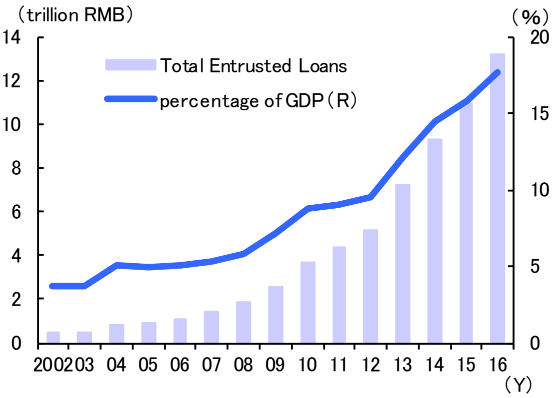
A typical example is the case of Sainty Marine Corporation (Shun Tian Chuan Bo), a company manufacturing and selling container ships and the like. As a state owned enterprise, in 2012 the company raised capital with a coupon rate of 6.6%, then from 2012 till the end of 2013 lent capital through an intermediary bank to multiple non-affiliate companies at an annual rate of 18% to 19%.

Recently, the case of Aluminum Corporation of China Limited (CHALCO) China's largest manufacturer of aluminum, has attracted attention. According to the February 10, 2017, edition of the the Wall Street Journal, CHALCO's interest income from entrusted loans in the first half of 2016 was 30.7 million yuan, more than four times as much as in the same period in the previous year. This amounts to about 50% of CHALCO's net profit. In this regard, CHALCO has stated that entrusted loans are a part of the company's flexible asset allocation strategy.

Also, there have been cases where an asset management company established by a state owned enterprise within its group handles the entrusted loans. Sunny Loan Top is a company under the umbrella of China National Tobacco Corporation, which exercises a monopoly over China's tobacco industry. Sunny Loan Top, which belongs to the finance sector, lends capital to small and medium sized enterprises at an annual interest rate of around 18%, with China CITIC Bank and others acting as intermediaries. Among these loans, there have been ten or more cases of high interest rates in excess of 20%. For example, the loan made to the Ningbo Jinchen Four Seasons Real Estate Company came with an annual interest rate of 21.6%.

The total of such entrusted loans swelled rapidly from 3.6 trillion yuan at the end of 2010 to 13.2 trillion yuan at the end of 2016, and rising from 8.8% to 17.7% as a percentage of GDP.

＜Total Entrusted Loans＞



Source: The Japan Research Institute, Ltd, based on the data of People's Bank of China

There are three reasons behind the sudden growth in entrusted loans. The first is the needs of fund management. In the aftermath of the Lehman shock, the government implemented monetary easing on a grand scale, slashing interest rates, for example. This enabled state owned enterprises to procure capital at low interest rates. As a result, the state owned enterprises were able to borrow at low interest rates from banks and other financial institutions and issue corporate bonds, and then operate fund management with high interest entrusted loans.

The second is the demand for capital from restricted industry sectors. The Chinese government, fearing excess production in sectors such as real estate and coal, restricts bank loans to these sectors. Operating companies in these sectors find it difficult to get financing from the banks, and so have come to rely on high interest entrusted loans in order to raise capital.

The third is the reality of the intermediating banks. If the banks adhere to the government line of restricting funding to the restricted industry sectors, they run the risk that the affected companies will run into business difficulties, resulting in a rapid increase in the banks' non-performing loans. The banks find themselves having to find a way around the government's restrictions and meet companies' financing needs. For that reason, rather than making loans directly to restricted companies, they have come up with this method of making loans to state owned enterprises and then having that capital passed on to the restricted companies by means of entrusted loans.

■ Potential economic destabilization factor

In addition to entrusted loans, bank financial commodities and trusts are highly popular financial assets as they provide high investment yields. Combining the statistics for the corporate and household sectors and financial institutions, the total for these three types of financial commodities was the equivalent of 80% of GDP at the end of 2016. Even among Japanese firms in China, there are said to be some that are using these high rate of return financial commodities for their asset management.

