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Topics Export-led Korean economy reaching a turning point

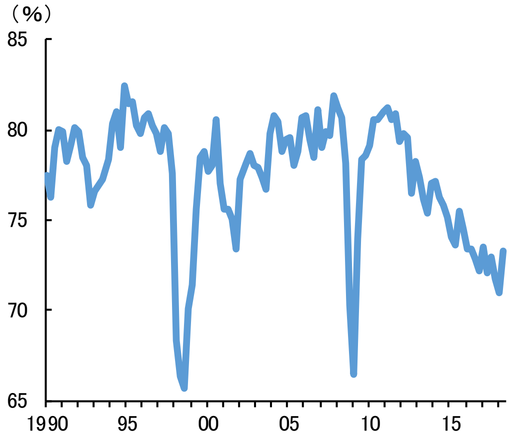
Capacity utilization has declined, causing manufacturers in South Korea to find themselves in a difficult situation. What lies behind this situation is intensifying competition with China that results in sluggish Korean exports. The chaebols-initiated export-led growth model of concentrating resources on a narrow segment to break through the barrier (known as the “South Korean model”) has reached a turning point.

■ Declining capacity utilization rate

The stagnation of manufacturers in South Korea has become increasingly apparent, with the fall in capacity utilization clearly illustrating their difficulties. Up to 2010, the capacity utilization rate remained around 80%. It has decreased since 2011, and currently is at near 70%. Although the rate dropped below 70% in previous recessions such as the Asian Currency Crisis and the collapse of Lehman Brothers, it is unusual for capacity utilization to fall to its current level during an economic recovery phase. Looking at the situation by industry segment, capacity utilization by manufacturers of electronics-related products (electronics components, communication equipment, and household electrical appliances) has declined sharply.

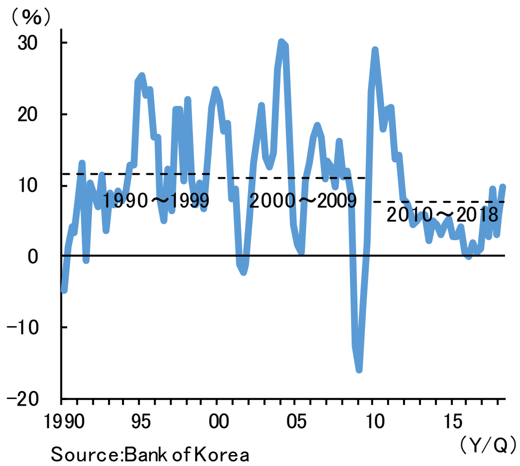
The main cause of the decline in capacity utilization is a slowdown in exports. Export volumes continued growing annually at a high rate of more than 10% on average (with some ups and downs), until around the failure of Lehman Brothers. However, export volumes decreased sharply in the early 2010s. Although the expansion of production capacity was restrained in the face of falling exports, the restraint seems to have not been extensive enough to match the slowdown of exports. Consequently, excess capacity has become chronic, leading to a continuation of the sharp decline in capacity utilization. This shows that South Korean manufacturers failed to respond to the unexpected slowdown of exports in a timely manner.

＜Manufacturing capacity utilization rate＞



Source:Statistics Korea

＜Export Volume Index(YoY)＞



Source:Bank of Korea

Note:Horizontal dotted lines are average of ten years.

■ Background for slowdown in exports

China began focusing on the production of electronics products, intensifying competition between South Korea and China. As a result, South Korea’s exports decelerated. Conversely, China began sharply increasing exports of electrical equipment and components in the 2010s. For example, Chinese manufacturers have recently increased their market share of smartphones in emerging Asian countries. Furthermore, China’s strengthening of electronic product production has led to the reduction of imports to the country. Specifically, Chinese manufacturers started producing LCD panels for TV sets and smartphones—products for which China had previously relied almost entirely on imports from South Korea and elsewhere. Accordingly, exports of LCD panels from South Korea to China drastically plunged. As we have seen, Chinese companies have gained a presence in the electronics field, where their South Korean counterparts were strong. We presume that this is the main reason for falling exports and sluggish capacity utilization by the South Korean manufacturing industry.

