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Topics Correcting the course of "Made in China 2025"

The boom in Business Fixed Investment is coming to an end, since the Chinese government has temporarily reduced its support for state-driven measures to develop the high-tech manufacturing industry. We believe that this will become an important factor in looking at the future development of the trade dispute between the U.S. and China.

■ Business Fixed Investment boom coming to an end

Business Fixed Investment for digitization and automation of manufacturing processes in China is slowing. In 2015, the Chinese government formulated "Made in China 2025," a plan to promote high-tech industry. Under the plan, the government identified 10 priority sectors: 1) Next-generation information technology (semiconductors, 5G and AI), 2) High-end numerical control machinery and robotics, 3) Aerospace and aviation equipment, 4) Maritime engineering equipment and high-tech maritime vessel manufacturing, 5) Advanced rail transport equipment, 6) Energy-saving and new energy vehicles, 7) Power generation equipment; 8) Agricultural machinery and equipment, 9) New materials, and 10) Biopharmaceuticals and high-performance medical devices. At the same time, it set numerical targets for four items: Digitization of Industry (integration of information communication technology into the manufacturing industry), Promotion of Innovation, Enhancement of Quality and Efficiency, and Eco (environment protection). The government aims to create new businesses and revitalize industries by collecting and storing a wide variety of data on consumption and production through IoT and sensors and then analyzing them, putting big data and AI to full use.

＜Main Numerical Targets of Made in China 2025＞

Category	Indices	2013	2015	2020	2025
Digitization of Industry	Chinese homes with broadband Internet (penetration %)	37	50	70	82
	Use of digital design tools (penetration %)	52	58	72	84
	Use of numerical control machines in key production processes (penetration %)	27	33	50	64
Innovation	Ratio of R&D spending to sales (%)	0.88	0.95	1.26	1.68
	Number of invention patents per sales of CNY 100 million (cases)	0.36	0.44	0.70	1.10
Quality and Efficiency	Quality Competitiveness Index	83.1	83.5	84.5	85.5
	Growth ratio of added value (%, comparison to 2015)	–	–	2	4
	Annual growth ratio of added value per capita (%)	–	–	approx. 7.5	approx. 6.5
Eco (Environmental Protection)	Decrease in industrial energy consumption per industrial added value (comparison to 2015, %)	–	–	18	34
	Decrease in CO2 emission per industrial added value (comparison to 2015, %)	–	–	22	40
	Decrease in water usage per industrial added value (comparison to 2015, %)	–	–	23	41
	Reuse of solid industrial waste (% of total waste)	62.0	65.0	73.0	79.0

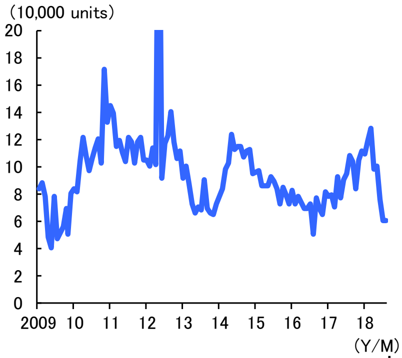
Source : Notice of the State Council, Guo Fa [2015] No. 28 (promulgated on May 19, 2015)

After devising "Made in China 2025," the central government gave preferential treatment, including tax cuts, subsidies, and low-interest loans, to the 10 priority sectors. Municipal governments competed fiercely to attract enterprises to their regions and offered special incentives to win the competition. Furthermore, a huge amount of money was provided through government-affiliated funds to municipal governments.

Consequently, Business Fixed Investment by private enterprises, mainly for digitization and automation of manufacturing processes, accelerated from the latter half of 2016. One of symbolic events was a sharp increase in imports of machine tools. The growth was equivalent to the massive increase in Business Fixed Investment from 2009 to 2010 brought about by China's four trillion yuan worth of economic stimulus packages after the global financial crisis.

However, the growth of machine tools imports finally turned negative. The number of machine tools imported to China fell to half in only five months from March 2018 to August 2018. As machine tools are "mother machines," they are a leading indicator of Business Fixed Investment. We believe that the decline in the import of machine tools indicates that the boom in Business Fixed Investment induced by "Made in China 2025" is temporarily coming to an end.

