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Asia: the uneven economic recovery and the supply-chain restructuring

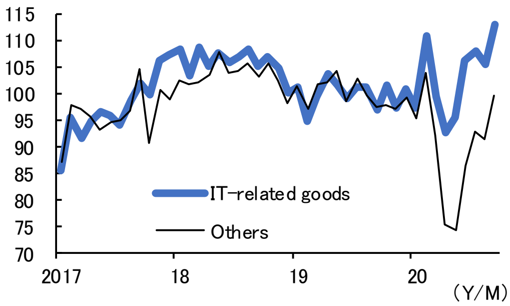
After deteriorating in 2020, the Asian economy will likely recover in 2021 and thereafter, but the pace of recovery could vary. For ASEAN ex Vietnam and India, accelerating supply chain realignment should be the key to a full-fledged recovery.

1. Economic outlook for Asia: ASEAN ex Vietnam and India remain in a difficult situation

The Asia economies bottomed out following their sharp deterioration in Q2 2020 due to the easing and lifting of restrictions on activities, and entered into a rebound phase with supports from special demand amid the Covid-19 pandemic.

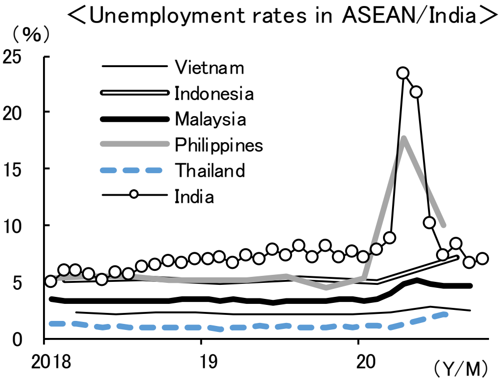
The situation on COVID-19 infection in Asian countries and regions as well as the countermeasures taken are not uniform. Some countries, such as China and Taiwan, aimed to thoroughly contain the virus, while others, such as India and the Philippines, eased restrictions on activities before the state of infection stabilized. It is difficult from an economic perspective for some counties to maintain their restrictions on activities while others judge that no such restrictions are necessary, despite differences in infection status. As a result, most countries in Asia have reached the common conclusion that they should move toward easing or lifting restrictions. In addition, special demand for medical and IT related products due to the COVID-19 pandemic continues. Demand for the former (e.g. masks, medical gloves, thermometers, etc.) led to a sharp increase in production mainly in China. Meanwhile, demand for the latter (e.g. PCs, servers and semiconductors) resulted in an increase in IT products-related goods' production in response to expanding implementation of telework worldwide, which has not only boosted exports from China but also from Taiwan, South Korea and Vietnam.

＜Exports of Asia ex China (USD, SA)＞



Source: JRI, based on CEIC
Note: IT-related goods are comprised of export goods categories including semiconductors, electrical/electronic equipment in Taiwan, Korea, Hong Kong, Thailand, Malaysia, Indonesia, Philippines, Vietnam, Singapore, and India.

＜Unemployment rates in ASEAN/India＞



Source: JRI, based on CEIC、CMIE

Overall, Asian economies are moving toward recovery. However, the pace of recovery has been uneven, and ASEAN ex Vietnam and India continue to face a difficult situation. In Q3 2020, year-on-year growth rates of real GDP were positive for China, Taiwan, and Vietnam, but negative for other countries. In the Philippines, GDP fell by 11.5% year-on-year, recording a double-digit decline for the second consecutive quarter.

As the factors exerting downward pressure on the economy will remain even after Q4 2020, ASEAN ex Vietnam and India will continue to lag behind. Firstly, the aftereffects of restrictions have placed downward pressure on activities. Unemployment rates have risen significantly in Indonesia and the Philippines, most recently recording rates of 7.1% (August) and 10% (July), respectively. They have remained at a considerably high level compared to the 2019 average of 5.12% and 5.05%. As exemplified by India, some areas are still designated as "containment zones" as the number of new coronavirus cases continues to increase. Therefore, restrictions on activities, albeit in part, have been exerting downward effects on the economies of some countries.

These countries have also been affected by weaker demand for non-medical/non-IT related goods as the developed economies have yet to return to levels seen prior to the COVID-19 outbreak. Furthermore, in ASEAN ex Vietnam and India, the export value of IT-related goods relative to GDP is smaller than that for Taiwan and Vietnam, and it is difficult for them to benefit from such exports.

In addition, destabilization of social conditions will weigh on the economy. In Thailand, demonstrations have been held after a court ordered the opposition party to dissolve in February. In

Indonesia, protests by labor unions against the Omnibus Law on Job Creation (amendments to laws related to 11 areas of labor and investment, including minimum wages, retirement allowance and unemployment compensation) continues. In Malaysia, the political turmoil has continued, with parliament intensifying its opposition to Prime Minister Muhyiddin Yassin.

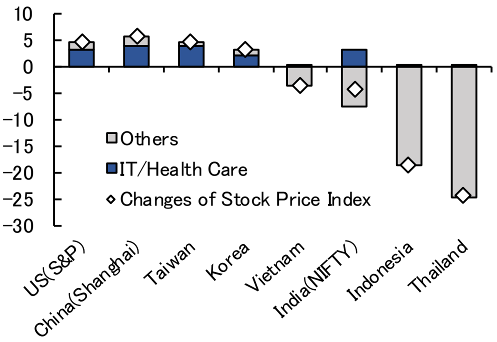
In the light of the above, it is highly likely that the pace of recovery will not improve for the time being due to (i) the aftereffects of restrictions placed on activities, (ii) sluggish external demand except for medical and IT-related products, and (iii) unstable social conditions. In 2020, we expect real GDP for the whole Asian economy to contract by 1.4%, mainly due to the sluggish economies of the ASEAN ex Vietnam and India. All countries are expected to have relatively high growth rates in 2021; however, this will simply reflect the reaction to the downturn experienced in 2020. Although the GDP of China, Taiwan, and Vietnam already exceeded the level prior to the outbreak of the COVID-19 as of Q3 2020 period, recovery for other countries will likely take a long time. Specifically, the GDP is not expected to return to the pre-coronavirus level until around mid-2021 for Korea, Malaysia and Indonesia, and around 2022 for India, the Philippines and Thailand specifically.

