ASIA MONTHLY

December 2018

株式会社日本総合研究所

http://www.jri.co.jp/english/periodical/asia/

This report is the revised English version of the December 2018 issue of the original Japanese version (published 26th Nov.).

.

Asian economy to see some divergence in 2019

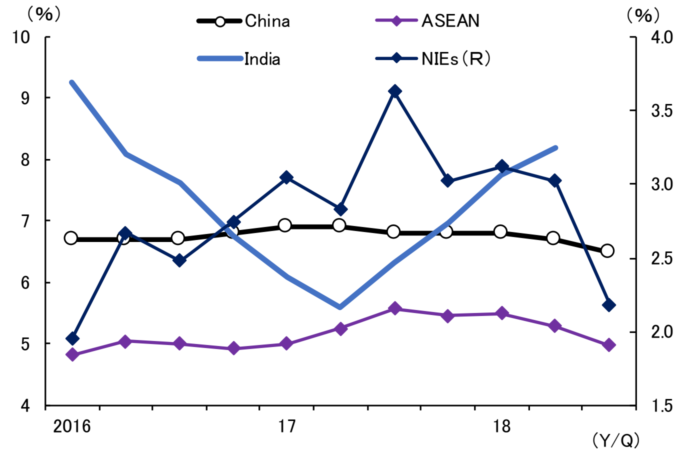
Although the Asian economy will remain firm overall, there will be a slight divergence between ASEAN and India, which are performing robustly on the back of infrastructure investment and the emergence of a middle class, and China and the NIEs, which are slowing as a result of being unable to overcome dependence on manufacturing.

1. Asian economy firm overall

In the second half of 2018, the Asian economy remains firm overall, but variation has begun to be seen depending on the country/regions.

To begin with, China and the NIEs (Korea, Taiwan, and Hong Kong) are starting to see a slowdown. In China, the real GDP growth rate in the July-September quarter was 6.5% compared with the same period in the previous year, down for the second straight quarter. Among the factors behind this were (1) the strengthening of the government's deleveraging policy, (2) reduced manufacturing production/investment in response to the U.S.-China trade friction, and (3) lower auto sales as a result of the ending of tax breaks on small cars. In the NIEs, meanwhile, a worldwide dip in IT demand caused a slump in exports of mainstays such as electronic components/devices. As a result, the July-September growth rate plunged to 2.2% year on year. However, this economic slowdown in the NIEs can be partially explained by the fact that a boom in IT demand in 2017 meant that growth was unusually high in that year, so the economies of the NIEs should be regarded as being in the process of dropping down to cruising speed.

＜Real GDP Growth in Asian Emerging Countries and Regions＞



Source : Government Statistics, CEIC
Note : Growth rates are calculated by US-Dollar-Denominated nominal GDP (moving average figures for the subsequent four quarters).

The ASEAN5 (Indonesia, Malaysia, Philippines, Thailand, and Vietnam) and India, on the other hand, are maintaining robustness. In the ASEAN5, aggressive investment in infrastructure in each of the countries has become the economic driver, and Thailand and Vietnam are also enjoying brisk exports of goods as a result of the global economic expansion and the opening of new plants owned by foreign companies. Thanks to this, the July-September growth rate stayed at the high level of 5.0% year on year. In India, the turmoil caused by the scrapping of high-denomination banknotes in November 2016 and the introduction of goods and services tax in July 2017 has subsided, and supported by strong consumption and infrastructure investment, it has become clear in 2018 that the growth rate is recovering. Although July-September GDP data has yet to be released, given that stock prices registered new highs for days on end during the summer, growth is likely to have remained high.

The above-described economic conditions in Asian emerging countries/regions do not look to have changed much going into the October-December quarter, so we predict that the growth rate for Asia as a whole will have been 6.3% in 2018.

2. Two causes for concern

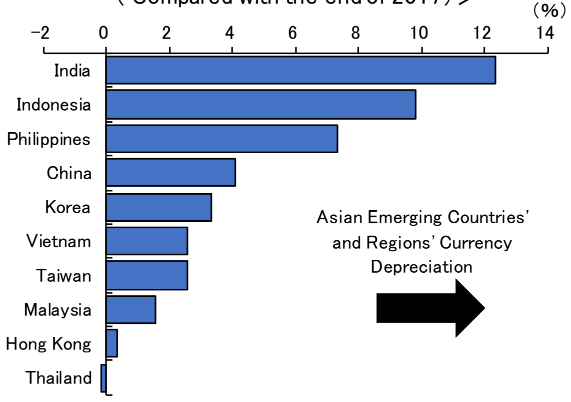
As for whether the Asian economy will maintain its robustness in 2019 and beyond, two causes for concern have emerged recently. These are (1) the outflow of funds from Asian emerging countries/regions and (2) the trade war between the U.S. and China.

(1) Outflow of funds from Asian emerging economies/regions

Since the middle of 2018, Asian emerging economies/territories experienced a significant outflow of funds due to concerns about higher U.S. interest rates and a slowdown in the Chinese economy and moves to avert risks associated with the U.S.-China trade war. As a result, the currencies of many Asian countries/regions lost value against the dollar. The margin of depreciation was particularly marked in India, Indonesia, and the Philippines, which are afflicted with "twin deficits," i.e. both a current account deficit and fiscal deficit. The effects of these weakening currencies are being felt in various areas. For example, in September, the inflation rate in Philippines reached 6.7%, while in Indonesia, Philippines, and India, the central banks began to intermittently raise policy interest rates from the summer of 2018 onwards. These price rises and policy-rate increases are having a negative impact on the economy.

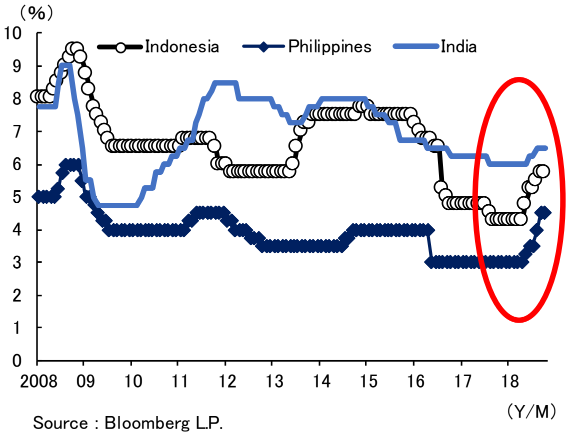
And going forward, a situation in which funds are apt to flow out of Asian emerging countries/regions is expected to continue. However, given that U.S. rate hikes are predicted to stop in the middle of 2019 and that the normalization of monetary policy in Europe is going to proceed at a cautious pace, with an eye being kept on the economic situation, the speed of depreciation of the currencies of Asian emerging countries/regions will probably be slow. In addition, in light of the fact that the governments of the countries/regions are already taking steps to stabilize prices, such as by providing fuel subsidies, inflation rates are expected to drop into the central banks' target ranges in early 2019, and as for the monetary policies of the countries/regions, pressure to raise interest rates is likely to ease. Because policy interest rates in Asian emerging countries/regions, which were reduced significantly following the collapse of Lehman Brothers, are at historically low levels, even if the rate hikes were to continue, they will not fall outside the category of Asia-style monetary policy normalization. In light of the above, it is deemed that the negative impact of fund outflows on the economies of Asian emerging countries/regions from 2019 will be possible to control.

<Currency Change Rate in Asian Emerging Countries and Regions (Compared with the end of 2017)>



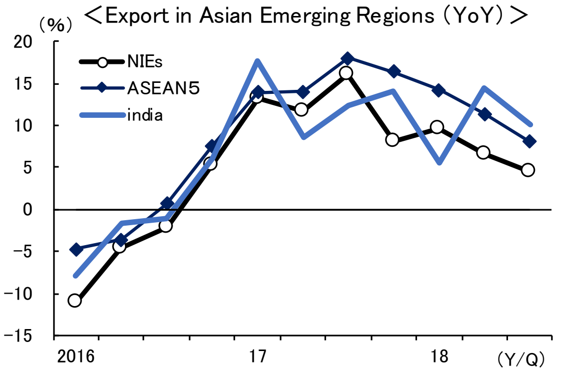
Source : Bloomberg L.P.

<Policy Rate in Indonesia, Philippines, India>



Source : Bloomberg L.P.

<Export in Asian Emerging Regions (YoY)>



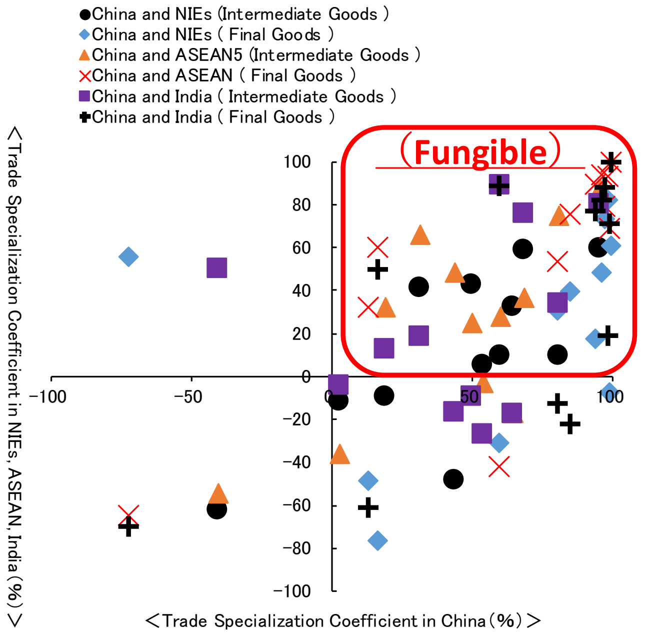
Source : Government Statistics, CEIC

(2) U.S.-China trade war

The trade war between the U.S. and China was triggered when China imposed retaliatory tariffs in response to the U.S. imposing an additional duty of 25% on $34 billion worth of imports from China on July 6, 2018. Regarding the impact on the Asian economy, China has seen production curtailed, particularly at manufacturing companies, and a deterioration in investor sentiment, but in Asian emerging countries/regions other than China, no substantial impact has yet been seen. In fact, nominal exports in dollar terms from Asian emerging countries/regions were increasing each year until recently.