＜Number of Machine Tools Imported＞
(Annualized Figures after Seasonal Adjustment)



Source: China Customs General Administration's Trade Statistics

■ Alert for excessive investment and preparation of a path for improving relationships with foreign countries

It can be pointed out that this was caused by the Chinese government's correction of the course of "Made in China 2025." In May 2018, the "National Manufacturing Power Construction Leading Group" led by Ma Kai, Vice Premier of China, and Miao Wei, the Minister of Industry and Information Technology dared to announce "Potential Problems of Municipal Governments and Proposal : 'Made in China 2025'," a written opinion. The opinion paper pointed out that municipal governments didn't understand "Made in China 2025" sufficiently and criticized the excessive preferential treatment offered by municipal governments. The number of occasions on which Chinese governmental institutions and media took up "Made in China 2025" obviously decreased in 2018. These movements apparently reflected a change in the Chinese government's policy for measures to support high-tech industry. We expect that the central government will pay attention to the risk of a sharp fall in Business Fixed Investment for the moment, while reviewing excessive preferential treatment to the high-tech industry to stabilize capital investment.

The following two points can be raised as reasons for why the Chinese government corrected the course of "Made in China 2025."

The first reason is to send an alert about excessive investment. Industrial policies led by the government often cause overinvestment. Problems of excessive investment have already surfaced this time. For example, when a large LCD panel manufacturer that had aggressively expanded its production and investment using a huge amount of subsidy started operations of a new plant at the end of 2017, supply exceeded demand, causing prices to decline. Macro statistics also show that capacity utilization in the industrial sector has already passed the peak. Under such circumstances, restraining Business Fixed Investment can be a reasonable measure to improve the supply-demand balance. If the government sticks to industrial promotion and offers additional preferential treatment, including tax cuts, subsidies, and low-interest loans, to 10 priority sectors identified under "Made in China 2025," the supply-demand balance will deteriorate further.

The second reason is to prepare the way for improving relationships with foreign countries. Quite a few companies in Europe, the U.S. and Japan have been forced to compete with Chinese counterparts in a disadvantageous environment due to the Chinese government's measures to support the high-tech industry in line with "Made in China 2025." Therefore, the U.S. government expressed displeasure with the Chinese government. One of symbolic examples is that the Trump administration has increased its pressure on trade with China, targeting the high-tech industry. The U.S. began investigations on the infringement of intellectual property rights by China in August 2017. In addition, It imposed punitive duties on steel and aluminum products from China, and expressed a plan to place high import duties on Chinese products worth $50 billion, including industrial robots and semiconductors, as sanctions on infringement of intellectual property rights in March 2018. We even heard that the U.S. government demanded the Chinese government to withdraw "Made in China 2025" in April 2018, but Beijing refused. Since then, the Trump administration has stepped up its punitive measures, intensifying the trade dispute between the U.S. and China. Also in Japan, many have strongly criticized the Chinese government's measures to support its high-tech industry and introducing unique rules regarding data access and use.

As we explained, behind the moves to correct the course of "Made in China 2025," there are alerts for excessive investment and improvement of relationships with foreign countries. Of course, it is not likely that the Chinese government will withdraw "Made in China 2025." It is quite important for China to keep technological innovation moving ahead, since China finds it difficult to maintain itself on the growth path by relying solely on massive labor and capital power. The status of "Made in China 2025" as a national policy to determine the future of the nation has not been changed. We should consider that the Chinese government has temporarily reduced its support for state-driven measures to develop the high-tech sector, only fearing overinvestment and deterioration of its relationships with foreign countries.

These moves can become an important factor to view the trade dispute between the U.S. and China that people feel uncertainties about. Correcting the course of "Made in China 2025" signifies that the Chinese government will have a strong bargaining chip in the negotiations to seek common ground to reduce the trade dispute between the U.S. and China. In the future, President Trump can boast to the electorate, "I have extracted big concessions from China," if China uses its trump card, "correction of Made in China 2025." We believe this can be one of scenarios that both sides will be willing and able to settle the issue without further intensifying the trade dispute between the U.S. and China.

(Shinichi Seki)

Korea Growing signs of economic slowdown

■ Both domestic and foreign demand slowed down

South Korea's real GDP in the April to June quarter grew 0.6%, compared to the previous quarter. Although the country managed to grow at a pace on par with its potential growth rate, both domestic and foreign demand has been showing growing signs of a slowdown.