<Economic Growth Forecasts for Asia>

	2019	2020 (F)	2021 (F)	2022 (F)
Asia	**5.2**	**−1.4**	**7.4**	**4.8**
Northeast	5.5	1.5	7.5	4.7
China	6.1	1.8	8.2	5.1
Korea	2.0	−1.0	3.0	2.1
Taiwan	2.7	2.0	3.9	2.1
Hong Kong	−1.2	−6.0	2.7	2.2
Southeast/Sout	4.9	−6.1	7.2	4.9
ASEAN	4.8	−3.3	5.7	5.0
Thailand	2.4	−6.3	3.4	2.9
Malaysia	4.3	−5.2	6.4	4.5
Indonesia	5.0	−1.4	5.4	5.2
Philippines	6.0	−9.4	8.1	6.1
Vietnam	7.0	2.7	7.2	6.6
India (FY)	4.2	−10.6	11.0	5.5

Source: JRI

<Year-to-date Changes in Stock Prices : as of the End of October in 2020>



Source: JRI, based on CEIC, Bloomberg. L.P.
Note: The contributions of IT/Health Care are estimated by the companies' market capitalization in these sectors. Stock prices in Malaysia and Philippines where do not have breakdown in equity market declined by 7.7%, and 19.1% from the beginning of the year to the end of October.

Stock prices have also been sluggish in the ASEAN ex Vietnam and India. At the time of the financial crisis in 2008, excessive liquidity was generated due to large-scale monetary easing on a global scale, and the funds flowed to emerging countries where high growth was expected. However, this time the situation is different. After 2009, stock indices for emerging economies, including Asia, bottomed out earlier than those of developed countries and rose rapidly thereafter. However, although stock prices in China, South Korea, and Taiwan are recovering with supports of good performance of IT and medical related companies in 2020, stock prices in Indonesia and Thailand remain sluggish. In other words, in 2009 when the same excess liquidity boosted financial market, funds flowed into emerging economies, but funds flowed selectively into cutting-edge fields such as IT and medical care in 2020. Expectations for growth in ASEAN and India, which lag behind in the growth of cutting-edge fields, are weak amid the COVID-19 pandemic.

2. Supply chain restructuring will be the key to reviving the ASEAN/India economies

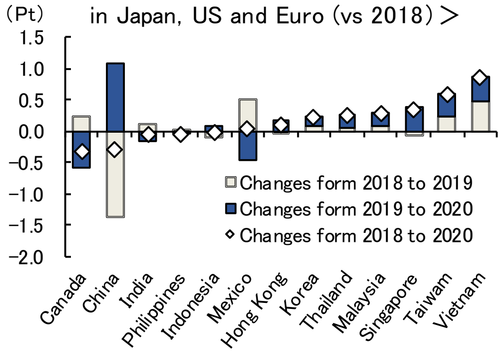
As described above, although the economy has bottomed out, it is difficult to see any signs of a strong recovery in ASEAN ex Vietnam and India. Under such circumstances, the shift of production bases by companies through supply chain restructuring is expected to boost the economy. Based on media reports, U.S. high-tech companies (e.g. Apple Inc. etc) have shifted their production bases from China to Vietnam, India, Thailand and Malaysia over the past three years, indicating that a growing number of developed countries are moving to rectify their overreliance on China for production bases. In countries to which production bases have been transferred, the increase in inward foreign direct investment (FDI) is expected to lead to an increase in export competitiveness as well as the strengthening of high-tech industries. In fact, the Vietnamese economy has already benefited greatly.

Excluding Vietnam, however, moves to reorganize supply chains are facing headwinds. As shown by changes in the share of imports from various countries to the United States, Europe, and Japan since 2019, exports from Vietnam have rapidly expanded, but other ASEAN countries and India have seen only small movement.

Three factors have contributed to this disparity. The first is the recovery of China's production amid the COVID-19 pandemic. Although production in China had been facing a backlash due to conflict with the United States, China's share regarding imports to the United States, Europe, and Japan has been rapidly recovering. As mentioned above, the COVID-19 pandemic resulted in special demand in the medical and IT sectors, which accelerated China's production recovery. The fact that China originally made up a large share of imports of masks and other medical goods which experienced supply shortages was advantageous, but it is also certainly true that China had established a system to supply such goods to the world in a short period of time.

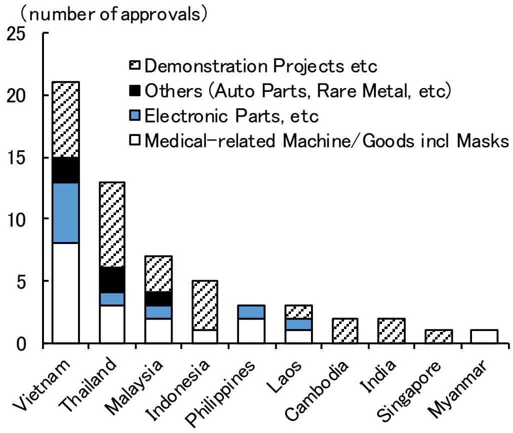
Second, the postponement of FDI also had significant impact. Even in Vietnam, growth in FDI has been sluggish since the beginning of this year, with the Ministry of Planning and Investment stating, "There have been cases in which foreign investors were unable to conduct business travel and where investment decisions were delayed or reviewed." This does not apply only to Vietnam. In fact, the COVID-19 pandemic made it difficult for people to travel, and large-scale investment will likely slow down for the time being, although small-scale investment such as expansion of existing production lines will continue.

＜Changes of Import Shares by Country in Japan, US and Euro (vs 2018)＞



Source: JRI, based on CEIC
Note: The data show changes of shares in aggregate imports of Japan, US and Euro Area. Shares in 2020 are calculated from average imports from January to July.