From 2019 onwards, the duel between the U.S. and China is expected to continue, but China's exports to the U.S. are likely to weaken. However, there are two points that, if taken into account, could ensure that the impact on other Asian emerging countries/regions is minor—or even positive.

<Competitive or Complementary Relationships with Asian Emerging Countries and Regions in Trade with the USA (2016)>



Source : RIETI-TID
Note : TSC = (Export − Import) / (Export + Import)*100

The first is that a serious deterioration in domestic demand in the U.S. and China will be averted. In China, the central government has already started mobilizing fiscal and monetary policy, reducing reserve deposit ratios, cutting value-added taxes, and overhauling personal income tax, in an effort to shore up the economy. And in the U.S., the effects of lower taxes and increased fiscal spending will give the economy a boost in the first half of 2019, while the FRB is expected to halt its interest-rate hikes in the middle of 2019, so the economy is likely to maintain its robust growth. As a result, exports to China and the U.S. from Asian emerging countries/regions will probably hold firm.

The second is that some of the goods that China exports to the U.S. are expected to be replaced with exports from NIEs, ASEAN, and India. In fact, a look at the sectors and production processes for Chinese exports to the U.S. and exports to the U.S. from other Asian emerging countries/regions reveals that in the case of most of the goods, China and other Asian emerging countries/regions are competing with each other. This indicates that other Asian emerging countries/regions can take the place of China for a lot of its exports. Furthermore, Chinese labor costs are continuing to rise, and the country is gradually losing its cost competitiveness in labor-intensive industries and production processes. Because of this, more and more foreign companies in China are expected to be spurred by the trade war to relocate their production facilities to ASEAN and India, where labor costs are comparatively low.

3. Bright prospects amid continuing divergence

Taking the above factors into account, the Asian economy is expected to remain firm overall from 2019 onwards. The growth rate is predicted to stay high, at 6.2%, in both 2019 and 2020. However, divergence among countries/territories is likely to become more apparent.

The economies of ASEAN5 and India are forecasted to stay robust, with strong domestic demand providing the driving force in these two regions as a result of the following three factors:

First, infrastructure investment is being substantially stepped up. In ASEAN5, India, etc., infrastructure is in significantly short supply. According to estimates from the Asian Development Bank, the 25 countries comprising Asia and Oceania will require an average annual infrastructure investment of $1.34 trillion over the five-year period 2016-2020. Yet at the moment an average of only $881 billion is being invested. Amid these circumstances, the national governments of ASEAN5 countries and India have increased their infrastructure budgets, and are employing public-private partnerships and providing official development aid to focus on this area, so they are expected to continue to be proactive in infrastructure construction going forward.

Second, the emergence of the middle class is boosting consumption. In ASEAN5 and India, stable growth until now has led to a steady increase in the middle class, which form the core of consumption activity. In fact, during the decade 2007-2017, the population over the middle class in ASEAN5 and India doubled from 203 million people to 423 million people. Furthermore, the population of those who have escaped poverty, and are therefore likely to join the ranks of the middle class in the near future, has reached 619 million, and this can be expected to provide structural support for private consumption for the time being.

Third, elections are predicted to result in increased government consumption and invigorated private consumption. In 2019-2020, parliamentary and presidential elections are scheduled in numerous Asian emerging countries/regions. So in countries/regions where elections take place, government consumption will be lifted to cover the cost of administering the elections. Furthermore, in ASEAN5, India, etc. election campaigns tend to improve consumer sentiment as the streets are engulfed by a carnival atmosphere, so the elections are expected to serve to give private consumption a boost.

＜Real GDP Growth Rate and Forecast in Asian Emerging Countries and Regions＞

(%)

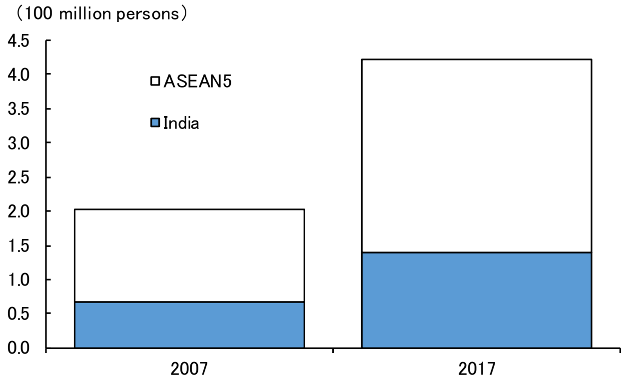
	2016年 (Actual)	2017年 (Actual)	2018年 (Forecast)	2019年 (Forecast)	2020年 (Forecast)
Asia	6.3	6.2	6.3	6.2	6.2
NIEs	2.3	3.1	2.8	2.4	2.3
Korea	2.9	3.1	2.7	2.5	2.3
Taiwan	1.4	2.9	2.7	2.2	2.1
Hong Kong	2.2	3.8	3.5	2.7	2.7
ASEAN5	4.9	5.3	5.3	5.3	5.3
Indonesia	5.0	5.1	5.2	5.4	5.3
Malaysia	4.2	5.9	4.9	4.8	4.7
Philippines	6.9	6.7	6.3	6.7	6.8
Thailand	3.3	3.9	4.3	3.7	3.8
Vietnam	6.2	6.8	6.8	6.7	6.7
India (FY)	7.1	6.7	7.5	7.3	7.7
Asia (exclude China)	5.9	5.4	6.0	5.9	6.0
China	6.7	6.9	6.6	6.4	6.3

Source : IMF, Government Statistics
Note1 : GDP figures in Asia, NIEs, ASEAN5 and Asia (exclude China) are calculated by PPP.
Note2 : In calculating Asia and Asia (exclude China), we use India GDP growth which is the calender year basis.

In addition, regarding external demand, Malaysia and Vietnam, which are among the 11 countries that have signed up for the TPP11, which will come into effect in the end of2018, are expected to see an increase in exports to other TPP members, and the replacement of certain Chinese exports to the U.S. is also set to lift exports.

In light of the above, the economic growth rate for ASEAN is expected to be 5.3% in both 2019 and 2020, while in India it is predicted to be 7.3% in 2019 and 7.7% in 2020.

＜ Population over the Middle Class in ASEAN5 and India＞



Source : World Bank「Povcal Net」, UN「World Population Prospects」, 「Kapsos and Bourmpolula (2013)」
Note: Figures are the population with daily expenditure of over US$6.08.

In China and the NIEs, however, economic growth rates are likely to weaken. In China, the growth rate is expected to be 6.4% in 2019 and 6.3% in 2020, while in the NIEs, it is predicted to be 2.4% in 2019 and 2.3% in 2020. For China, the problems of U.S.-China trade friction and excess production capacity will serve as a drag on growth, while the NIEs' growth will be weighed down by factors such as slumping electronics/device exports and a fallback in capital expenditure. Another reason is for the economic slowdown in China and the NIEs is that the shift has not been completed from manufacturing industry to non-manufacturing industry as the driver for the economy. In fact, in 2016 secondary industry still accounted a high proportion of GDP in China and South Korea, at 39.9% and 30.0%, respectively. The high level of dependence on manufacturing industry, which is easily affected by fluctuations in demand, will therefore act as a headwind.

It should be noted that even though the outflow of funds and the U.S.-China trade war will not have a significant negative economic impact, caution needs to be exercised with regard to the downside risk posed by political developments. In Indonesia and Thailand, big elections are scheduled, so there will be greater temptation to come up with economic policies that will be welcomed by citizens. If the kind of populism seen in recent years in Europe and South America becomes more influential, the likelihood of stalls in economic restructuring and lax fiscal management will increase, and this could undermine economic fundamentals over the medium term.

(Yuta Tsukada)

NIEs Growth to steady to cruising speed

■ Growth declining after peaking in 2017

The real GDP growth rate in the NIEs in 2018 (South Korea, Taiwan, and Hong Kong) is expected to have slowed to 2.8% year on year, falling back from 3.1% in 2017. The main reason for the drop is that the rapid worldwide expansion in IT demand from the second half of 2016, saw a lull from the beginning of 2018. In both South Korea and Taiwan, semiconductors and other electronic components are a mainstay industry. Hong Kong, meanwhile, hardly engages in any production, but it is trade hub for East Asia, with electronic components being the main products handled. As a result, the economies of the NIEs are heavily influenced by IT demand. The high growth seen in 2017 was due in large part to the rapid expansion of IT demand. Even though 2018 has seen a slowdown, growth is still higher than the underlying growth rate, so there is no need to view the current situation negatively.

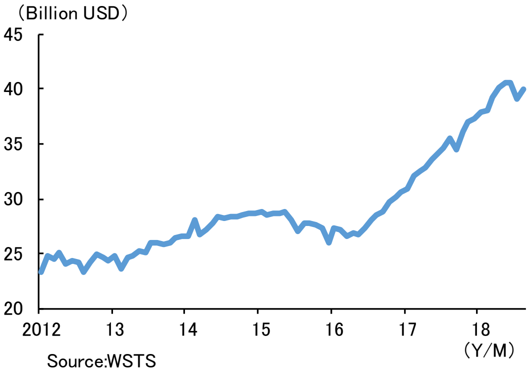
＜Real GDP Growth Rate and Forecast of NIEs＞

(%)

	2015 (Actual)	2016 (Actual)	2017 (Actual)	2018 (Forecast)	2019 (Forecast)	2020 (Forecast)
NIEs	2.1	2.3	3.1	2.8	2.4	2.3
Korea	2.8	2.9	3.1	2.7	2.5	2.3
Taiwan	0.8	1.4	2.9	2.7	2.2	2.1
Hong Kong	2.4	2.2	3.8	3.5	2.7	2.7

Source:IMF, Government Statistics

＜Worldwide Semiconductor Market(SA)＞



Source:WSTS

From 2019 onwards, the growth rate is expected to continue to fall as a result of the following three factors. The first is the internalization of semiconductor production in China. To step up in-country production of semiconductors, for which it has hitherto relied on imports, it is making huge investments in semiconductor factories, and from 2019 more and more of these new plants are expected to go into operation. Because the bulk of semiconductor exports from the NIEs go to China, the NIEs will be greatly affected by China's internalization of semiconductor production. Competition with China will become particularly fierce in the field of semiconductor memories, such as DRAM and NAND, and given their susceptibility to market conditions, there is also a risk of a steep fall in prices. Because of this, the impact on South Korea is likely to be relatively high, as memory is one of the country's mainstay products. The second is the intensification of U.S.-China trade friction and the resultant slowdown in the Chinese economy. The NIEs are heavily reliant on

exports to China, so they will be unable to avoid being affected by the Chinese economic slowdown. However, because South Korea and Taiwan are expected to serve as substitute production centers for China in response to the U.S. tariff increases on imports from China, it looks as though it will be possible to offset the negative impact to some extent. The third is higher interest rates in conjunction with the U.S. rate hikes. Rising interest rates not only negatively affect housing investment and capital expenditure, they are also a factor in pushing down stock and real-estate prices. Hong Kong will be especially affected, as its currency is pegged to the U.S, dollar. This means that it is directly affected by U.S. monetary policy, so U.S. rate increases translate into higher domestic interest rates.