■ Sophistication of the Chinese manufacturing industry

China has been focusing on the electronics field to change their economic growth model. Wages have been rising in China, mainly in coastal areas. Compared to other Asian countries, wages have become noticeably high. Therefore, China needs to transform its leading industry from labor-intensive manufacturing to technology and capital-intensive industries. The country has decided to concentrate on the electronics industry, primarily LCD panels and semiconductors. This was because the industry fulfills the following three conditions that will allow Chinese companies to succeed.

The first condition is that technical barriers to entry are relatively low. As most parts necessary for LCD panel and semiconductor manufacturing processes are available to the public, the LCD panel and semiconductor markets are characterized by ease of entry. Even a late starter can easily launch the production of LCD panels and semiconductors, if such company can prepare manufacturing facilities and components.

The second condition is that the size of the global market is huge. In China, the manufacturing sector accounts for around 30% of the GDP—a figure that is high compared to other countries. Therefore, when sophisticating its industrial structure, China needs to target business fields with relatively larger market size. In this regard, the electronics field is large enough for the country to enter, since the size of global demand is considered to be equivalent to 300 trillion yen.

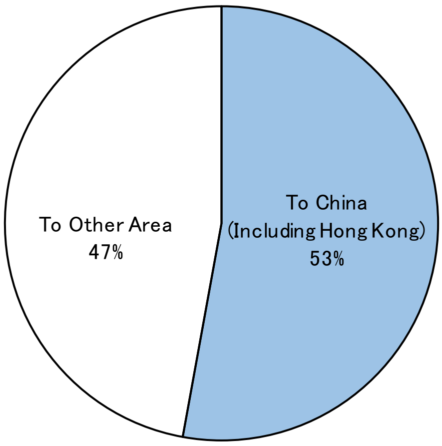
The third condition is economy of scale. Chinese manufacturers are most familiar with a business model in which they use abundant capital to make large-scale investments and churn out products. As LCD panels and semiconductors are typical process industries, it is possible for Chinese companies to use their advantage.

This is similar to what happened in the past, when South Korea caught up with and outpaced Japan. South Korean companies, mainly chaebols, intensively invested in the electronics field and achieved high growth by taking the market share away from leading countries, including Japan. However, in the 2010s, Chinese companies with large amounts of capital invested heavily in the industry to catch up with their Korean counterparts. The conditions for entry into the market that once worked in favor of South Korea are now operating in favor of China, a latecomer. The South Korean model that was effective in the 2000s has largely worked against South Korea in the 2010s due to the emergence of China, a competitor with more capital than South Korea.

■ Future outlook

We expect competition between South Korea and China to become fiercer. The sophistication of the Chinese manufacturing industry is now under way. Chinese companies have been constructing new factories to manufacture electronics-related products one after another by also using government subsidies. Furthermore, South Korean companies export the majority of their electronics products to China. As the Chinese government backs its domestic producers, it is highly possible that South Korean products will be forced to fight an uphill battle. In addition, we forecast that even in global markets other than China, South Korean companies will face fierce price competition with Chinese counterparts that have cultivated their ability in the home market.

＜Share of Electronic Export of Korea(2017)＞



Source: UN comtrade
Note: HS code 85 and 90 are defined as electronics.

As we have explained, the emergence of Chinese companies puts South Korea's export-led growth model at a crossroads. We believe that whether the South Korean economy can overcome the current dire situation will depend on efforts of the South Korean manufacturing industry, including electronics manufacturers, to shift to high-value-added fields where their Chinese counterparts cannot follow.