＜Supports for Manufacturing Supply Chain Diversification by Japanese Govt＞



Source: JRI, based on JETRO

The third factor is the impact of the economic downturn and social disorder described above. Even companies that are considering to move their production bases to other parts of the world are hesitant to expand into areas with growing uncertainty. Moreover, from the viewpoint of cost and efficiency, many companies are focusing on local production and local consumption as part of their local production strategy, and many companies are not expected to enter markets where demand is declining. Vietnam has steadily gained an advantage from attracting foreign companies through its low wages and the aggressive moves to conclude free trade agreements (FTAs). The advantages of Vietnam in terms of the stable economic growth and social stability are particularly prominent in the wake of the COVID-19 pandemic, which may be one reason why Vietnam has emerged as an attractive production base.

Against this backdrop, it will be important for ASEAN ex Vietnam and India to actively promote policies to increase their attractiveness to entice businesses and promote free trade agreements. In October, the Omnibus Law on Job Creation, which aims to attract investment, was passed by Indonesia's People's Representative Council (DPR). Furthermore, in November, agreement was reached on the RCEP (Regional Comprehensive Economic Partnership in East Asia), which is an important event for companies planning to transfer their production bases. This also serves as a tailwind for improving the business environment.

In the U.S., a new administration will be inaugurated early 2021, but there will be no change in the U.S.' hawkish stance on China, and there is a strong possibility that the U.S.-China confrontation, particularly in the high-tech field, will continue. It should be noted that opportunities for U.S. companies to shift their production bases from China and reorganize their supply chains will increase in the future. In addition, the Japanese government, which has taken issue with the limited supplies of medical products in the wake of the COVID-19 pandemic, will earmark 23.5 billion yen for the “Overseas Supply Chain Diversification Support Program” to support a shift of production bases and promote business development of several companies in ASEAN nations and India. South Korea also plans to strengthen its relations with ASEAN nations and India under its "New South Policy." Whether or not the destinations for the transfer of production bases from China will expand beyond Vietnam will be a focal point of discussion when looking at the Asian economy in 2021 and thereafter.

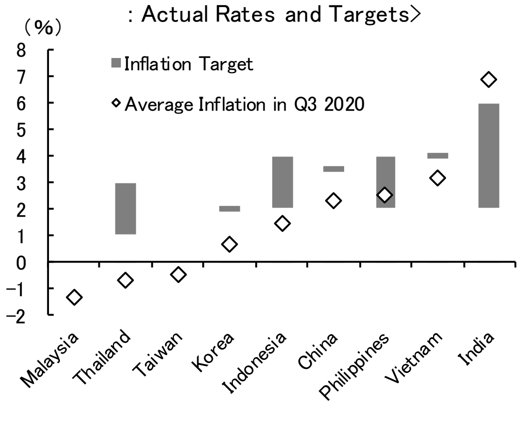
3. Fiscal and monetary policy: ASEAN and India will likely keep easing policy

Currently, there are differences in fiscal and monetary policies between Northeast Asia and ASEAN nations and India in accordance with their economic disparities. Policy responses by Asian and regional authorities could affect medium-term economic trends.

In Northeast Asia, a general tightening trend is evident. For example, with regard to fiscal policy, South Korea announced in October that it would maintain fiscal discipline by limiting the balance of government debt and the budget deficit to 60% and 3% of GDP, respectively, after 2025. As for monetary policy, although inflation rates are low in China, South Korea, Taiwan, and Vietnam, asset prices, including those for real estate, have risen markedly, reducing the possibility of further monetary easing. In fact, although there has been no change in the interest rate policy in China, the central bank has begun to tighten its policy by guiding short-term market interest rates higher. Meanwhile, Vietnam was labeled as a currency manipulator in the U.S. Treasury Department’s foreign exchange report, raising tensions in trade relations between the two countries. Although monetary easing has continued since the beginning of this year, there is a possibility that Vietnam may try to ease tensions by tightening its monetary policy and taking a stance to correct its currency depreciation.

On the other hand, the opposite trend is being seen in ASEAN ex Vietnam and India. In its fiscal policy, Indonesia announced in March that it would shelve its fiscal discipline rule of keeping its fiscal deficit within 3% of GDP for a limited period of three years from 2020. Also, in July, Indonesia government agreed with the central bank regarding the direct underwriting of government bonds, and Indonesia’s central bank directly purchased government bonds worth about 400 trillion rupiahs (3.8% of GDP) using this normally prohibited method. Monetary policy is also expected to continue easing. While interest rate cuts were concentrated in various countries around the world in the first half of 2020, Indonesia and the Philippines strengthened their accommodative stance even in the second half of the year by implementing additional interest rate cuts in November. Relatively stable foreign exchange markets and low inflation have given them room for monetary easing. India's inflation rate has remained high and it is unable to take active steps to ease its monetary policy. However, it apparently wants to rely on monetary easing to support its economy if the situation permits.

＜Inflation in Asia : Actual Rates and Targets＞



Source: JRI, based on CEIC
Note: Targets for Thailand, Korea, Indonesia, Philippines, and India are set by central banks, while those for China and Vietnam are set by the governments. There is no inflation target in Malaysia and Taiwan.

As shown above, there have been contrasting policy stances. In the short term, fiscal and monetary tightening will increase the risk of economic slowdown in Northeast Asia, while ASEAN ex Vietnam and India, could reduce the risk of economic downturn by maintaining and expanding fiscal and monetary easing. However, after 2022, the U.S. will become more aware of the need to normalize its monetary policy by tapering its asset purchases, and it is assumed that downward pressure on Asian currencies and the risk of capital outflow will increase as a result. In this case, it should be noted that the latter is more likely to bear medium-term economic and financial risks.