However, even though negative factors like these exist, the governments of the NIEs are supporting domestic demand through various economic stimulus measures, so the pace of deceleration is likely to be slow. The NIEs are therefore expected to see growth of 2.4% in 2019 and 2.3% in 2020.

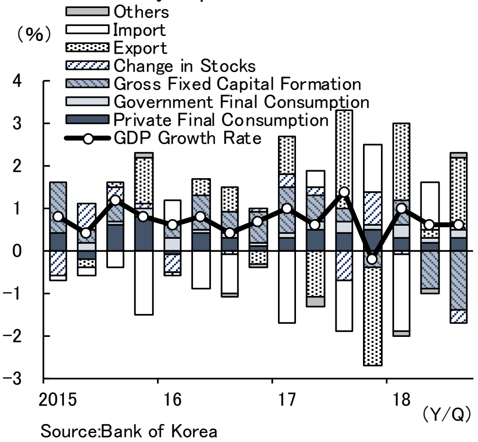
1. Korea Growth of 2.7% in 2018 and 2.5% in 2019

■ 2.7% growth in 2018

South Korea's real GDP growth rate in the July-September quarter of 2018 was 0.6% compared with the same period in the previous year (same below), so the pace of growth slowed slightly. Of particular cause for concern is the fact that gross fixed capital formation, which had been increasing for some time, dropped sharply for the second straight quarter. Reasons included the topping-out of condominium construction and a fallback in investment as a result of a slowing in the pace of expansion of semiconductor exports. Although exports and consumption picked up, this was not enough to maintain the growth rate.

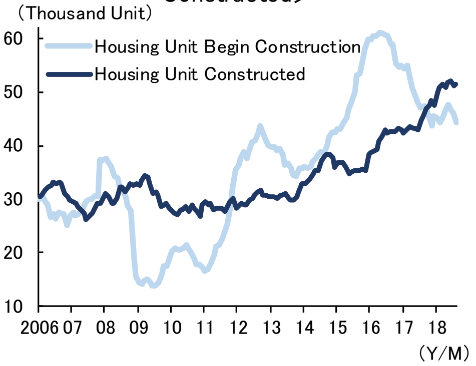
Consumer sentiment has also deteriorated recently, and it is difficult to see there being a recovery in the pace of growth in the October-December quarter. With internal/external demand declining as a driving force, the growth rate in 2018 is predicted to have been 2.7%, dropping back from the 3.1% recorded the previous year.

<GDP Growth Rate and Contributions by Expenditures>



Source:Bank of Korea

<Housing Unit Begin Construction and Constructed>



Source:Ministry of Land, Infrastructure and Transport
Note:12-month moving average

■ 2.5% growth in 2019

In 2019, like those of the other NIEs, the South Korean economy is forecast to continue to slow down due to factors such as the slowdown in the Chinese economy and a reduction in the pace of expansion of semiconductor exports. There are also downside economic factors that are unique to the South Korean economy, such as pressure to correct excessive housing investment and capital expenditure.

To begin with, housing construction, which has increased massively in recent years, had already peaked, and from 2019 is predicted to enter a clear downward trend. The rapid rise in housing construction was due to mortgage rates dropping to their lowest levels ever as a result of the South Korean central bank's loose monetary policy as well as the easing of mortgage regulations in July 2014 as a means of stimulating the economy. As a result, the number of housing unit begin construction, which had hovered around 30,000 per month until 2013, increased to around 50,000 per month. In response, from August 2017 the government has come out with one policy after another to cool the housing market. For example, it has once again tightened mortgage regulations. As a result of these policy changes, the number of new housing starts has begun to decline, and from 2019 the drop in housing construction is expected to put downward pressure on the economy.

In the corporate sector, the process of correcting excessive investment is set to continue. In addition to lower fund procurement costs, in 2015 a system of corporate income tax rebates (wage increases, dividends, and investments are deducted from 80% of taxable income, with the residual amount taxed at a fixed rate) was introduced, and despite the slowdown in exports capital expenditure actually accelerated. As a result, excess capacity has emerged, and capacity utilization rates in the manufacturing sector have remained low. Recently, the government has been urging the chaebol to step up investment, so a sudden stall in capital expenditure will probably be avoided. However, because pressure to correct investment will continue, capital expenditures can be expected to remain in a downward trend for the time being.

Besides these efforts to shore up capital expenditure, the South Korean government is also endeavoring to boost consumption, so the pace of the economic slowdown is likely to be slow. Policies have been targeted in particular at low-income earners, whose propensity to consume is high. From 2019, the basic pension for elderly people in the bottom 20% for income will be raised from 250,000 won per month to

300,000 won per month, and the plan is to extend this to cover the bottom 40% of elderly people for income from 2020. Furthermore, unemployment benefits are going to be increased from 50% to 60% of average wages, and the period during which they can be collected will be lengthened from eight months to nine months. Other additional measures have also been announced. For example, 59,000 new short-term jobs, such as internships and environmental clean-up jobs, are to be created in the public sector, while fuel taxes are to be cut by 15%. And if concerns about a slowdown in the economy become heightened going forward, the government will probably take further steps.

In light of the above, the pace of the economic slowdown is highly likely to be gentle, with the growth rate in 2019 expected to be 2.5%.

However, addressing excessive investment goes beyond the capabilities of the government, so caution needs to be exercised with regard to the risk of economic deceleration. The oversupply of housing, in particular, had continued for a long time, so the possibility that housing construction will fall sharply cannot be ruled out. Furthermore, house prices have been supported by speculators aiming to sell on for a profit, so both supply and prices could fall at the same time. In South Korea, real estate accounts for around 70% of household assets, so such a collapse in the housing bubble would have a negative asset effect and therefore put immense downward pressure on consumption. In South Korea, household debt in relation to disposable income is at a high level compared with other countries, so there are also concerns that a rapid correction of the housing market could lead to a loss of confidence in credit due to defaults by households and bankruptcies of construction companies.

2. Taiwan　Growth of 2.7% in 2018 and 2.2% in 2019

■ 2.7% growth in 2018

Taiwan's real GDP growth rate in the July-September quarter of 2018 was 2.3% compared with the same period in the previous year (same below), so the pace of growth slowed dramatically compared with the April-June quarter (3.3%). The main reason was a slowing in the expansion of exports of semiconductors and other electronic components due to factors such as the smartphone market topping out and a decline in demand for servers for the mining of virtual currencies.

In the October-December quarter, this trend is continuing, so the growth rate for 2018 is forecast to have been 2.7%, slowing from the previous year (2.9%).

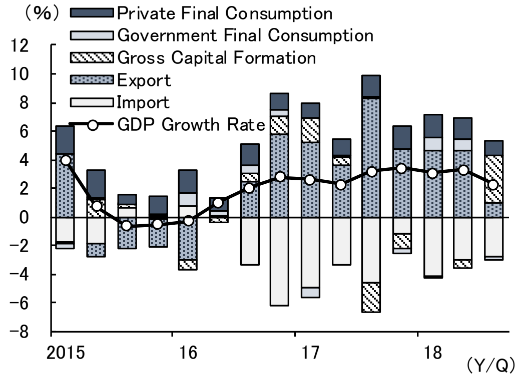
■ 2.2. % growth in 2019

In 2019, too, the growth rate is expected to fall as a result of the slowing in the expansion of semiconductor exports. However, because domestic demand is firm, the pace of the slowdown is likely to be gentle.

Furthermore, the environment in terms of employment and incomes remains favorable thanks to falling unemployment rate and rising wages. As a result, consumption is expected to continue to grow at a steady rate.

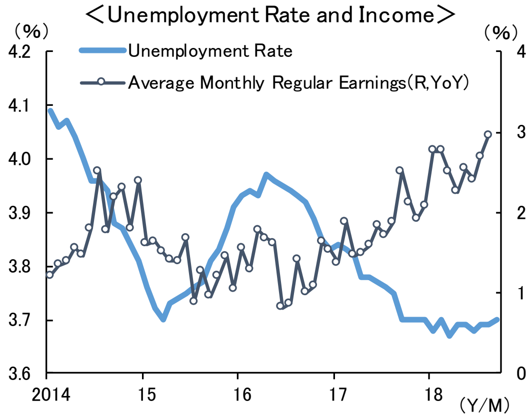
Moreover, capital expenditure and public investment are predicted to expand in 2019. The second half of 2017 through the first half of 2018 saw a lull in capital expenditure by chipmakers, so capital expenditure continued to weaken. From the second half of 2018, the mass production of advanced products featuring more intricate integrated

<GDP Growth Rate (YoY) and Contributions by Expenditures>



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

<Unemployment Rate and Income>



Source:Directorate-General of Budget,Accounting and Statistics, Executive Yuan semiconductor circuits has been getting underway in earnest, so capital expenditure, centered on the semiconductor sector, is forecast to recover. In addition, construction work connected with the "Forward-looking Infrastructure Development Program," a government plan for large-scale infrastructure investment, is also expected to start getting up to full tilt in 2019. As a result, public investment such as railway development is forecast to expand.