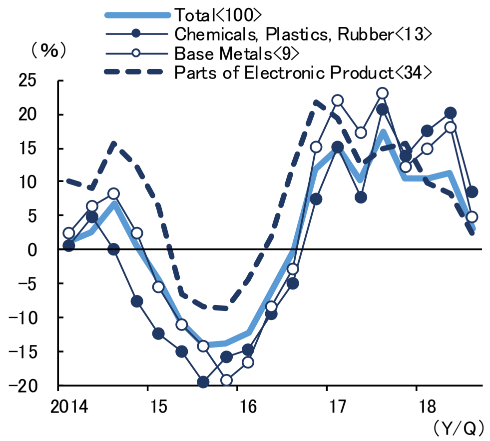
(Michinori Naruse)

Taiwan *Internal demand supports GDP growth despite slowdown in exports*

■ Sharp increase in exports has come to an end

Exports, which have strongly driven the Taiwan economy since the latter half of 2016, have slowed down. The amount of exports (in terms of U.S. dollars) in the July to September quarter of 2018 grew 3.1%, compared to the same period in the previous year. This is the first time in eight quarters that the growth remained at a single digit level. The biggest factor responsible for the slowdown of exports is sluggish shipments of electronic components (which account for more than 30% of exports) due to the saturation of demand for smartphones. In addition, the shipments of raw materials (including chemical and metal products), which represent the next largest export item after electronic components, also decelerated recently. This has occurred because capacity utilization has risen, nearing its upper limit, although demand has been expanding globally.

<Export (US$ basis,YoY)>

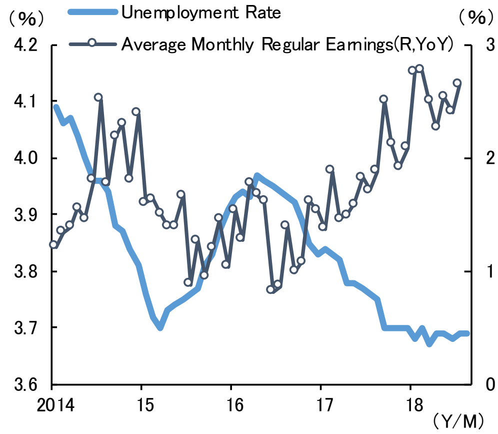


Source: Ministry of Finance
Note: Inside< > of legend is share in export of 2017.

Looking at the future, we believe that there is only a small chance that exports will decline. This is because demand for electronic components is expected to expand on a long-term basis, supported by widespread use of IoT, big data and onboard vehicle equipment. However, it is unlikely for the moment that exports will increase sharply, as they did just previously.

It is unavoidable that GDP growth will slightly decelerate, owing to the slowdown of exports. However, although the momentum of external demand as a growth driver will decrease, Taiwan is likely to maintain solid growth at a 2% level for now, due to robust internal demand. Private consumption seems to remain strong under favorable employment and income environments. Furthermore, capital expenditures and public works spending are expected to expand because the leading semiconductor manufacturers plan to boost their capital investments to move the miniaturization process forward, and also because large-scale infrastructure projects (Forward-looking Infrastructure Development Program) are anticipated to get fully under way, mainly in the railway field. In addition, government annual spending will exceed NT$2 trillion for the first time in the budget for fiscal 2019. As fiscal spending is on an expansionary trend, government consumption is also estimated to continue growing.

<Unemployment Rate and Income>



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

■ The administration's approval rating has declined due to the cut-off of diplomatic relations

In May 2016, the Democratic Progressive Party (DPP), which has a strong inclination for independence, took office. Since then, China has been building up pressure on Taiwan. Using overwhelming economic power, Beijing has forced countries that have established diplomatic relations with Taiwan to cut their ties. China aims to isolate Taiwan in the global arena. In August 2018, El Salvador cut its diplomatic ties with Taiwan, the fifth country to break off relations under the Tsai administration. This leaves Taiwan with only 17 formal diplomatic allies, mainly in Central and South America and Oceania.

This diplomatic issue is directly linked to a drop in the Tsai administration's approval rating. The approval rating, which stood at around 70% soon after the inauguration, has fallen to around 30% now. Taiwan will hold nationwide local elections in November 2018, and they are seen as a preliminary for the 2020 Presidential election. If the ruling DPP loses the election, it is possible that the power pushing forward economic policies will weaken.