(Minoru Nogimori)

NIEs The economy rebounded on strong IT-related demand

■ 2021 will see a high growth rate of +3.2%

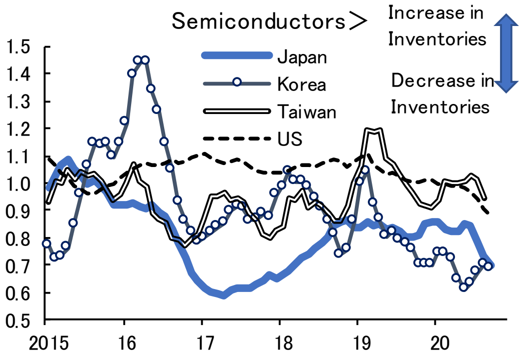
The real GDP growth rate of NIEs (South Korea, Taiwan and Hong Kong) for 2020 is expected to decline by 0.6% year-on-year, shifting to negative growth from the positive growth of +1.8% in 2019. However, with the exception of Hong Kong, the degree of economic deterioration in NIEs was relatively small despite the restriction in economic activity due to the spread of the COVID-19 and the significant deterioration in the global economy. This is because demand for IT products (e.g. personal computers) contributed to an increase in exports from Taiwan and South Korea as it surged due to an increase in telework amid the COVID-19 pandemic. Moreover, China, NIEs' largest trading partner, achieved economic recovery ahead of other countries, which positively influenced the economies. Although there is no prospect for a recovery in the retail and travel industries, the recovery of goods trade mainly with China has supported the NIEs economy.

＜GDP Growth Forecasts for NIEs＞ (%)

	2017	2018	2019	2020 (F)	2021 (F)	2022 (F)
NIEs	3.3	2.9	1.8	−0.6	3.2	2.1
Korea	3.2	2.9	2.0	−1.0	3.0	2.1
Taiwan	3.3	2.7	2.7	2.0	3.9	2.1
Hong Kong	3.8	2.8	−1.2	−6.0	2.7	2.2

Source:JRI, based on Government Statistics

＜Inventory/Shipments Ratios for Semiconductors＞



Source: JRI, based on CEIC
Note: Inventory/shipments ratio is calculated by the dividing inventory index by the shipment index. 3-month moving average.

In 2021, NIEs are expected to strengthen their recovery trend. South Korea, Taiwan, and Hong Kong each introduced strict infection control measures since the beginning of the outbreak of the COVID-19, and have generally succeeded in controlling the number of cases, which will result in a lower risk of severe restrictions on economic activity going forward. As for IT-related goods, in addition to demand for personal computers for telework, the demand is anticipated to increase for 5G-compatible mobile phones and remote control and automatic operation systems as the introduction of 5G begins in earnest. Correspondingly, demand for semiconductors will continue to increase, which will act as a tailwind for Taiwan’s and South Korea’s exports. In fact, the ratio of inventories to shipments of semiconductors in the major semiconductor producing countries has been declining or remained at a low level, indicating tight supply-demand balance. Additionally, the strength of Chinese consumption is expected to return, which will benefit NIEs countries and regions. Overall, the NIEs economy in 2021 will likely perform well thanks to the virtuous cycle of IT-related demand and the recovery of the Chinese economy, with real GDP growth forecast for 3.2% higher than the previous year. Then, in 2022, real GDP growth is expected to settle down to cruising speed at a growth rate of 2.1%.

Attention should also be paid to the new U.S. administration that will emerge in early 2021. The Democratic Party of the U.S. has been criticizing China over several issues such as human rights, and there is therefore a risk that sanctions for related areas against China will be tightened. In addition, although a series of sanctions by additional tariffs may be eased in the future, the U.S. remains wary of China with regard to the high-tech field, and the possibility of additional sanctions cannot be ruled out. In this case, downward pressure on the economy would increase, not only in China but also in NIEs countries.

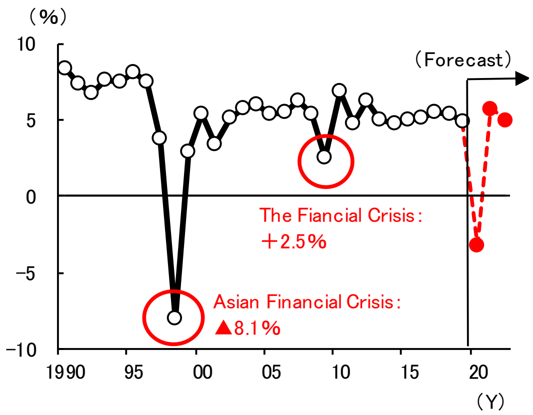
(Minoru Nogimori)

ASEAN Vietnam serves as the driving force

■ The ASEAN5 economy worsened in 2020 due to the outbreak of the novel coronavirus

In 2020, the real GDP growth rate of ASEAN5 (Indonesia, Malaysia, Philippines, Thailand, and Vietnam) dropped 3.3% from the previous year, which is expected to be the worst economic downturn since the Asian Financial crisis of 1998, when the growth rate dropped 8.1%. As a result of the global outbreak of the novel coronavirus since the beginning of 2020, the economies of the ASEAN5 countries were greatly affected by the introduction of strict restriction placed on activities, including curfews. Although some sectors benefited from increased demand for some products, such as medical products and IT-related products due to the rapid spread of telework, downward pressure due to restrictions placed on activities greatly surpassed such benefits, and economic activity as a whole fell sharply.

<Real GDP Growth in ASEAN5>

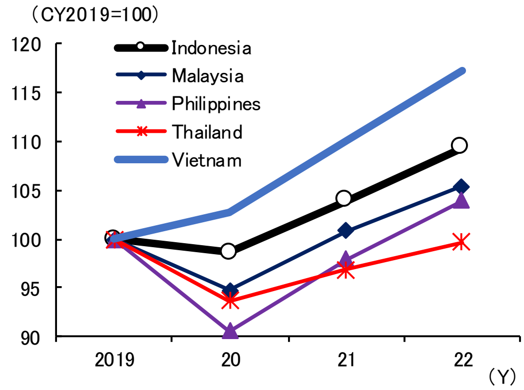


Source : Prepared by The japan Research Institute, Limited based on each country's statistics, IMF,CEIC
Note : ASEAN5 is the weight average value.