Regarding the U.S.-China trade friction, about 90% of overseas production by Taiwanese companies takes place in China, and production facilities in China ship a considerable portion of their output to the U.S., so the trade friction is likely to put a dent in corporate earnings. However, because Taiwanese firms are also moving to bring production back to Taiwan, the negative impact on the economy within Taiwan will probably be limited.

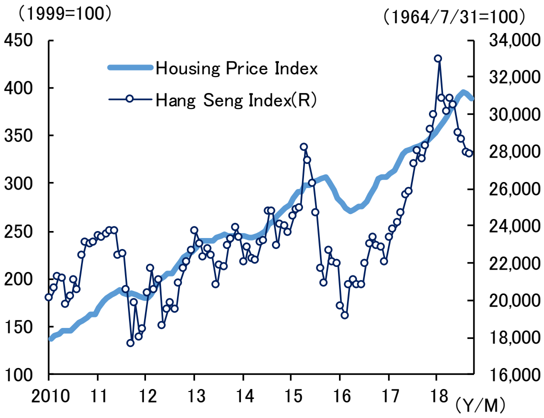
In light of the above, while the growth rate in 2019 will slow to 2.2%, it is not expected to fall back to the kind of low growth that was seen in 2015-16.

3. Hong Kong　Growth of 3.5% in 2018 and 2.7% in 2019

■ 3.5% growth in 2018

Although the Hong Kong economy remained strong until the first half of 2018, it has experienced a slowdown recently. The impact of the U.S.-China trade friction has slowed the expansion in trade volume, and corporate sentiment is deteriorating. In addition, because the depreciation of the yuan has reduced the purchasing power of visitors from mainland China, retail sales, and sales of jewelry in particular, have seen a significant slowing in the rate of increase. The growth rate for 2018 is forecast to have been 3.5%, slowing slightly from the previous year (3.8%).

<Housing Price Index and Hang Seng Index>



Source:Statistics Department, Rating and Valuation Department

■ 2.7% growth in 2019

The slowdown is forecast to continue in 2019. With intermediary trade the main form of trade, Hong Kong is heavily dependent on trade-related services such as logistics, finance, and legal services, so the U.S.-China trade friction will place immense downward pressure on the economy.

In addition, because Hong Kong's currency is pegged to the dollar, monetary policy follows that of the U.S., so increases in interest rates in tandem with U.S. rate hikes are likely to put downward pressure on asset prices. In fact, in 2018 stock prices entered a correction phase, and recently house prices have also started to fall. Going forward, there is a risk that consumption will be reduced as a result of the negative asset effect.

However, there are also a number of positive factors for the economy, so the growth rate is not expected to drop to the level it did in 2015-16. For starters, the Guangzhou–Shenzhen–Hong Kong Express Rail Link opened in September 2018, followed by the Hong Kong–Zhuhai–Macau Bridge in October, and these have significantly improved access to mainland China. The number of Chinese tourists is expected to rise as a result, and business involving partnerships with the mainland is also expected to increase. Furthermore, the Chinese government is moving forward with the "Greater Bay Area" concept, a priority government policy to construct a vast economic zone to promote economic cooperation among Guangzhou, Hong Kong, and Macau, and this is likely to help strengthen Hong Kong's position as financial and logistics center. In the 2018 policy address that she gave in October, Chief Executive Carrie Lam declared that innovation-related government spending would be increased and housing construction would be stepped up.

In light of the above, while the growth rate in 2019 will slow significantly to 2.7%, the solid pace of growth is expected to be maintained.

(Michinori Naruse)

ASEAN Economy to remain firm in 2019 and 2020

■ ASEAN growth rate to remain fairly stable in 2018

In 2018, the real GDP growth rate is expected to have been 5.3% compared with the previous year in the ASEAN5 (Indonesia, Malaysia, Philippines, Thailand, and Vietnam). In Malaysia, growth plummeted due to a slowdown in exports caused by factors such as a lull in IT demand, but in the other countries robust domestic demand as a result of factors such as infrastructure investment provided support, so the growth rate for ASEAN as a whole is forecast to have been unchanged since the previous year.

■ Maintaining growth of in the lower 5.0% range going forward

The economies of the ASEAN5 are also expected to maintain their strength in 2019 and 2020.

The driving force will continue to be domestic demand. To begin with, infrastructure-related projects in each country will be getting into full swing, so the increase in gross fixed capital formation is predicted to gather speed. In Malaysia, however, where hidden debts incurred by the previous government have been discovered, the priority will be on reducing government debt, so public investment will be probably continue to fall year on year. Next, structural factors will have a positive effect, with a boost in consumption caused by the expansion of the middle class expected to occur. As a result of steady growth until now, the number of people in over the middle class, which form the core of consumption activity, has increased substantially in the ASEAN5. In Indonesia, the Philippines, and Vietnam, where per-capita GDP is around $3,000, a large number of people are expected to move into the middle class soon, so the benefits of the resultant higher consumption can be expected to be enjoyed over the long term. Among other factors giving a lift to domestic demand, large-scale national elections are scheduled for 2019 in Indonesia, Thailand, and the Philippines, which will lead to an expansion in government consumption in order to administer the elections, while past experience tells us we can expect to see high private consumption during the election periods.

External demand, on the other hand, will probably continue to rise at the same pace despite the turmoil expected to be caused by the U.S.-China trade war. This is because the economies of advanced countries will remain firm and some of China's exports to the U.S. will be replaced by exports from ASEAN5.

In light of the above, the economic growth rate of the ASEAN5 is expected to be 5.3% in both 2019 and 2020.

Regarding risk scenarios, it is possible that populism will hold greater sway over the policies of each country. One of the reasons that the ASEAN countries have maintained solid growth these past few years is that strong leadership has ensured that macroeconomic policy administration has been appropriate. In Europe and South America, populism and the rise of nationalism in recent years has led to major disruption in politics and economics. Ahead of large elections in the majority of the ASEAN5 in 2019, attention should be paid to the possibility of an expansion in populist policies such as pork barreling and the deferment of structural reform.

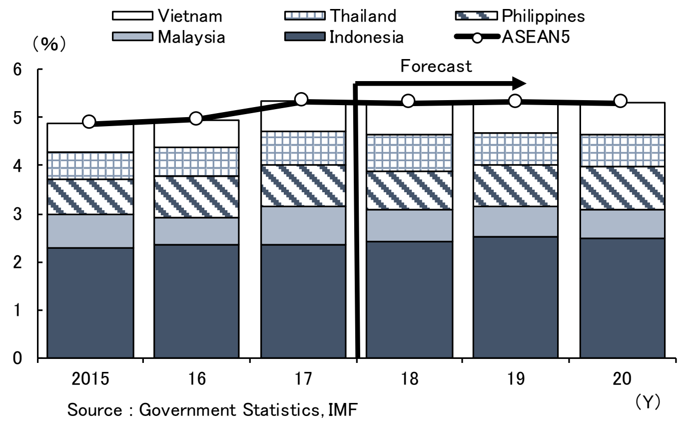
＜Growth Rate Prospects of ASEAN5＞

(%)

	2015 (Actual)	2016 (Actual)	2017 (Actual)	2018 (Forecast)	2019 (Forecast)	2020 (Forecast)
ASEAN5	4.9	4.9	5.3	5.3	5.3	5.3
Indonesia	4.9	5.0	5.1	5.2	5.4	5.3
Malaysia	5.1	4.2	5.9	4.9	4.8	4.7
Philippines	6.1	6.9	6.7	6.3	6.7	6.8
Thailand	3.0	3.3	3.9	4.3	3.7	3.8
Vietnam	6.7	6.2	6.8	6.8	6.7	6.7

Source : Government Statistics
Note : "ASEAN5" is the weight average value.

＜Real GDP Growth Rate of Contribution by Countries of ASEAN5＞



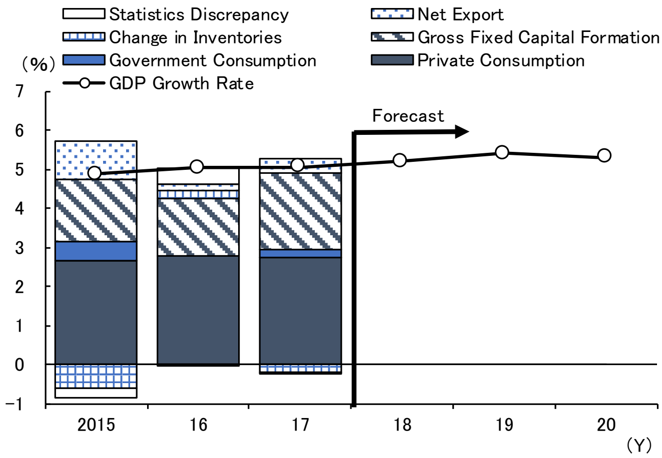
Source : Government Statistics, IMF

1. Indonesia Growth of 5.4% in 2019

■ Growth to have decelerated slightly in 2018 to 5.2%

The real GDP growth rate in 2018 is expected to have been 5.2%, falling short of the government's target (5.4%), but marking the third straight year of slightly accelerating growth. A big factor has been firmness in gross fixed capital formation in conjunction with progress in infrastructure construction by the public sector. And in the private sector, an improvement in the employment and income environment has given private consumption a boost. External demand, on the other hand, is seen as having exerted downward pressure on the growth rate. However, this is because the expansion in domestic demand means that imports have increased faster than exports. Exports are continuing to rise as the economies of advanced countries recover, so the external-demand environment can also be regarded as favorable.

＜Real GDP Growth Rate and Contribution by Expenditures＞



Source : BPS

■ Recovery trend to continue in 2019 and 2020

The rebound in the Indonesian economy is expected to continue in 2019 and beyond. The driving force will continue to be domestic demand.

To begin with, progress with infrastructure development will give a lift to gross fixed capital formation. In the fiscal 2019 budget, 420.5 trillion rupiah has been allocated to infrastructure development, 2.5% more than was allocated the previous year. Furthermore, projects for which funds were allocated in past years will be moving forward at full steam, so additional investment is expected. Although the outlook for 2020 will depend to some extent on the results of the presidential election in the spring of 2019, all the candidates recognize the lack of infrastructure as the country's biggest issue, so the budget for infrastructure development is unlikely to be reduced significantly.