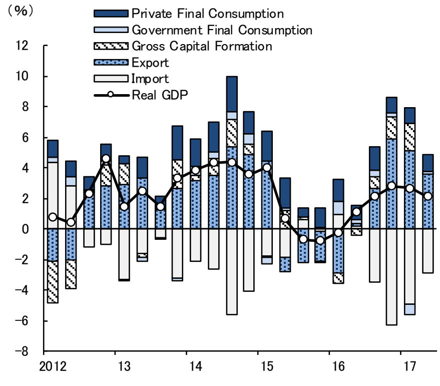
These developments bear a close resemblance to Japan's bubble economy years. In the mid to late '80s, large scale monetary deregulation in Japan allowed companies to raise massive sums of money, large portions of which were diverted into zaitech money management. This was one factor that contributed to the growth of the bubble economy, and which caused serious problems later. As mentioned above, there has been a sudden expansion in recent years of both corporate financial assets and corporate debt in China. As in Japan in the past, it may be said that these speculative activities are intensifying the potential risks. In China it is often the case that attention is focused on real estate bubbles, but attention also needs to be paid to corporate financial asset investment, which could lead to economic deceleration.

(Shinichi Seki)

Taiwan Economy stable though pace of recovery slows

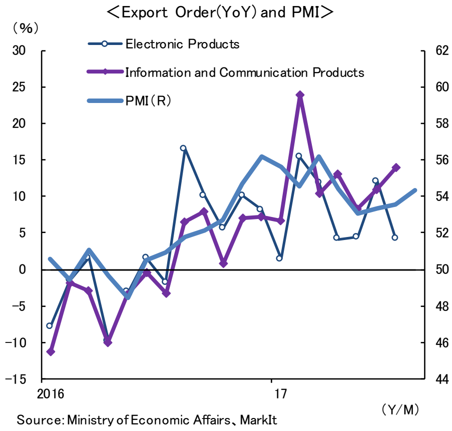
■ Export growth slowing recently

<GDP Growth Rate and Contributions by Expenditures>



Source: Directorate-General of Budget, Accounting and Statistics, Executive Yuan

<Export Order(YoY) and PMI>



Source: Ministry of Economic Affairs、MarkIt

Taiwan's real GDP growth rate for the April to June quarter of 2017 was 2.1%, compared to the same period in the previous year, slowing from the January to March quarter (2.6%, similarly), but still maintaining growth of over 2% for four consecutive quarters.

In terms of demand items, with the lull in plant and equipment investment among semiconductor related companies, gross capital formation growth slowed massively to just 0.2%, similarly. On the other hand, private sector consumption grew a solid 2.0%, similarly, encouraged by a healthy income growth environment, and export growth increased strongly to 5.0%, similarly, well in excess of the previous year's figures, and underpinning economic growth.

Looking at recent export trends, export growth in August (dollar based) was solid at 12.7% compared to the same period in the previous year. Exports of electronic components grew strongly at 14.4%, similarly, reflecting the increased demand for their use in new smartphone products, etc. In addition to increased exports to the US, Europe and other industrialized economies along with the global ecnomic recovery, exports to China and ASEAN have increased over a broad range. Export orders received, which are a leading indicator for export growth, also continued to do better than the previous year, with electronic parts and components up 4.2%, similarly, and information communications equipment up 13.9%. In response to these improvements, the PMI (purchasing managers' index) for the manufacturing industry in August rose to 54.3, staying above 50, the level at which good or poor performance is judged. As the demand for new smartphones gets fully underway from September, the probability is high that the momentum in export growth will strengthen.

However, it will be important to be careful of the risk posed by the excess supply of semiconductors, a major export product. In addition to the fact that the expansion in investment in semiconductors in China is getting fully underway, smartphone shipment quantitites have been on the verge of peaking in recent years, and the future of supply and demand is uncertain. Although is expected that there will be an increase in demand in the future in new fields, such as automatic driving and AI related applications, the full scale expansion of demand in these fields is thought likely to take some time.

■ Premier Lin Chuan resigns

Since President Tsai Ing-wen took office, there has been a certain amount of progress on the policy front, including reform of the pension system, which had long been stalled, and decisions to proceed with major infrastructure investment plans. However, in addition to the fact that the results so far have not equaled the initial high expectations when she first took office, from the start there has been little progress in the improvement of cross-strait relations, as symbolized by the decline in the number of visitors from mainland China, and her approval rating has recently dwindled to below 30%.