■ The ASEAN5 economy is gradually recovering

In 2021 and thereafter, the ASEAN5 economy is expected to show positive growth, with real GDP growth expected to reach +5.7% year-on-year in 2021 and +5.0% year-on-year in 2022. As for domestic demand, although it will take time to lift the restrictions on activities completely, it is forecast that the easing trend will continue and that economic activity will gradually increase. In addition, infrastructure investment will likely expand, which will play an important role in boosting the economy as a measure to stimulate demand, as well as raising employment. Furthermore, the spread of telework and growing demand for telecommunications infrastructure such as 5G will help to maintain momentum in IT-related exports, particularly in Vietnam, which has an advantage in this field, thereby supporting economic recovery in the region. As the global economy recovers at a moderate pace, the recovery in exports is expected to gradually spread not only to IT and medical services, but to all industries.

<Real GDP in ASEAN5>



Source: Prepared by The Japan Research Institute, Limited based on each coutry's statistics

On the other hand, there are also downside risks, and attention should be paid to the following two points. First, many ASEAN5 countries still have vulnerable healthcare systems, and if the number of coronavirus cases surges again, ASEAN5 governments will be forced to tighten restrictions on activities once again. The second problem is political and social turmoil. If recent demonstrations in Thailand and Indonesia and political turmoil in Malaysia escalate, economic recovery in these countries could be hampered.

■ Vietnam's dominance will likely continue

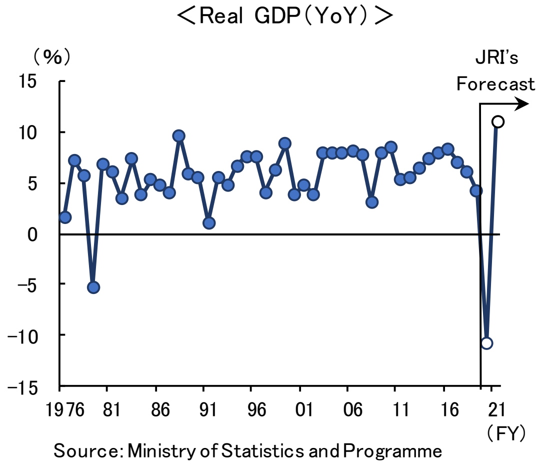
A comparison of recent economic trends within ASEAN5 shows that while many countries affected by restrictions on activities amid the outbreak of the novel coronavirus experienced negative growth, only Vietnam continued with positive growth as the "sole winner." This pattern is expected to continue for the time being on the back of Vietnam’s thorough measures to combat the coronavirus and successful accumulation of production bases for the electrical and electronics industries.

(Yuta Tsukada)

India Economic recovery entails downside risks

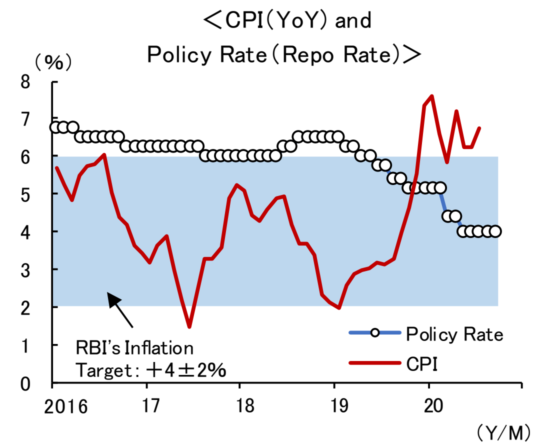
■ The growth rate for fiscal 2020 is estimated to be -10.6%

The Indian economy deteriorated rapidly through the beginning of the spring of 2020, mainly due to its strict lockdown measures aimed at curbing the spread of the novel coronavirus. Although the economy then bottomed out as economic activity gradually resumed, the pace of recovery remained slow due to continued restrictions on economic activity in areas designated as "containment zones" and independent lockdowns by state governments. As a result, India's real GDP in the April-June 2020 period fell 23% from the same period of the previous year, recording its largest decline ever.



Source: Ministry of Statistics and Programme Implementation

Since September, the spread of the novel coronavirus in India has subsided, and economic recovery is expected to continue together with the further easing of restrictions on activities. However, due to the country's fragile medical infrastructure, the government will remain vigilant against a coronavirus "second wave" and "third wave" until its vaccine development and supply system are established, and restrictions on activities with the aim of preventing the spread of the virus will remain to some extent. The pace of economic recovery will therefore continue to be low. The real GDP growth rate for fiscal 2020 (April 2020 through March 2021) is estimated to be minus 10.6%, a sharp drop that exceeds the level seen in fiscal 1979 when the economy worsened rapidly due to the great drought and the second oil shock.



Source: Reserve Bank of India

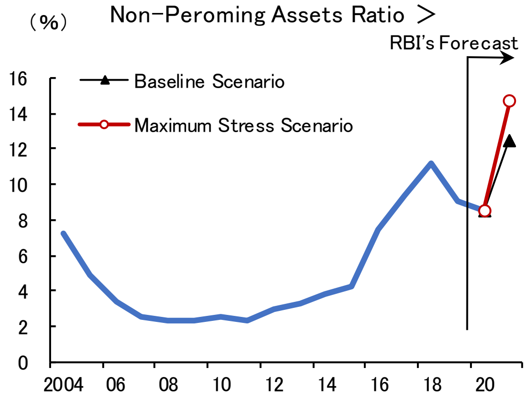
As for price trends, the rate of inflation has continued to exceed the Reserve Bank of India's target due to food shortages stemming from disruptions in the interstate supply chain and higher fuel taxes for the purpose of securing tax revenue. Under such circumstances, the Reserve Bank of India lowered its policy rate by 1.15% in total during the first half of 2020 in line with interest rate cuts in various countries. However, the policy rate has remained unchanged since then due to concerns about stagflation. Since the latter half of August, aiming to curb inflation by raising short-term interest rates and stimulate the economy by lowering long-term interest rates, the government has implemented a twist operation in which government bonds with long maturity are purchased, while the same amount of government bonds with short maturity are sold. However, the effect of this policy is uncertain, partly because India's inflation rate is sensitive to food prices.