Next, private consumption is expected to continue to expand due to the emergence of a middle class. As a result of comparatively stable growth until now, the number of people over the middle class reached 95.6 million people in 2017. Furthermore, the population of people that have escaped poverty, who are being positioned as the middle class of the future, stands at 103 million, and if some of them join the ranks of the middle class, consumption will be boosted further.

In addition to these positive structural factors, the general election and presidential election, which are set for April 2019, will bring with them an increase in government consumption, while private consumption can also be expected to rise during the election period.

However, the impact of higher interest rates is gradually curtailing private-sector investment and consumer spending on durable goods, and companies are waiting to see what the policy stance of the new government after the presidential election will be. As a result, they are likely to defer large expenditures for the time being.

In light of the above, the real GDP growth rate in 2019 and 2020 is expected to be 5.4% and 5.3%, respectively, so the recovery trend is forecast to be extremely gradual.

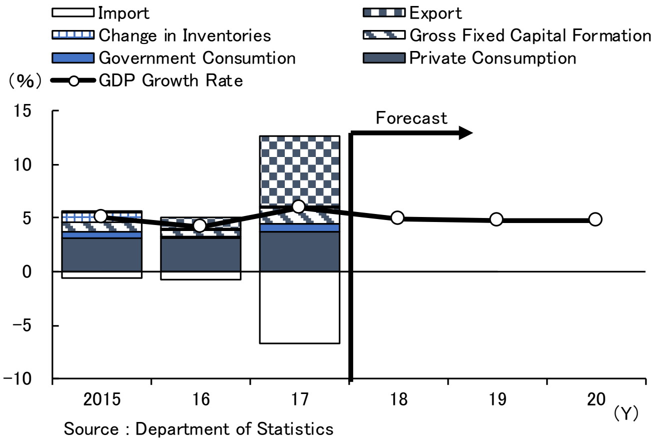
On the other hand, given that 2019 will see a general election and presidential election, it is going to be an important year politically. And the result of the presidential election, in particular, will dictate the direction for economic policy for the next five years. According to the most recent opinion polls, the support rate for incumbent President Joko Widodo and his running mate Ma'ruf Amin is far higher than that for rival pair Prabowo Subianto and Sandiaga Uno, who are running for president and vice-president, respectively. However, turbulence has emerged in the form of the discovery of corruption in the current Joko administration, so the incumbent president has no room to be complacent. If a new president is elected, economic policy may be in for a massive overhaul, to the upcoming election battle will be watched with interest.

2. Malaysia Gradual slowdown to continue in 2019 and beyond

■ Sharp slowdown to 4.9% in 2018

The real GDP growth rate in 2018 is expected to have been 4.9%, far lower than the figure for 2017 (5.9%). Export growth has slowed sharply as a result of a worldwide lull in IT demand and as a reaction to the rapid expansion seen in the previous year, and this has also led to weakness in private-sector investment. The economy was supported by a rise in government consumption and private consumption at the time of the election as well as surges in demand ahead of the new government's cut in the Goods and Services Tax in June and its replacement with the Sales and Service Tax in September, but these factors were not enough to offset the slowdown in exports and investment.

＜Real GDP Growth Rate and Contribution by Expenditures＞



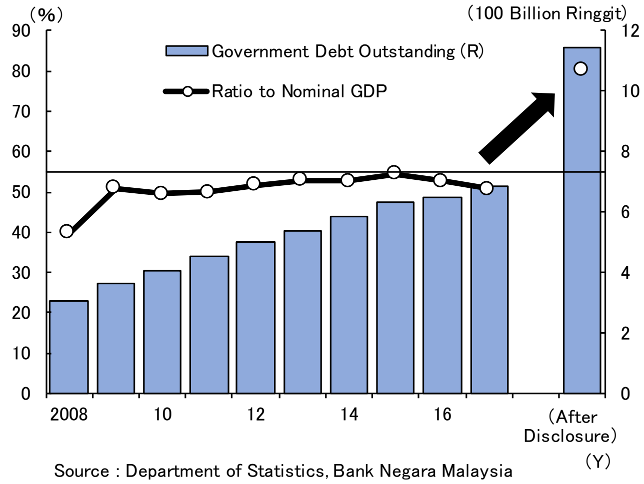
Source : Department of Statistics

■ Growth to hold steady at the top end of the 4% range from 2019 onwards

The Malaysian economy is expected to see a gradual slowdown in 2019 and 2020. The two main reasons for this predicted slowdown are as follows:

The first is a drop in public investment. The new Mahathir government, which swept to power in the May 2018 general election in the first victory for opposition parties ever seen in Malaysia, discovered at the end of the same month that the previous Najib government had hidden debts, and announced that government debt at the end of 2017 had been 80.3% of GDP, far higher than the legal limit of 55% of GDP. In response, the new government conducted a review of large-scale public works projects, and cut spending for infrastructure development by 13.6% in its fiscal 2019 draft budget. It's going to take time to extinguish the massive debts, so austerity with respect to government spending is predicted to continue into 2020s.

＜Govenment Debt Outstanding＞



Source : Department of Statistics, Bank Negara Malaysia

The second is the slowdown in private consumption. The review of public investment by the new government is expected to cause a deterioration in the employment/income environment. Furthermore, because rush purchases ahead of the change in the tax system in the summer of 2018 will eat into future demand, this reactionary drop is forecast to put downward pressure on consumption in 2019.

However, there are two factors that, if taken into account, could enable a significant slowdown to be avoided. The first is that even though exports will continue to be dragged down by the slowdown in the Chinese economy, the economies of advanced countries remain robust, so the upward trend is expected to be maintained. The other is the impact of various policy measures from the new government. In its draft budget for fiscal 2019, the new government has announced that a scheme for fuel subsidies will be restored and maintained and that assistance will be provided to those on low incomes to enable them to purchase homes. It is expected that the lower fuel prices will increase purchasing power and give a boost to housing investment.

In light of these various factors, the real GDP growth rate in 2019 and 2020 is expected to be 4.8% and 4.7%, respectively, meaning that the slowdown will be gradual.

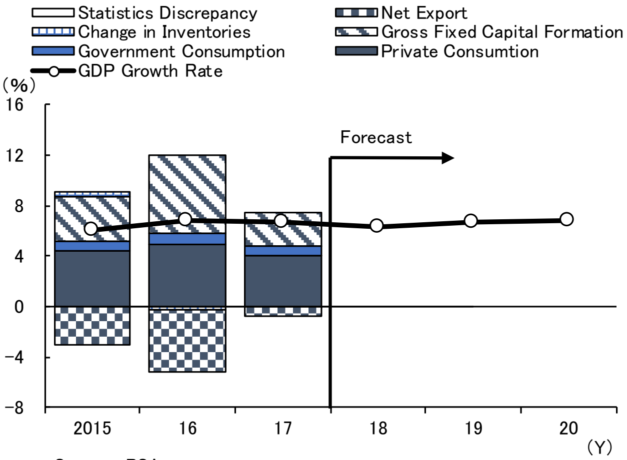
3. Philippines Growth of in the upper 6% range in 2019 onwards

■ Slight slowdown in 2018 to 6.3%

In 2018 the Philippines economy is expected to have slowed for the second straight year to a growth rate of 6.3% year on year.

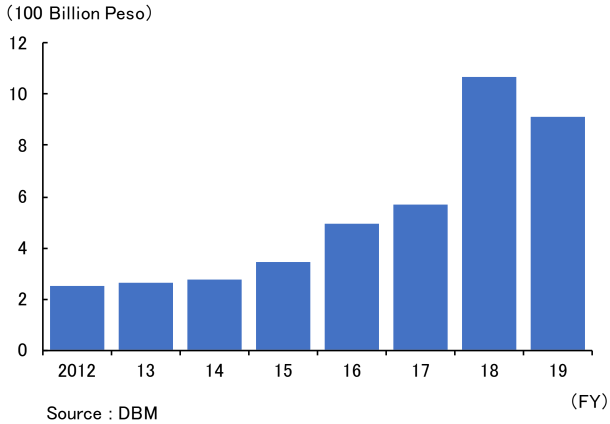
However, economic conditions should be viewed as not having deteriorated as much as the drop in the growth rate. There are two main factors behind the fall in the growth rate: weaker consumption as a result of rising inflation and higher interest rates in conjunction with this and increased imports of capital goods as a consequence of infrastructure investment. Both factors reflect strong domestic demand, and it can be concluded that the Philippines economy is remaining firm as a whole.

<Real GDP Growth Rate and Contribution by Expenditures>



Source : PSA

<Infrastructure Budget>



Source : DBM
Note : The figures untill 2017 FY are actual.

■ Growth rate to accelerate again from 2019

The Philippines economy is expected to retain its strength from 2019 onwards.

The driving force for growth will continue to be infrastructure investment. The draft budget for fiscal 2019 calls for a reduction in the infrastructure development budget of 909.7 billion pesos, or 14.9%, but this is due to a change in the method of compiling the budget. Until now, expenditure in subsequent years for a project were booked in the first year of the project, but from fiscal 2019, expenditures will be booked in the year that they actually occur. Because of this, infrastructure budgets until fiscal 2018 should be viewed as inflated, with the fiscal 2019 budget actually marking an increase. Given that the Duterte administration has put together a huge infrastructure development plan worth 8.4 trillion pesos for the period 2016-2022, investment should remain firm for at least the next few years.

Furthermore, private consumption, which accounts for 70% of real GDP, is also expected to return to firmness. To begin with, the inflation rate is predicted to return to the central bank's target range as a result of the government taking measures such as reforming the system for the import of food in the second half of 2018, the impact of the increase in taxes on goods at the start of 2018 having run its course and a slowdown of the depreciation of the pesos being expected in response to the halt of U.S. rate hikes from the second half of 2019. In addition, the employment environment is expected to improve as a result of increased government spending, remittances from OFWs (overseas Filipino workers) are likely to be firm due to the robustness of advanced economies, and the midterm elections in May 2019 will probably give consumption a lift. Factors such as these will also serve to encourage an expansion in consumption.