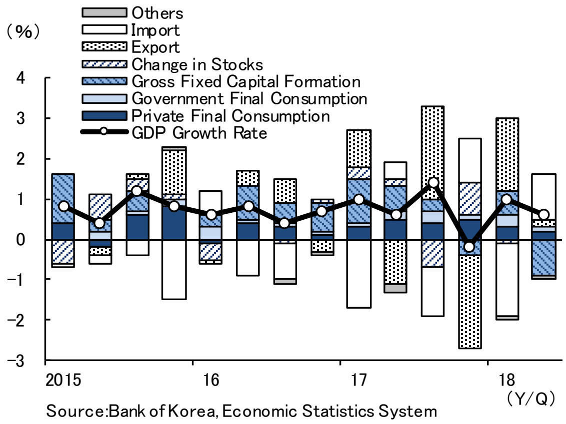
It is concerning that among other things, the quarter-on-quarter contribution (the same applies to the following) of gross fixed capital formation to GDP growth sharply decreased, down by 0.9% from the previous quarter. This was partly due to a reaction against the large investment in semiconductors in the previous quarter. However, it reflects signs of a slowdown in investment activities, since the export of semiconductors lost momentum and the construction of condominiums passed the peak.

Meanwhile, the contribution of private consumption to GDP growth also declined gradually due to a rising unemployment rate, mainly among the young generation, and worsening consumer sentiment.

The contribution of exports was also small, or up 0.2%. This was because the exports of semiconductors, which had grown thanks to the expansion of global IT demand, lost steam gradually due to the saturation of demand for smartphones and competition from Chinese semiconductor manufacturers that expanded production.

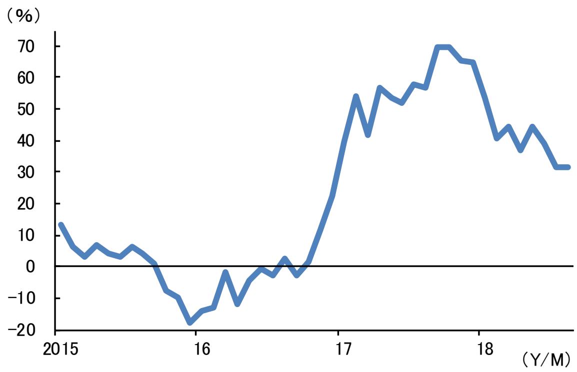
Looking at the future outlook, GDP growth is likely to decline owing to lingering weakness in exports and capital expenditure, since the move toward protectionist trade polices originating from the U.S. has been spreading and the economy in China, a main importer of South Korean products, has slowed down. However, the government has already taken employment measures, such as the expansion of an employment subsidy to small and medium-sized businesses, and implemented economic stimulus measures including the reduction of the specific sales tax on automobiles (from 5.0% to 3.5%). Therefore, it is expected that negative growth can be avoided for the moment.

＜GDP Growth Rate and Contributions by Expenditures＞



Source:Bank of Korea, Economic Statistics System

＜Export of Semiconductor (YoY)＞



Source:Ministry of Trade, Industry and Energy

■ The political base becomes stronger and relationship with chaebols improves

A nationwide local election and by-election of parliament members were held on June 13, 2018. The ruling Democratic Party swept the elections by taking 14 out of 17 mayoral and provincial governor positions and 11 of the 12 by-election seats. The victory was attributable to popular support for the president among the electorate due to his appeasement policy toward North Korea, although the opposition conservative party contributed to its own downfall because of internal strife as well.

The Moon administration has kept a certain distance from the business world, especially chaebols, because President Moon won power after the previous administration collapsed due to scandals caused by too cozy relationships with chaebols. However, the administration has gradually changed their stance, since it finds it necessary to turn to the business community for cooperation due to the fall in business confidence, leveraging its strengthened political base. This is demonstrated by the fact that the Moon administration held discussions with the top management of large chaebols. Several major chaebol groups responded to the administration's appeal by announcing large-scale investment and employment plans immediately after the meetings. We believe that economic recovery will depend on whether the Moon administration can implement economic policies to step up corporate activities in the future, instead of placing too much emphasis on the redistribution of wealth.