Fortunately, this year's monsoon season (June to September) saw good weather compared to previous years, and the resulting increase in crop production brought about downward pressure on food prices. Nonetheless, the slowdown in the inflation rate during the year will be moderate because price pressure remains due to the locust plague (agricultural damage caused by a grasshopper outbreak) in northwest India and other countries.

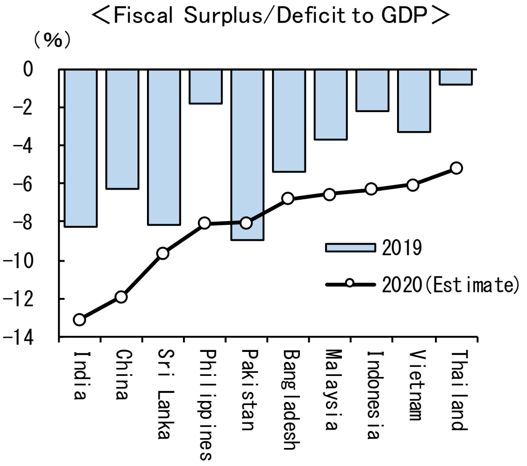
■ Growth rate for fiscal 2021 is predicted to be +11.0%

The Indian economy is expected to continue on a recovery trend even after the beginning of fiscal 2021, mainly due to the gradual easing of restrictions on economic activities and global economic recovery. The real GDP growth rate is expected to increase by double digits, up 11.0% on a year-on-year basis, due to the rebound from the previous year, but the downside risk is expected to remain high amid financial and fiscal constraint.

In the financial sector, the risk of destabilization of the financial system is increasing due to the deterioration of financial institutions' balance sheets caused by the economic downturn and the moratorium on debt repayments announced as economic measures for individuals and companies. The Reserve Bank of India said in its July financial stability report that the NPA ratio of commercial banks would rise to the 10% level by 2021 and that some banks would suffer from a capital shortage. Furthermore, since the real GDP growth rate in fiscal 2020 is projected to be worse than the forecast detailed in the report (minus 4.4% and minus 8.9%, respectively, according to the baseline scenario and maximum stress scenario), there is a greater risk that the NPA problem will be worse than the forecast. If the business environment for commercial banks deteriorates, the liquidity risk of nonbanks, which depend on loans and investments from commercial banks for the most part, will increase. Therefore, the default of nonbanks could lead to a situation in which lending attitudes of financial institutions become more stringent amid the spread of credit unrest throughout the financial markets, as was the case between 2018 and 2019, thereby constraining economic growth in terms of fund provision.



Souce: Reserve Bank of India



Source: IMF "World Economic Outlook 2020 October"

In addition, boosting of the economy cannot be expected from a fiscal perspective due to the large fiscal deficit. India's general government budget deficit and outstanding debt as a percentage of nominal GDP are high among major emerging countries in Asia, and fiscal consolidation has long been an important issue. However, further expansion of the budget deficit is unavoidable this fiscal year due to a decrease in tax revenue caused by the economic downturn. Therefore, the government is cautious about implementing economic stimulus measures. In May 2020, the government drew up a large-scale economic stimulus package worth 20 trillion rupees (equivalent to 10% of nominal GDP), focusing on projects that do not involve direct fiscal spending, such as credit guarantees for small and medium-sized enterprise loans and long-term funds-supplying operations by the Reserve Bank of India.

On the political front, the Modi administration continues to enjoy high approval ratings despite the economic downturn, against the backdrop of its hard-line stance toward China over border issues and growing emphasis on Hindu supremacy. However, such a political stance carries risks such as hindering the supply of cheap intermediate goods from China and intensifying religious conflict.

Given the various downside risks, India's ability to return to a high-growth path hinges on whether it can take the coronavirus pandemic as an opportunity for fundamental reform and implement reforms that have been stagnant so far, such as facilitating expropriation of land in order to promote direct investment in the manufacturing sector, easing restrictions on dismissal, and improving the management efficiency of state banks.

(Shotaro Kumagai)

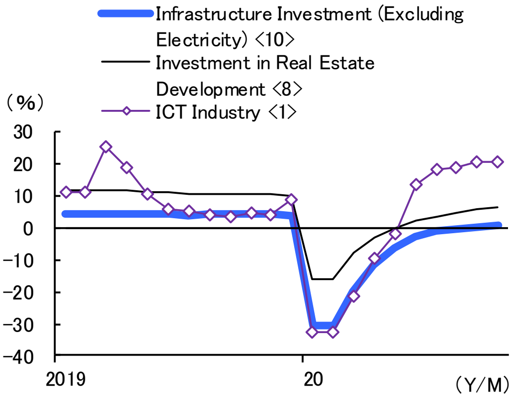
China China's growth rate for 2021 is expected to recover to +8.2%

■ China's economy will rebound ahead of the rest of the world

In China, the real GDP growth rate for the July-September quarter of 2020 increased by 4.9% from the same period of the previous year, marking its second consecutive quarterly increase. In the January-March quarter, the Chinese economy fell into negative growth due to the novel coronavirus pandemic for the first time since 1992 when quarterly statistics became available, but has recovered ahead of Japan, the United States, and Europe.

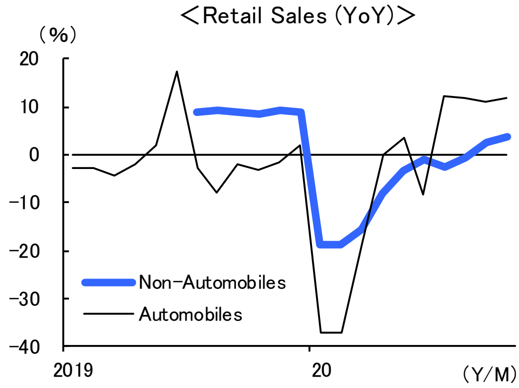
The following three points are of note as the background behind this. The first is the government's direction to resume activities starting from an early stage. Although the Chinese government imposed strict restrictions on economic activities in January, it directed their resumption in February after thoroughly monitoring the infection status of the Chinese people. Industrial production recovered to the same level as the previous year as early as March as state-owned enterprises and other companies rushed to resume operations. Regarding the early stages of recovery of the Chinese economy from the coronavirus pandemic, recovery on the supply side was more pronounced than on the demand side.