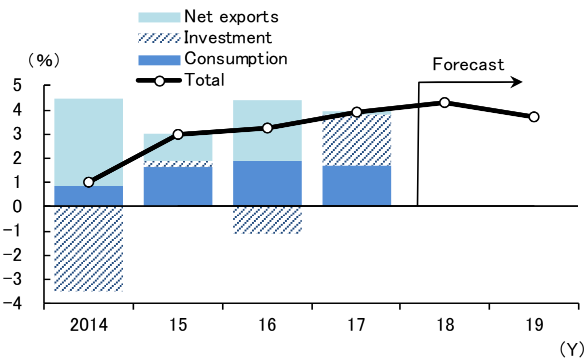
However, compared with other ASEAN countries, the Philippines is behind in developing its manufacturing industry, and relies heavily on the import of capital goods. Because of this, if infrastructure development continues to increase as it did in 2018, imports will expand significantly, meaning that the ripple effects of the economic expansion will partially disappear overseas. As a result, the growth rate in 2019 and 2020, is expected to be 6.7% and 6.8%, respectively, meaning that the acceleration will only be moderate.

4. Thailand Growth to slow to 3.7% in 2019

■ 4.3% growth in 2018—the highest level since 2012

In 2018, Thailand's real GDP is expected to have grown 4.3% year on year, its fastest rate for six years, as a result of an increase in exports of goods and tourism services in conjunction with the worldwide economic expansion and firm domestic demand resulting from an improvement in consumer/investor sentiment. Although real GDP in the July-September quarter of 2018 remained firm thanks to an improvement in the view of the economy among consumers and firms as the domestic economy recovered and stock prices climbed, a slowdown in exports to other parts of Asia and negative growth in the agriculture, forestry, and fisheries sector, the growth rate softened to the lower part of the 3% range. As for the October-December quarter, the intensification of the U.S.-China trade war reduced exports of goods to China, but in December arrival visas for tourists from 21 countries/territories including China began being issued free of charge, meaning that tourism service exports can be expected to have increased, and that as a result, the economy is likely to have maintained its robust growth.

<Real GDP (YoY)>



Source: Office of the National Economic and Social Development Board

Regarding prices, inflationary pressures are building as the economic rebound gathers momentum and energy prices climb. However, the central bank is maintaining its current monetary policy stance because the core inflation rate remains low and it is still unclear whether the economic recovery will be sustained.

■ Growth to slow to 3% range in 2019

In 2019, the driving force for the economy is expected to be progress with infrastructure development in the EEC (Eastern Economic Corridor). However, with downside factors such as export growth slowing amid the intensification of the U.S.-China trade war, uncertainty about political stability following the general election scheduled for the first half of next year, and a slump in investment as a result of tighter regulations on mortgage lending, growth is predicted to soften to 3.7%. Regarding monetary policy, however, the policy interest rate is expected to be maintained as slower growth eases inflationary pressures and because of the political uncertainty.

The biggest area of interest in the first half of 2019 will be the general election, and the government is eyeing February-May as the period during which the election will be held. However, Prime Minister Prayut has stated that the general election will take place after the coronation ceremony for King Vajiralongkorn, though the date for the coronation has yet to be set. As a result, it is possible that the general election will be held later than planned. If it goes ahead as planned, the upper-house selection committee, whose members are nominated by the military junta, will select the majority of upper-house members. Moreover, seats will be allocated to military and police leaders, so the strong influence of the military looks set to continue. As for the lower house, it is expected that the Pheu Thai Party, whose main support base is low-income earners from the provinces, which produced former Prime Minister Yingluck Shinawatra, will secure a majority. However, given factors such as the launch of new parties and changes in the election system, it is unclear whether the Pheu Thai Party will be able to obtain a majority on its own.

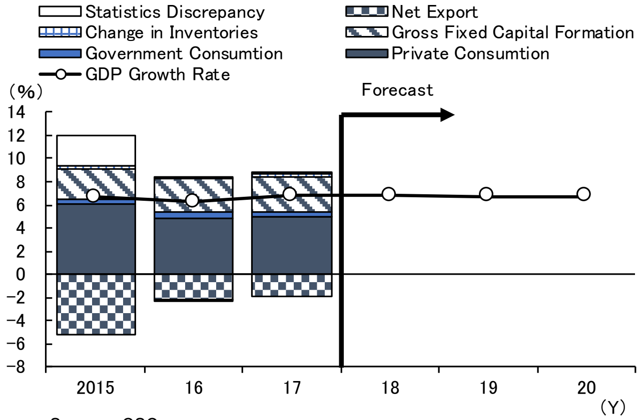
With the influence of the current military junta, particularly in the upper house, set to continue, and there being little difference between the opposition parties in terms of their view of the importance developing the EEC and attracting foreign capital, the economic policy stance is unlikely to change significantly regardless of the general election results. However, because it will no longer be possible to implement super-judicial measures based on Article 44 of the interim constitution, which until now has basically granted absolute power to the prime minister, the pace of policy implementation is expected to slow.

5. Vietnam　Firmness expected to continue in 2019 and beyond

■ Growth of 6.8% in 2018

In 2018, the real GDP growth rate is expected to have been 6.8%, the same as the previous year and beating the government's target (6.7%). Although the imposition of non-tariff barriers on imports of finished vehicles has put downward pressure on consumption, exports have increased thanks, for example, to South Korean electronic component manufacturers launching operations at new plants in Vietnam. The employment/income environment has improved as a result, and the high growth looks to have continued overall.

＜Real GDP Growth Rate and Contribution by Expenditures＞



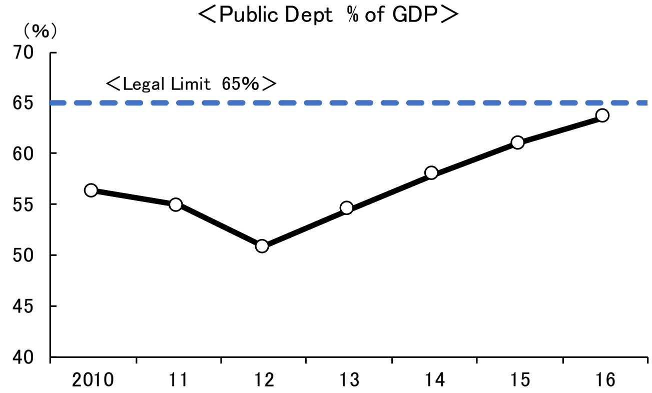
Source : GSO

■ High growth to be maintained in 2019 onwards

From 2019 onwards, the Vietnamese economy is expected to maintain high growth in the upper half of the 6% range.

To begin with, domestic demand will be bolstered by continued firmness in consumption. In 2019, the impact of the non-tariff barriers on the import of finished vehicles will run its course, and this will serve to boost consumption in comparison with the previous year. In addition to such temporary consumption-boosting factors, a lift will also be provided by structural factors, namely the emergence of the middle class. In fact, the number of people in the middle class or higher in Vietnam has increased rapidly from 13.2 million people in 2007 to 62.5 million people in 2017, thanks to high rate of economic growth. This means that the middle class now make up two-thirds of the population.

＜Public Dept　% of GDP＞



Source : Ministry of Finance, CEIC

Furthermore, the expansionary trend in investment looks set to continue. With the public debt balance approaching its legal maximum, it is unavoidable that a stance of austerity will continue to affect public investment. However, TPP11, which Vietnam is a member of, will come into force in the middle of January 2019, while expectations are building for the domestic consumer market due to the emergence of the middle class and a population that will exceed 100 million people in the future. As a result of such factors, more foreign companies are predicted to move in or expand their investments, while Vietnamese companies are expected to boost private-sector investment.

Exports, on the other hand, will maintain their pace of expansion because domestic demand in the U.S. is seen as remaining firm, and Vietnam will replace China for some of the latter's exports to U.S. And with TPP11 coming into force, exports to member countries are also expected to rise substantially. However, Vietnam's manufacturing industry remains labor intensive, so the country is forced to rely on imports of capital goods such as machinery that it needs when investing plant and equipment. As a result, on a net basis exports will continue to have a negative effect on GDP for the time being.

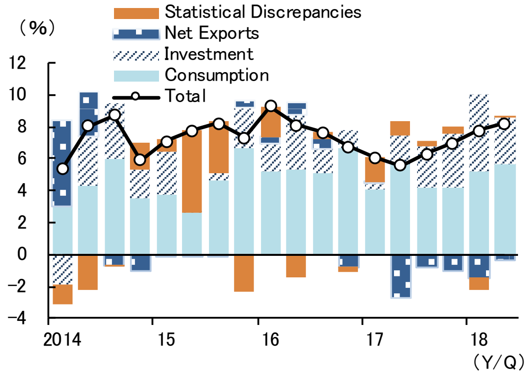
Taken together, these factors lead to the prediction that Vietnam's growth rate will be 6.7% in both 2019 and 2020.

Thailand:　(Shotaro Kumagai)
Excluding Thailand：(Yuta Tsukada)

India Robust growth being maintained

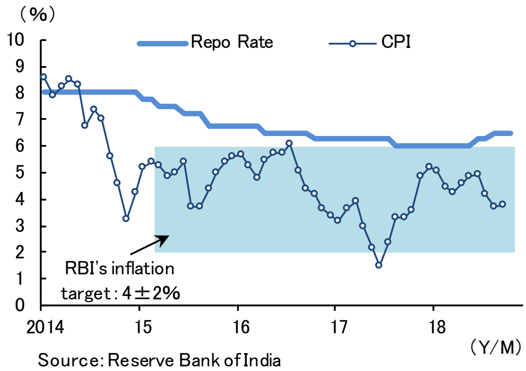
■ 7.5% growth in fiscal 2018

<Real GDP (Y o Y)>



Source: Ministry of Statistics and Program Implementation

<Policy Rate (Repo Rate) and CPI (Y o Y)>



Source: Reserve Bank of India

In November 2016 the Indian government suddenly announced the scrapping of high-denomination bank notes as a means of getting a grip on money laundering and forged bank notes, and with the aim of simplifying the tax system, it introduced the GST (Goods and Services Tax) in July 2017. These measures were accompanied by turmoil, and the economy slowed throughout the first half of 2017. After that, the negative impact of the measures receded for the most part, and the economy has continued to recover. After slowing to 5.6% in the April-June 2017 quarter, real GDP rebounded for four straight quarters, reaching 8.2% in the April-June 2018 quarter. In addition to the ending of the above-described negative factors for the economy, the SENSEX index, an indicator of stock prices, repeatedly reached highest-ever levels between July and late August, buoyed by the global appreciation in stock prices. The ongoing strong performance by the stock market has contributed to the recovery in consumption/investment by improving sentiment among households and companies.