(Michinori Naruse)

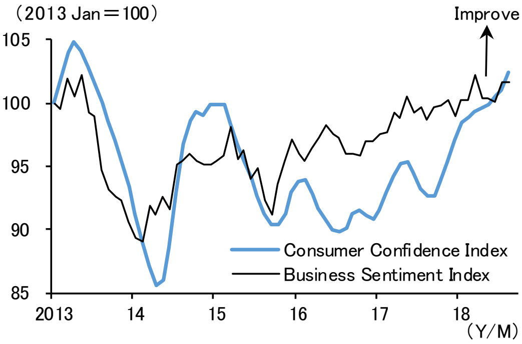
Thailand *Economic recovery certain*

■ Business sentiment continues improving

In Thailand, economic recovery has become more certain with the increase in exports of capital goods and tourism services due to the expansion of the global economy and robust internal demand based on the improvement in consumer and capital investment sentiment. The Thai stock market has moved steadily higher, spurred by strong stock prices, mainly in Europe and North America. Also, the domestic economy is seeing a recovery. These factors have pushed household and corporate sentiment to a five-year high. With the trade war between the United States and China intensifying, there is concern that exports of goods to China (which account for a little over 10% of total exports) may decline in the future. However, even if exports to China decrease, it is likely that a sharp economic slowdown may be avoided. This is because the following positive effects can be expected: the export of items that compete with Chinese exports to the United States are forecast to increase, replacing Chinese exports; and foreign companies may transfer their production bases from China to Thailand.

Meanwhile, with regard to monetary policy, the Central Bank has maintained its policy interest rate (repo rate) at the current level, although inflationary pressure has been mounting because of clearer signs of economic recovery and rising energy prices. In the Monetary Policy Committee (MPC) held in September 2018, two out of seven MPC members voted for a 0.25% repo rate hike. They formed this opinion because the GDP has continued growing at more than 4% annually and the consumer price index rose by 1.6% from a year earlier in August 2018—the largest increase since the previous year. However, the other MPC members voted to leave the repo rate unchanged. They reasoned that the current increase in the inflation rate was mainly caused by rising energy prices and the core inflation rate has been tamed, and the sustainability of the economic recovery is still uncertain.

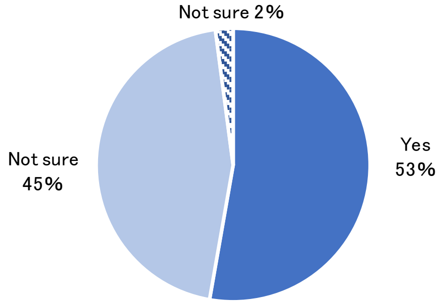
＜Consumer Confidence Index and Business Sentiment Index (3 Months -Moving Average)＞



Source: University of the Thai Chamber of Commerce
Bank of Thailand

＜Survey about Next General Election＞

Do you think the next general election could be held in February 2019 ?



Source: National Institute of Development Administration
“ประชาชนอยากได้ใครเป็นนายกรัฐมนตรีคนต่อไป ตามกฎหมายการเลือกตั้งปัจจุบัน (ครั้งที่ 4)”

■ Ban on political activities partially lifted

The Thai government aims to hold a general election in the first half of 2019. They partially lifted a ban on political activities in the middle of September 2018, including a gathering to elect officers and revise rules and regulations of political parties. Although political activities related to elections are still prohibited, we predict that a movement toward the general election will gain momentum, if the ban on these activities is lifted in the future. Prime Minister Prayuth Chan-ocha has declared that the government will call a general election after King Vajiralongkorn’s coronation. However, the precise date of the coronation remains unfixed, so we cannot rule out the possibility that the general election will be postponed.

The date of the general election was put off many times previously, due to delays in the preparation of election-related bills. The results of a survey on the next general election announced by the National Institute of Development Administration (NIDA) in September 2018 show that the majority of Thai people doubt that the general election will be held as scheduled. If the general election is postponed, confidence in the feasibility of economic policies will be diminished, causing a negative impact on the Thai economy.