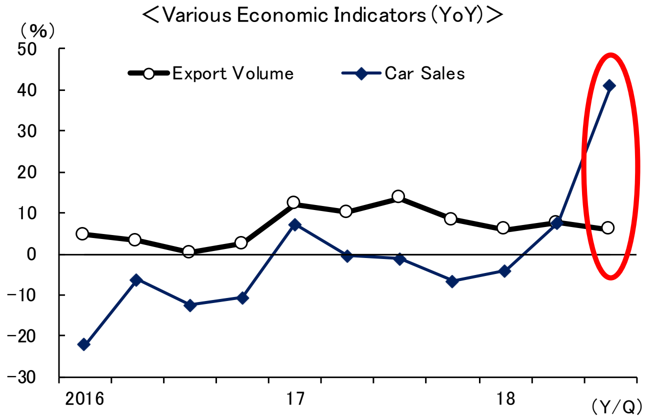
(Michinori Naruse)

Malaysia Economy is likely to slow down again

■ Economy has recovered for the present

The Malaysian economy has been recovering toward the middle of 2018. Especially, private consumption was solid. For instance, the number of automobiles sold in July 2018 increased by a hefty 41.0% from the previous year. Furthermore, the export volume index also maintain increased momentum, while the global economy grew steadily. Therefore, real GDP growth in the July to September quarter is expected to accelerate from the April to June quarter (up 4.5% from the previous year).

＜Various Economic Indicators (YoY)＞



Source : Deparment of Statistics Mlalaysia, Malaysian Automotive Association
Note : 2018/3Q is July 2018.

However, the economy is highly likely to decelerate again in the future. In the first place, the current robust consumer spending, represented by automobile sales, is a temporary phenomenon supported by the revision of the taxation system. The new Mahathir administration abolished the GST (Goods and Services Tax) introduced by the former Najib administration by lowering the rate to 0% on June 1, 2018. Furthermore, the new administration announced that it will reintroduce the SST (Sales and Service Tax) from September 1, 2018 instead, which is considered to place less burden on consumers. This was why a last-minute rise in demand before the reintroduction of the SST pushed up private consumption substantially between June and August, when neither the GST nor the SST was imposed. From the end of 2018, consumer spending is expected to stagnate due to front-loading of demand prior to the revision of the taxation system. In addition, a review of large-scale infrastructure projects by the new government will put downward pressure on investment. Meanwhile, foreign demand is also forecast to become sluggish due to a lull in IT-related demand and the impact of a hike in import duties by the U.S. and China. As we have seen, there are many factors that may push down both domestic and foreign demand.

■ The first 100 days have passed safely since the inauguration of the new administration

On August 17, 2018, the new Mahathir administration, which was established on May 10, 2018, marked 100 days. Taking a look at the “10 promises in 100 days” espoused in the election manifesto of the new ruling coalition Pakatan Harapan (PH) led by Mr. Mahathir, the administration realized the abolishment of the GST, reintroduction of fuel subsidies, review of large-scale infrastructure projects, and introduction of an employees’ provident fund (EPF) scheme for housewives. It also started deliberation on an increase in the minimum wage and introduction of a healthcare assistance program for the bottom 40% of working class individuals. It can be said that the new government has made a good start. However, many of policies in “10 promises in 100 days” were ones that appealed to people and ones that the ruling coalition PH found easier to carry out. The next focal point is whether the Mahathir administration can revamp the country’s economic structural reform.

＜Ten Promises in the First 100 Days＞

1)	Abolish the GST and take steps to reduce cost of living.
2)	Stabilise the price of petro and introduce targeted petrol subsidies.
3)	Abolish unnecessary debts that have been imposed on FELDA settlers.
4)	Introduce EPF contribution for housewives.
5)	Equalise the minimum wage nationally and start the processes to increase the minimum wage.
6)	Postpone the repayment of PTPTN to all graduates whose salaries are below RM4,000 per month and abolish the blacklisting policy.
7)	Set up Royal Commissions of Inquiry on 1MDB, FELDA, MARA and Tabung Haji, and to reform the governance of these bodies.
8)	Set up a Special Cabinet Committee to properly enforce the Malaysia Agreement 1963.
9)	Introduce *Skim Peduli Sihat* with RM500 worth of funding for the B40 group for basic treatments in registered private clinics.
10)	Initiate a comprehensive review of all megaprojects that have been award to foureign countries.

Source : Pakatan Harapan(PH) homepage

Especially, Malaysia can’t afford to put off fiscal improvement, since national debts hidden by the former administration were discovered. As implementing the necessary reforms will inevitably be accompanied by a great deal of pain inflicted on the people, the ability of Mr. Mahathir, who has only ever steered the Country to high growth with his strong leadership, will be tested again.