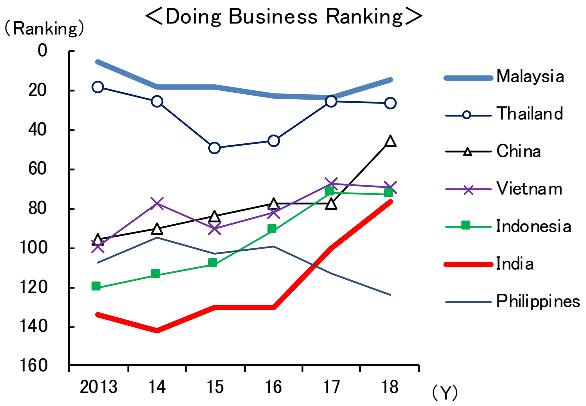
Regarding monetary policy, inflationary pressures have been building not only as a result of the economic upturn, but also because of factors such as rising oil prices and a weakening of the rupee. As a result, monetary policy began to be tightened from the middle of 2018. Although the consumer price index has long been within the target range (4±2% year on year) set by the Reserve Bank of India, higher oil prices and a sharp increase in the MSP (Minimum Support Price) for purchases of agricultural products cropped in the June-September 2018 are viewed as creating inflationary pressure in the near future. In response, the Reserve Bank of India tightened its monetary policy in June and August 2018 in order to guard against inflation. These policy moves resulted in a total increase in the policy rate (repo rate) of 0.5 percentage points.

Robust growth underpinned by domestic demand is expected to continue for the time being. However, because there are no powerful economic drivers in the near future, real GDP growth has been slowing during the second half of the fiscal year, so it is forecast to be 7.5% in fiscal 2018 (April 2018 – March 2019). Regarding monetary policy, the rupee is hovering at its lowest ever level against the dollar, and the rupee is expected to weaken further under pressure from outflows of funds in response to additional U.S. rate hikes. As a result, inflationary pressure will continue, and the Reserve Bank is expected to maintain its monetary-tightening stance. If the rupee depreciates significantly, it is likely that the Monetary Policy Committee will announce additional rate increases when it meets in December 2018 or February 2019.

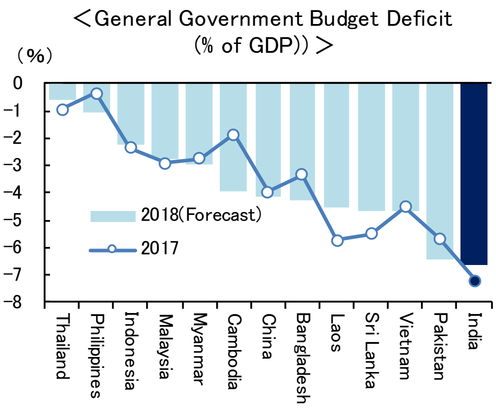
■ Growth to stay steady at 7.3% in fiscal 2019

Looking ahead to the Indian economy in fiscal 2019, factors such as the penetration of durable consumer goods in conjunction with rising per-capital incomes as well as urbanization will support growth over the medium term. Furthermore, the positive impact of economic reforms implemented until now will gradually become apparent. As a result, the real GDP growth rate is expected to remain firm at 7.3%.

The economic reforms implemented by the Modi government are beginning to produce concrete results. For example, India's ranking in the ease of doing business index published by the World Bank each year has improved substantially. In 2017, it shot up the rankings from 130th place the previous year to 100th place as a result of the establishment of the Insolvency and Bankruptcy Code, the introduction of the GST, and the introduction of online systems for applying for building permits and establishing businesses. And in 2018 it continued to move higher, rising to 77th place as a result of factors such as the streamlining of import-export-related procedures. In addition to the improvement in the domestic business environment, another factor boosting inward investment in India is that companies are reviewing the locations of their production facilities in response to rising personnel costs in China and the increasing severity of the U.S.-China trade war. This increase in inward direct investment will serve to expand the economy by improving productivity and creating jobs.



Source:World Bank



Source: IMF

However, a sharp acceleration in growth is unlikely to occur because (1) among the main emerging countries in Asia, the country is carrying a large fiscal deficit, so a fiscal policy characterized by austerity will be unavoidable, and (2) monetary policy will remain fairly tight in response to inflationary pressures caused by rising oil prices and the depreciation of the rupee. Although the Indian economy is susceptible to the effects of the oil-price trend, when the oil price is much higher than $60 per barrel, the pace of increase in U.S. shale gas production accelerates, which puts downward pressure on prices as the demand-supply balance improves. It can therefore be concluded that there is little likelihood of oil prices moving significantly higher than they are now over the long term. As a result, it is expected that a situation like the one seen in late 2013 will be avoided. At that time, the Reserve Bank was forced to significantly raise interest rates to curb high inflation caused by rising oil prices, and this led to a sharp drop in demand for durable consumer goods and in investment.

Finally, regarding the political situation, a general election for the lower house will be held by May 2019. The election has been preceded elections for state assemblies, which have been closely watched as harbingers of the general election result. The results so far indicate that there is overall support for the current government. Furthermore, opinion polls concerning upcoming state assembly elections and the lower-house general election have also followed a similar trend. As a result, the prevailing view is that the NDA (National Democratic Alliance), which is dominated by the BJP (Bharatiya Janata Party) will retain control of the government after the general election. However, in the upper house, where seats will be gradually coming up for reelection, the NDA is expected to obtain a majority in the near future. If the NDA gains a majority in the lower house, it will have a majority in both the upper and lower houses, so progress may be made with economic reforms in areas such as land acquisition and rules on job dismissals. That being said, some opinion polls are indicating a gradual narrowing in the difference between support for Prime Minister Modi and Rahul Gandhi, the president of the Indian National Congress, the largest opposition party. It is therefore also possible that the neither the NDA nor the UPA (United Progressive Alliance), a coalition of opposition parties centered on the Indian National Congress, will be able to obtain a majority, or that the UPA will secure a majority in the lower house. If the latter occurs, the upper and lower houses will continue to be controlled by different camps, though in a reversal of the current situation, so there is a risk that the economy could be negatively impacted if the pace of economic reform slows as a result of political discord between the ruling and opposition parties.

(Shotaro Kumagai)

China Growth to slow to 6.4% in 2019

■ Economy slowing

China’s real GDP for the July-September 2018 quarter slowed for the second straight quarter to 6.5%. Background factors to this included the government’s deleveraging policy (curbing of credit and debt) and the U.S.-China trade friction.

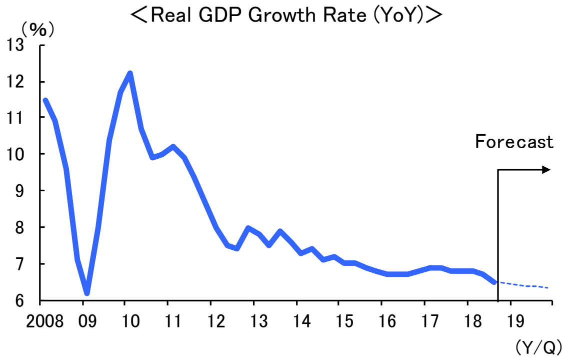
The deleveraging policy has been a particularly significant cause of the economic slowdown. At the Central Economic Work Conference held in December 2017, the Xi Jinping government declared the curtailing of financial risks to be the top policy priority for the next three years, and this marked the full-fledged start of deleveraging. On the financial side, it began with a shift toward what is effectively a tighter monetary policy, with short-term interest rates being guided upwards. Financial regulation and supervision was also beefed up. For example, banks were ordered to reduce off-balance-sheet transactions (so called “shadow banking”).

As a result, the rate of growth of total social financing excluding RMB loans (e.g. third-party loans) slowed sharply. Local financing vehicles, which are special purpose companies established by regional governments for the purpose of procuring funds have run into financial difficulties, forcing numerous infrastructure investment projects to be reviewed.

On the fiscal side, the government has moved to curtail regional infrastructure investment involving the abuse of PPPs (public-private partnerships). In November 2017, the Ministry of Finance instructed regional governments to substantially reduce PPP projects. As a result, PPP projects worth 1.8 trillion yuan had been suspended as of April 2018, while projects worth 3.1 trillion yuan were under review. The total amount, 4.9 trillion yuan, accounts for 36% of all PPP projects.

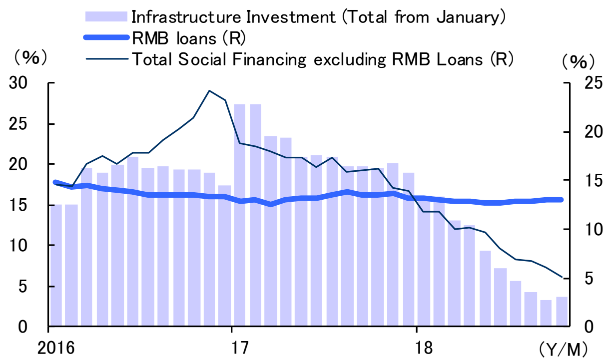
As a result of these measures, the pace of expansion in infrastructure investment in a wide range of fields, including railways, roads, and water conservancy/environmental/public facilities, has slowed significantly.