(Shotaro Kumagai)

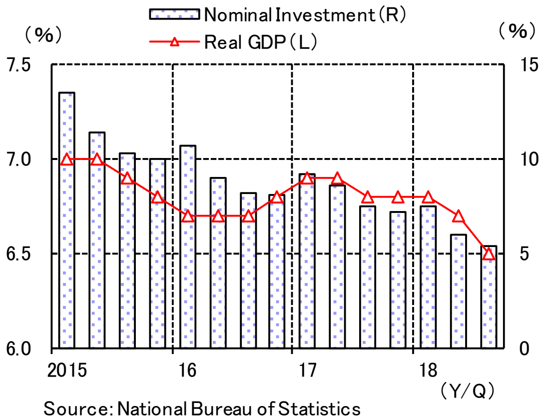
China Economic slowdown apparent

■ GDP grew 6.5% in the July to September quarter of 2018

The Chinese economy has been slowing down. In the July to September quarter of 2018, China's real GDP grew 6.5%, compared to the same period in the previous year. It fell 0.2 of a percentage point from the preceding April to June quarter. A possible cause is that trade frictions between China and the United States cast a dark shadow over the outlook of the Chinese economy after the government had strengthened its measures to reduce mounting debt and excessive facilities.

Looking at the contribution of demand items, sluggish investment was the chief culprit. In the January to September period of 2018, investment in fixed assets (excluding rural households) increased 5.4% from the corresponding period of the previous year, showing growing signs of a slowdown. The main probable cause is a sharp decline in infrastructure investment caused by the implementation of deleveraging measures. In the January to September period of 2018, retail sales grew 9.3% from the corresponding period of the previous year, falling below the January to June period of 2018 (down 0.1 of a percentage point) due to the continuation of sluggish retail sales. This was attributable to the fact that the number of automobiles sold fell below the previous year in three consecutive months. Online sales, which had grown sharply in the past, also hit a lull.

＜Real GDP, Fixed Assets Investment (Y o Y)＞



Source: National Bureau of Statistics
Note: Investment figures are year-to-date excluding rural households.

Meanwhile, external demand has been expanding steadily. Exports to the United States are the biggest concern amid intensifying trade frictions. They increased in September 2018, supported by a last-minute rise in demand. On the other hand, imports from the United States decreased, due to the impact of a retaliatory tariff imposed by China.

■ Stepping up economic stimulus measures may lead to a resurgence of the excessive debt problem

Looking ahead, we anticipate that the economy will continue slowing down due to negative factors, such as a slump in investment and production sentiment caused by intensifying trade frictions with the U. S. and a reaction to a last-minute rise in demand related to exports to the U.S.. However, we think that the risk of a plunge in growth rate is small for the following two reasons.

The first reason is that the effect of the past economic stimulus measures will become apparent. The Xi administration announced and implemented additional economic stimulus measures successively. These include 1) the lowering of the deposit reserve ratio by China's central bank three times in 2018, 2) the reduction of individual income tax, and 3) the refund of value added taxes levied on exported goods. Furthermore, the government carried out both fiscal and monetary measures to stimulate internal demand, such as the reduction of taxes and lowering of money market rates, since the middle of 2018. We expect these economic stimulus measures to produce effects, stopping a downturn in the economy.

The second reason is that exports are likely to expand gradually. It is unlikely that exports to the United States will turn downward, since the U.S. economy will continue growing faster and the yuan is forecast to continue depreciating against the U.S. dollar, even if the raising of tariffs works to curb exports to the U.S.. Exports to countries other than the United States are forecast to grow further, since the economies in Japan, Europe, and Asia are expected to remain solid.

However, there is a danger that the excessive debt problem could flare up again, since structural reforms will be put aside to step up economic stimulus measures. The ratio of corporate debt to GDP was on the decline, but it has recently started to rise again. There is a high probability that corporate debt will increase further in the future, since the strengthening of economic stimulus measures results in the expansion of borrowing demand for investment expenditures. The longer economic stimulus measures are implemented, the more serious structural problems will become for the Chinese economy.

(Junya Sano)