Under these circumstances, Premier Lin Chuan resigned his post on September 4 and was replaced by William Lai (Lai Ching-te), who has a strong reputation in municipal administration (having served as mayor of Tainan city). However, since most government ministers have stayed on in their posts, with the exception of some posts such as the Ministry of Economic Affairs, etc., there is very little sense of freshness in the government, and any administrative buoyancy effect will likely be limited. In the run-up to nationwide local elections at the end of 2018, in order to regain her political authority, President Tsai will need to produce some tangible results in domestic structural reform and in foreign affairs, principally in relations with China.

(Kentaro Matsuda)

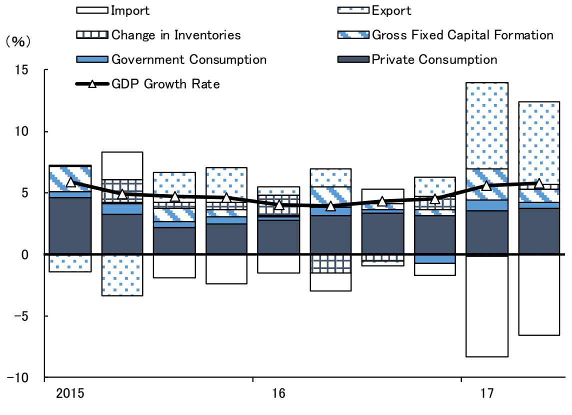
Malaysia Economy maintains strength

■ 5.8% growth in Q2, 2017

Malaysia's economy continues to grow strongly.

The real GDP growth rate for the April to June quarter of 2017 was 5.8%, compared to the same period in the previous year, gaining slightly on the January to March quarter (5.6%, similarly), its strongest growth level in nine consecutive quarters.

＜Real GDP Growth Rate and Contribution by Expenditures (YoY)＞



Source: Department of Statistics Malaysia

Strong private consumption and export performance were the drivers of growth. Private sector consumption grew 7.1%, similarly, strengthening from the January to March quarter (6.6%), and reflecting the improvement in consumer sentiment. The improvement in consumer sentiment has been brought about by a falling inflation rate and better employment conditions. The inflation rate began to fall, after peaking at 5.1% in March of 2017, reflecting the fall in crude oil prices. The employment index, released by the Malaysian Instute of Economic Research and showing the state of employment in Malaysia, was 75.6 for the April to June quarter, rising from the January to March quarter (71.8%).

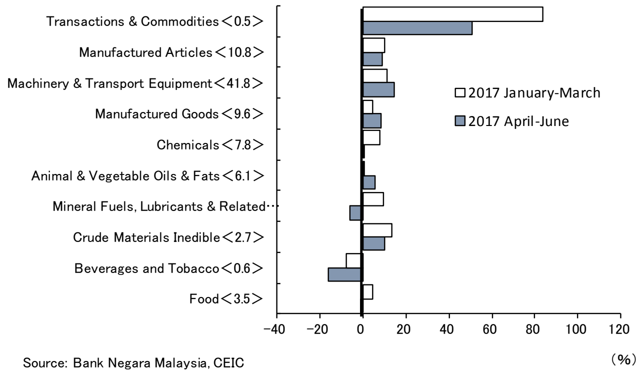
In exports, meanwhile, major export items such as palm oil and semiconductors performed strongly, against the backdrop of global economic recovery and expanded IT demand. In fact, examination of the export volume index by item shows that growth is increasing in machinery and transportation equipment and in animal and vegetable oils and fats.

■ Attention needs to be paid to the effect of the general election

The economy appears to be continuing to perform strongly most recently also.

The export volume index for July, 2017, was 21.9%, compared to the same period in the previous year, accelerating by a wide margin from the April to June quarter (10.3%, compared to the same period in the previous year). In Addition, as regards domestic demand, automobile sales for July grew 14.3%, similarly, changing to positive growth from the -0.4% posted for the April to June quarter.

＜The Growth of Export Volume＞



Source: Bank Negara Malaysia, CEIC
Note: SITC 1 digit. ＜＞ is the share of nominal export value by individual item.

Looking ahead, although a relatively high growth rate can probably be maintained from the October to December quarter of 2017 through to the first half of 2018, the expectation is that it will be a rather stop-start affair.

First of all, export growth, which has been the driver of growth thus far, will likely contract as a result of the recoil from the recovery that has continued since the end of 2016, as well as a lull in IT demand. With regard to domestic demand, meanwhile, although the waning of the effect of increased benefits awarded to low income earners may prove to be a restricting factor, it is thought likely that demand will continue to stay generally strong, with growth being underpinned by the vitalization of election-related consumption accompanying the general election slated for the spring of 2018, and by progress in infrastructure development projects.