＜Real GDP Growth Rate (YoY)＞



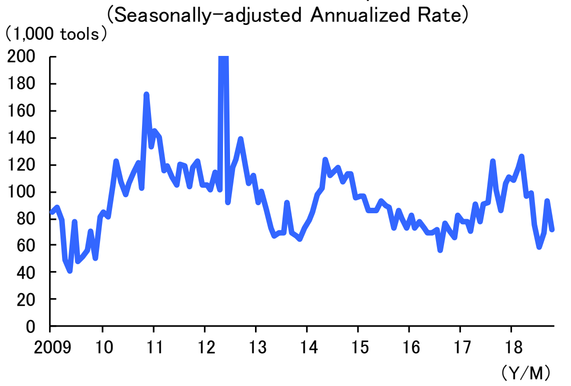
Source: The Japan Research Institute, Ltd, based on National Bureau of Statistics of China

＜Infrastructure Investment and Total Social Financing (YoY)＞



Source: The Japan Research Institute, Ltd, based on National Bureau of Statistics of China, People’s Bank of China

＜No. of Machine Tools Imported＞
(Seasonally-adjusted Annualized Rate)

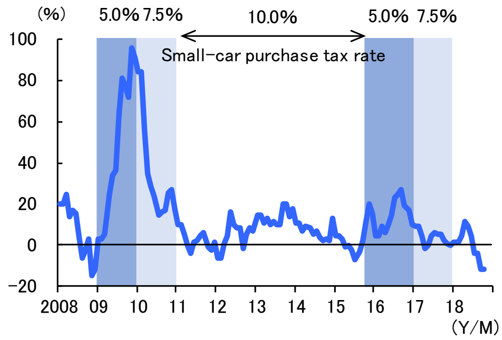


Source: The Japan Research Institute, Ltd, based on General Administration of Customs of China

Furthermore, while the negative impact on the economic growth rate remains limited, the U.S.-China trade friction is weighing down on the economy. With the U.S. applying increasing trade pressure with Chinese high-tech manufacturing industry as its target, China’s manufacturing sector has started cutting back on production and investment. From 2016, capital expenditure continued to increase to allow the adoption of IT and the automation of manufacturing processes, but there are now signs that capital expenditure in the manufacturing sector is weakening. For example, imports of machine tools have been falling recently. Given that investment increased rapidly in a short period of time, indications of overcapacity have become stronger, and with market conditions deteriorating, the U.S.-China trade friction intensified, increasing the risk of a downturn in exports. As a result, companies concerned about worsening profitability were forced to become more cautious about making new investments. Another factor weighing on capital expenditure is that the central government has become keener to curb over-generous investment subsidy packages from regional governments.

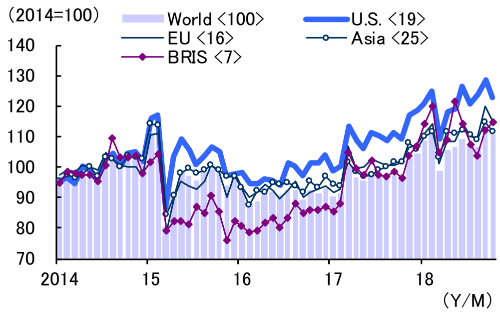
The U.S.-China trade friction has had a negative impact on the auto market. In October, the number of new vehicles sold dropped 11.7% year on year, marking the third straight month of year-on-year decline. In addition to the end of tax breaks on small cars, other influences have been the slump in stock prices and reluctance to purchase American cars. In fact, sales of U.S-branded vehicles plummeted by 26.7% in the same month.

<Automobile Sales (YoY)>



Source: The Japan Research Institute, Ltd, based on China Association of Automobile Manufacturers

<Export (Seasonally-adjusted, USD)>



Source: The Japan Research Institute, Ltd, based on General Administration of Customs of China

Note 1: Figures in < > denote 2017 share

Note 2: BRIS: Brazil, Russia, India, South Africa

■ Sharp growth slowdown expected to be avoided

Looking ahead, the Chinese economy is expected to continue slowing down. The following two points are likely to weigh down on the economy.

The first is capital expenditure in the manufacturing sector. Investment expanded at a rapid pace during the past two years, so it will take a considerable amount of time to reduce the perception that there is overcapacity. Furthermore, a clear easing of the U.S.-China trade friction is still some way off. And until it happens, the manufacturing sector is expected to remain cautious about capital expenditure.

The second is exports. Exports to the U.S. have been robust thanks to the booming U.S. economy and the strong dollar. Going forward, however, hikes in import tariffs mean that export growth to the U.S. is expected to soften. In the past few months, the PMI, an indicator of new export orders in the manufacturing sector, has remained under 50, the threshold that denotes “neutral” territory, meaning that it is likely that total exports may soon top out.

However, a major growth stall is expected to be avoided. To begin with, if the U.S.-China trade friction doesn’t get any worse, exports will probably not decline significantly. This is because the tariffs already imposed only cover a limited range of products. Total exports to the U.S. of products subject to the tariffs that have already been imposed amount to $252.7 billion (steel/aluminum: $2.7 billion; industrial robots, semiconductors, etc.: $50 billion; household appliances etc.: $200 billion). Yet total exports from China are worth $2.3 trillion. Even with the pessimistic estimate that the $252.7 billion in exports to the U.S. falls by 50% as a result of the high tariffs, the drop in total exports will only be 5%. So the impact would be around one-quarter of the 20% plunge in total exports that occurred after the collapse of Lehman Brothers.

Although the increase from 10% to 25% in tariffs on $200 billion worth of Chinese products, which will take effect in early 2019, cannot be taken lightly, monetary and fiscal measures such as reductions in reserve-deposit ratios, refunds of value-added tax at the time of export, and reductions in personal income tax look capable of supporting the economy by offsetting the tariff hit.

The government has already made it clear that its emphasis is on stable growth. In July, President Xi Jinping, at a Politburo meeting, called for “six stabilities,” with economic stimulus packages to target six fields: employment, finance, trade, inward investment, fixed asset investment, and growth expectations

The first move the government made was monetary easing. The People’s Bank of China reduced the reserve-deposit ratio in April, June, and then again in October, and also begun guiding short-term interest rates lower. At a State Council Executive Meeting in July, the issuance of 1.35 trillion yuan worth of local-government bonds was approved, regional governments were asked to make use of surplus funds, and financial institutions were told to meet the funding needs of local financing vehicles. If the impact of these measures becomes evident, the growth of total social financing excluding RMB loans will bottom out, and infrastructure investment will make a gradual recovery.

In addition, various tax reductions are expected to help support the economy. To ease the tax burden on companies, the government reduced the rate of value-added tax in July. Furthermore, the amendment of the Individual Income Tax Law in January 2019 is also expected to boost consumption. Specifically, the basic deduction will be increase, the scope of application of low tax rates will be expanded, the scope of application of high tax rates will be reduced, and special deductions will be introduced for education expenses, medical expenses, interest on housing loans, rent, and elderly dependents. The increase in the basic deduction and the changes in the scope of application of income tax rates, which were implemented early in October, are predicted to reduce personal income tax payers as a proportion of urban workers from 44% to 15%. Although government finances will be put under pressure, an expansion in consumption, particularly of services, is expected to prop up the economy for the time being.

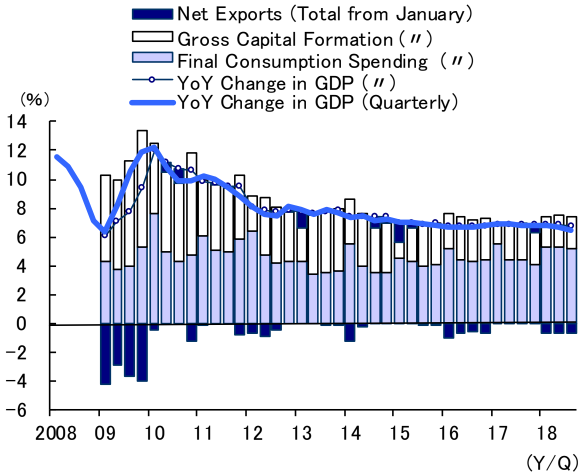
Furthermore, as additional economic stimulus measures, infrastructure investment may be further expanded, tax breaks on small cars may be reintroduced, corporate income taxes may be reduced, and the policy interest rate may be cut. The government is already preparing to fully mobilize fiscal and monetary policy. For example, the Ministry of Finance has put together a plan to once again reduce the rate of tax imposed on purchases of small cars.

＜Government's Economic Stimulus Measures＞

Date Announced	Details
April 25	Announcement of reduction in reserve-deposit ratio (implemented same day)
June 24	Announcement of reduction in reserve-deposit ratio (implemented July 5)
July 23	At a State Council Executive Meeting, the issuance of 1.35 trillion yuan worth of local-government bonds was approved, regional governments were asked to make use of surplus funds, and financial institutions were told to meet reasonable funding demand by local financing vehicles
July 31	President Xi Jinping, at a Politburo meeting, called for stability in six fields: employment, finance, trade, inward investment, fixed asset investment, and growth expectations
August 31	The Individual Income Tax reform bill passed the Standing Committee of the National People's Congress (China's parliament), and took partial effect in October (reduction in personal income tax)
October 7	Announcement of reduction in reserve-deposit ratio (implemented October 15)

Source: The Japan Research Institute, Ltd, based on press releases and media reports

＜Breakdown of Contributions to Real GDP Growth Rate (YoY)＞



Source: CEIC, National Bureau of Statistics of China

So while the U.S.-China trade friction will weigh heavily on the economy, with policy administration emphasizing stable growth, the real GDP growth rate is expected to be 6.6% in 2018 and 6.4% in 2019, so a sharp decline looks set to be avoided.

Of course, if the U.S.-China trade friction becomes more severe, it may be beyond the capabilities of the government to cope with it. On October 4, U.S. Vice President Pence strongly criticized China, and this is just another example of why it is difficult to expect a swift improvement in relations. The possibility that the U.S. will impose penal tariffs on all imports from China can also not be ruled out. The next step would be the U.S. to widely regulate the export of U.S-made components to China by, for example, citing security concerns. Because the manufacturing sector continues to account for a large share of the Chinese economy, if restrictions on both exports and imports were substantially strengthened in this way, the economy will probably become more likely to lose speed.

(Shinichi Seki)