<Fixed Income Investment (YTD, YoY)>



Source: "National Fixed Asset Investment" and "National Real Estate Development Investment and Sales Report" by the National Bureau of Statistics
Note: Figures in parentheses < > indicate the share of GDP.

<Retail Sales (YoY)>



Source: "Total Retail Sales of Consumer Goods" by the National Bureau of Statistics of China
Note: Figures for January and February are the total of January and February.

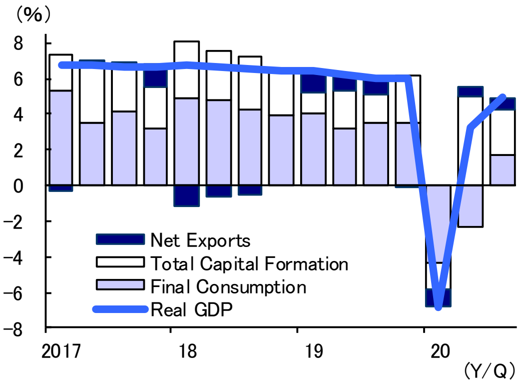
The second point regarding China's accelerated recovery pertains to its economic measures. In February, the government ordered the implementation of an infrastructure investment plan ahead of schedule in order to boost the economy. The government increased the issuance of local government bonds by 1.6 trillion yuan compared to last year in order to significantly expand financial resources for investment in 5G and new energy, while substantially boosting the amounts of industrial subsidies. At the National People's Congress in May, the government decided to raise the ratio of the fiscal deficit to GDP for this year to more than 3.6% in order to secure funds for protecting employment and providing financial support, through reductions and exemptions of social security expenses for companies and tax cuts.

On the financial front, in February and April, the People's Bank of China lowered the LPR (Loan Prime Rate), which had been set as the new policy interest rate since August of last year. In addition, the Bank increased the supply of funds in the interbank market and induced market interest rates to fall. Moreover, the Chinese government supported small and medium-sized enterprises that were facing financial difficulty through the expansion of loans by state-owned banks to small and medium-sized enterprises and the postponement of interest payments by companies.

The recovery in investment in infrastructure, real estate, and information and communications came on the back of the government's fiscal stimulus and monetary easing. During the January-February period, China's investment dropped 30% from the same period last year, but during the January-October period, it recovered to the same level on a year-on-year basis. Fixed asset investment such as investment in real estate development and in the ICT industry recovered to significantly higher levels than the previous year. Automobile sales have also been strong, with sales in October posting double-digit growth for the fourth straight month. The government's policies have had positive effects on these results. On top of the actualization of demand which had been suppressed due to the restrictions placed on outings, people tended to refrain from using public transportation. Amid this situation, demand was stimulated by the government's decision to ease regulations on the purchase of cars and to provide subsidies for automobile purchases.

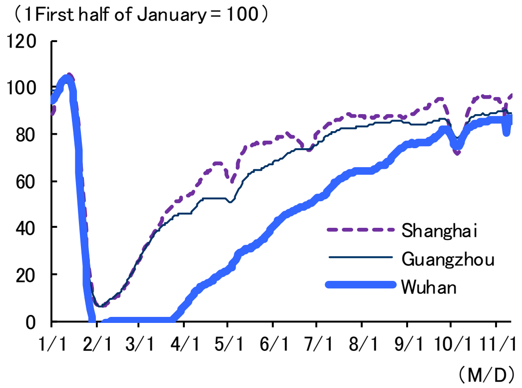
The third point regarding China's accelerated recovery is the recovery of external demand. China's exports recovered to levels that were higher than those prior to the novel coronavirus outbreak, reflecting resumption in overseas economic activity and growing demand for telecommunications equipment. China's exports of computers and peripherals are at record levels, and exports of textiles and toys are recovering steadily.

<Real GDP Growth Rate (YoY)>



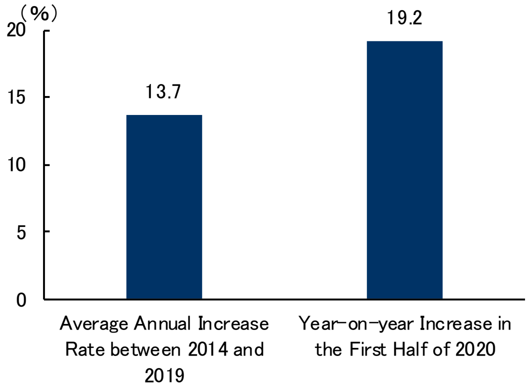
Source: CEIC, "System of National Accounts" by the National Bureau of Statistics of China

<Number of Subway Passengers (HP Filter)>



Source: Prepared by The Japan Research Institute, Ltd, based on "Subway Traffic Volume" by the Wind Database

<Rate of Increase in Industrial Subsidies>



Source: Prepared by The Japan Research Institute, Ltd, based on the annual reports of 4,019 listed companies and the Wind Database

■ Movement toward normalization will likely continue

Future prospects indicate that the economic engine is expected to shift from investment to consumption. Looking at the degree of contribution to GDP by demand item, gross capital formation and net exports as well as final consumption turned positive during the July-September quarter. As progress is made in the development of COVID-19 vaccines, the negative impact of the novel coronavirus is anticipated to ease going forward and the contribution of final consumption to GDP will likely increase further. The Chinese government is working hard to develop vaccines, with large-scale trials underway. Currently, there are four vaccines at the phase just prior to formal approval. Some local governments, including the city of Shaoxing in Zhejiang Province, have already started accepting applications for vaccinations from residents.