Further, should the general election be brought forward to this year, though increased election-related consumption will likely cause an economic upswing within this year, attention needs to be paid to the growing possibility of a significant economic deceleration in 2018. Given that economic performance in the April to June quarter of 2017 was stronger than the government had anticipated, it would now be all the easier for Prime Minister Najib's party, "United Malays National Organisation" (UMNO), to bring the election forward, and careful attention still needs to be paid to developments on the political front.

(Yuta Tsukada)

China Attention on avoiding economic deceleration

■ Secure economic stability through policy measures

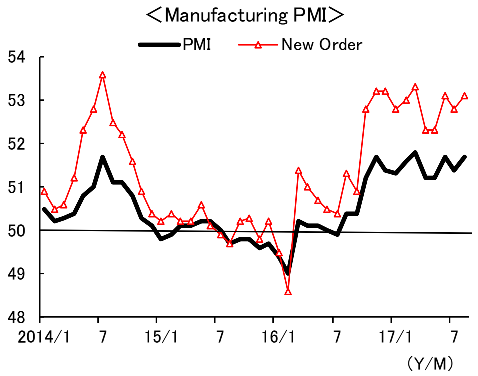
Since the start of 2017, the Xi Jinpin administration has been strengthening restrictions related to overseas investment. On August 18, the State Council (central government) released a new set of guidelines relating to overseas investment. The guidelines described 1) infrastructure development in countries in the Belt and Road initiative, 2) the export of competitive Chinese production equipment and 3) energy development as fields in which overseas investment would be encouraged, and identified real estate, hotels, cinemas, leisure facilities and sports clubs as items in which overseas investment would be subject to restrictions. The establishment of overseas equity investment funds with no specific projects attached was also listed as restricted.

The background to this development is that, in addition to the economic reasons of attempting to curb overseas investment in speculative fields, there is also the desire to prevent political fallout from an outflow of capital overseas. At the moment, within the administration, the priority is on removing any factors that may give the impression of economic instability, and on holding the once-in-every-five-years Party Congress without a hitch. For this reason, current major economic policies are concentrating on stable economic management, including the prevention of turmoil in international financial markets and the avoiding of domestic economic deceleration.

According to the most recent indicators, these policies have paid off and the economy is generally stable. For example, August's foreign currency reserve was $3.915 trillion, topping the previous month for seven consecutive months. The renminbi has been trending strongly, with the exchange rate surpassing the $1 = 6.4 yuan level in early September, for the first time in one year and four months. Both of these indicate that capital outflow pressure overseas is easing.

Further, import growth in August was 13.3%, compared to the same period in the previous year, marking ten consecutive months of growth, and an increase in the pace of growth on the previous month. As trends since the beginning of the year, import volumes of crude oil, iron ore, automobiles, etc., have been increasing, and the overall tone of improvement in China's domestic consumption is boosting import growth.

As far as can be told from the manufacturing industry PMI (purchasing managers' index) for August, domestic demand may be judged to be continuing to perform robustly overall, though there are indications of a lull in the momentum of recovery.



Source: National Statistics of Bureau

From the foregoing, it looks as if the aim of holding the Party Congress against a backdrop of economic stability is being achieved.

■ Communist Party Congress to be held on October 18

It has been formally decided that the Communist Party Congress will be held from October 18. It is being seen as a virtual certainty that General Secretary Xi Jinping will be re-elected, with the further reinforcement of the power base of the Xi Jinping administration, and that the focus of attention, both internally and externally, will shift to economic management after the Party Congress. Meanwhile, a number of policies and measures have been trotted out over July and August in areas such as the reform of state owned enterprises and the opening up of Chinese markets, based on the premise that the current regime would continue to stay in power beyond 2018.

It is anticipated that, in addition to a range of structural reforms, there will also be measures to resolve the issues of overproduction and corporate debt, and a ramping up of measures to curb the asset bubble. While both of these initiatives are essential to the Chinese economy, they also run the risk of causing economic deceleration. The single most significant economic management challenge for the Xi Jinping administration in its second term will be whether it can implement these initiatives and still avoid economic deceleration.

(Junya Sano)