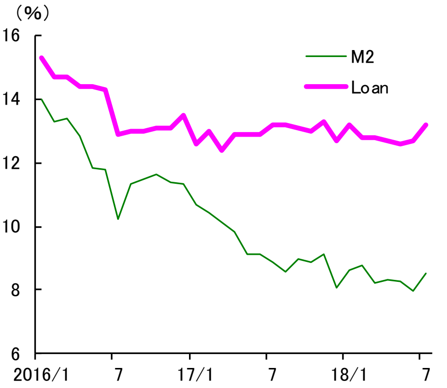
(Yuta Tsukada)

China Carefully stepping up pump-priming measures

■ Modest economic stimulus measures

The Chinese government has strengthened its economic measures against the backdrop of a slowdown in economic growth and intensifying trade dispute with the U.S. As for monetary policy, the government announced its policy to increase lending to small and medium-sized businesses by relaxing regulations on financial institutions' loan-deposit ratio. It also began guiding short-run market rates down. As for fiscal policy, the Chinese government reduced the tax burden of individuals and enterprises by cutting tax for automobiles and endeavored to accelerate the implementation of infrastructure development through the issuance of special local bonds.

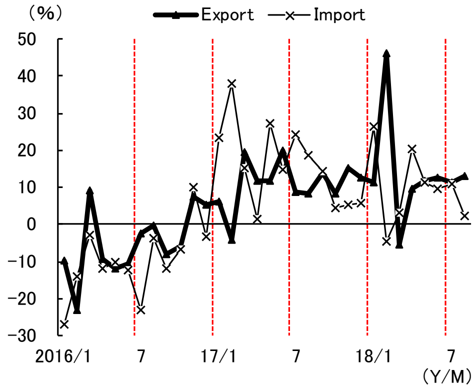
<M2, Loan (Y o Y)>



Source: The People's Bank of China, CEIC

However, the government didn't embark on an expansion policy without regard for appearances, but it is carefully implementing its policy. As for monetary policy, China has not changed its policy rates since October 2015 and didn't lower the rate at the point of early September 2018. Although outstanding bank loans and money supply grew slightly, they still remain at lower levels. As for fiscal policy, local governments have taken a conservative stance. For instance, the fact of the matter is that the acceleration of infrastructure development through the issuance of special local bonds was the front-loading of infrastructure projects under construction. It is highly possible that the effect of pushing the growth rate upward will be limited, since the government didn't increase infrastructure investment greatly.

<China's Trade with the U.S. (Y o Y)>



Source: General Administration of Customs of China, CEIC

The government is implementing its pump-priming measures in a constrained manner, since it reflected on the side effects of large-scale economic stimulus measures after the global financial crisis. China was able to avoid economic recession thanks to its large-scale economic stimulus packages. However, problems, such as a sharp increase of debts by state-owned enterprises and local governments, excessive facilities, and overheated real estate market, became more serious. We assume that the Xi Jinping administration has taken a cautious stance toward the stepping up of pump-priming measures to prevent these structural problems from deteriorating further.

■ Additional measures will depend on the development of trade dispute

Taking a look at the future, it is highly possible that the trade dispute with the U.S. will impose downward pressure on the growth of the Chinese economy. Despite the U.S.-China trade talks at vice-minister level in late August 2018, neither side compromised to solve the issue. As both sides imposed the additional punitive duties as scheduled, the U.S.-China trade dispute is expected to last for a long period. In August 2018, Chinese exports to the U.S. increased due a last-minute rise in demand before the sanction, while Chinese imports from the U.S. largely dropped. Consequently, China's trade surplus with the U.S. expanded. This is one of reasons preventing the issue from being solved soon.

Meanwhile, the Xi administration sets doubling the real GDP in 2020 compared to that in 2010 by keeping the Chinese economy growing at the 6% level as a high priority national target. It will become more difficult for the Chinese government to implement its policy, if the trade dispute with the U.S. is added to the trade-off between the solution of the long-standing structural problems and stabilization of economic growth. Additional pump-priming measures are expected to prop up economic growth for the time being, but a strong sense of hopelessness induced by future economic prospects and the trade issue can't be erased and is highly possible to linger. Thereby, we believe that the trade dispute with the U.S. can't be considered as a short-term risk for the Chinese economy but should be regarded as a long-term risk factor.

(Junya Sano)