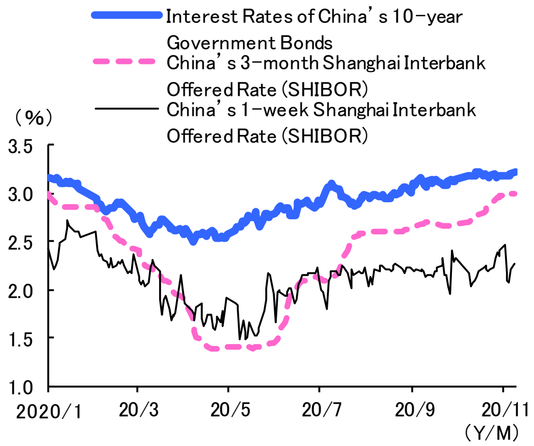
While consumption has been on a recovery trend amid an increase in the number of people out and about, consumer spending is still affected by the novel coronavirus. The growth of retail sales, which had been growing about 8% year-over-year prior to the virus outbreak, remains around 4% year-on-year. In addition, the number of travelers during the National Day holidays in October dropped 20% from that of the previous year, indicating further room for improvement in service consumption if consumer fear can be overcome.

In addition, investment in 5G and new energy will likely continue to support the Chinese economy. Although the U.S. government had asked China to drastically review industrial subsidies, the amount of subsidies companies received from the government has increased significantly. In fact, the total amount of subsidies for all 4,019 listed companies in the first half of this year increased by 19.2% from the same period last year, up from an average annual increase rate of 13.7% between 2014 and 2019.

China's new "dual circulation" economic development model suggests that the government will continue to provide generous support in the high-tech sector. While the U.S. government is expected to continue taking a tough stance against China, the Chinese government plans to reduce its dependence on the United States for strategic materials such as semiconductors used in 5G base stations by expanding its subsidy system and strengthening relations with emerging countries; thus strengthening China's self-sufficiency (reinforcement of the supply chain).

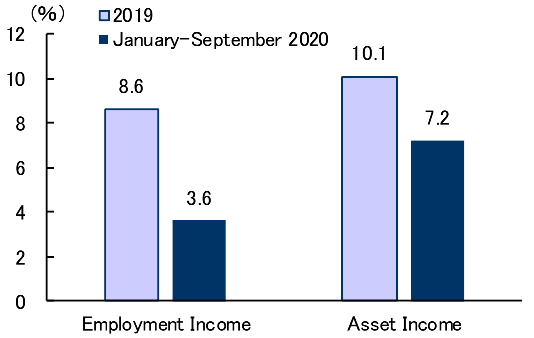
On the other hand, although the U.S. government had announced various sanctions against China, the resulting negative impact on the Chinese economy is thought to be limited. Despite friction between the United States and China, China's nominal income in 2019 increased nearly 10% from the previous year. Exports to the United States have also returned to levels before the United States raised tariffs in 2018. The U.S. government banned parts exports from U.S. companies to Huawei, but sooner or later, other Chinese companies are expected to supply equipment on behalf of Huawei.

<Interest Rates of Major Markets>



Source: National Interbank Funding Center

<Employment Income and Asset Income (YoY)>



Source: Prepared by The Japan Research Institute, Ltd, based on "Per Capita Disposable Income of Chinese Residents" by the National Bureau of Statistics of China

■ Some concerns remain

Meanwhile, the following two points can be noted as causes of concern in China.

First, the effects of the economic measures are expected to decline. The Chinese authorities have become the first in the world to tighten monetary policy to prevent the asset bubble from expanding. As a result of higher short-term interest rates, interbank lending rates, which are regarded as principal market rates, bottomed out in April and started to rise thereafter. Other major market interest rates, such as the three-month SHIBOR, are also on an upward trend. Even if monetary tightening is moderate, it will weigh on private fixed asset investment, real estate development investment, and housing sales in the future, given the lingering effects of the coronavirus pandemic on the economy.

As for fiscal policy, the purchase subsidy of 3,000 yuan per car provided by Guangzhou City in Guangdong Province is scheduled to end at the end of 2020. The subsidy, in which Hubei Province pays 3% of the purchase price per vehicle, will terminate at the end of March 2021. In other regions, demand is expected to surge ahead of the end of the subsidy program, which will be followed by a reactionary decline after the end of the program.

Second, the widening gap caused by the coronavirus pandemic may hinder economic recovery. In the first half of this year, the number of state-owned enterprises in the red increased only 10% from the same period last year thanks to economic measures, while the number of private enterprises in the red increased 30% from the same period last year. The recovery in employment income has been slow, due mainly to deteriorating earnings from private companies. On the other hand, asset inflation following monetary easing has led to a remarkable recovery in asset income. The growth rate of median disposable income has also been lower than the average growth rate. The outbreak of the novel coronavirus has widened the income gap. Amid these developments, there has been a polarization in consumption and a delay in demand recovery for goods and services in the low to middle price range. The Producer Price Index (PPI) for clothing and daily necessities was lower than the previous year due to the delay in demand recovery. Looking at the CPI growth rate, service prices, which had been up 1.2% year-on-year in December of last year, fell to 0.3% year-on-year in October of this year. On the other hand, sales of luxury cars rose 30% in October from a year earlier, far exceeding the 8% year-on-year increase seen for all passenger cars. High-priced goods and services are recovering rapidly, also helped by a shift in spending from overseas travel to domestic consumption.

Overall, looking at the Chinese economy going into next year, the growth rate for the October-December quarter is expected to rise to +5.6%. As a result, the annual growth rate for 2020 is forecast to be +1.8%. Given the lower growth level in the previous year, it is estimated that the Chinese economy will grow by 8.2% year-on-year in 2021 due to a slight reactionary increase. Although the annual growth rate will fluctuate significantly, the quarterly growth rate will most likely maintain the potential growth rate due in part to policy guidance through economic stimulus measures.

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(Shinichi Seki)