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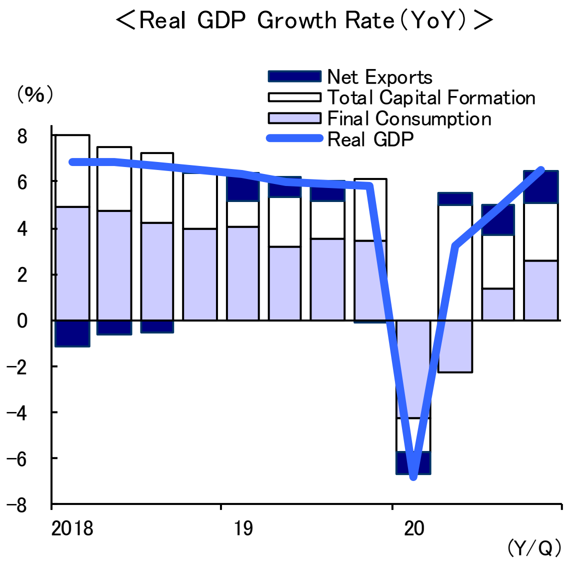
Topics *What is the outlook of the Chinese economy in 2021?*

The Chinese economy has been recovering ahead of the rest of the world. Looking ahead, the consumption stimulus measures are expected to ease downward pressure on the economy due to the restrictions on activities, while the investment control measures are anticipated to gradually cool down overheated economic activity in certain areas.

■ The Chinese economy is overheating, mainly in the area of investment

The Chinese economy has been recovering steadily despite stagnation of the global economy, with some recent signs of overheating. The real GDP growth rate for the October-December 2020 period increased by 6.5% from the same period of the previous year, which was higher than the potential growth rate of around 5%. Although the credibility of China's GDP statistics has been questioned, exports from major countries to China and business recovery by Japanese companies in China are evident. China's trade statistics, which have a relatively high degree of credibility, show that imports of capital goods are expanding at a much faster pace than the trend, indicating that the economy is overheating.



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

By sector, prominent signs of overheating can be seen in capital investment by state-owned enterprises. State-owned enterprises are rapidly increasing their capital investment in response to the government's desire for an early economic recovery from the COVID-19 pandemic. The government's fiscal stimulus and monetary easing have supported capital investment, and this trend has not changed in high-tech sectors such as telecommunications and new energy, as well as in sectors with excess capacity and debt such as the steel industry.

The real estate market remains in a bubble. The easing of monetary policy in response to the COVID-19 pandemic has expanded floor space for housing sales to a level well above that before the outbreak of COVID-19. In addition to overdevelopment by real estate developers, soaring real estate prices have become a problem.

In addition, there are strong signs of overheating in the areas of luxury cars and white sake. Subsidies for car purchases are being provided by local governments, and there is a movement toward choosing to travel by private car to avoid public transportation. As a result, the total number of passenger cars sold in December 2020 increased 6.6% from the same month of the previous year. Sales of luxury cars in particular rose 26.0% on a year-on-year basis. The reasons for this include a sharp increase in asset income mainly among high-net-worth individuals due to the rise in global asset prices, and a shift in consumption of services such as overseas travel to luxury cars.

Exports have also been growing at a faster than expected pace. Demand for telecommunications equipment such as personal computers, tablets, monitors and data servers, is growing significantly on a global scale, while demand for masks and medical supplies remains strong.

On the other hand, there has been a delay in the recovery of service consumption due to restrictions on activities to prevent a resurgence of COVID-19 infections. While retail sales had been increasing by about 8% year-on-year before the COVID-19 outbreak, annual growth has remained at a 4% level due to the decline in the number of social outings.

■ The government is taking a stance of boosting consumption while curbing investment

As for future prospects, tighter restrictions on activities are expected to put downward pressure on the economy. Since the beginning of the year, the number of new COVID-19 cases has increased, and the government has again tightened restrictions on movement, particularly across provinces, cities and autonomous regions. In Hebei Province in particular, strict restrictions were imposed. The government also called on people to refrain from returning to their hometowns during the Spring Festival holiday.

However, consumption stimulus measures are expected to offset to some extent the downward pressure on the economy due to restrictions on activities. Local governments are actively distributing regional gift certificates and admission tickets to local tourist spots to stimulate consumption. With limited restrictions on activities in each province, city, and autonomous region, retail sales for this year's Spring Festival holiday increased by 28.7% compared to 2020, and by 4.9% compared to 2019. The government also announced in January that it would expand subsidies for the purchase of automobiles, home appliances and furniture in rural areas.

Another reassuring factor is the steady improvement in employment and income conditions. In response to the government's intention to aim for an early recovery from the COVID-19 pandemic, competition to increase the resumption of business operations intensified in various regions from around March 2020. As a result, the unemployment rate began to decline as early as March 2020, reaching the same level as before the COVID-19 outbreak in December 2020. As the employment outlook diffusion index (DI) exceeds the "50-point mark," which indicates a general trend of improvement, many predict that the employment situation will remain favorable in the future. Nominal disposable income began to recover around the spring of 2020, and in the October-December 2020 period, it increased by 7.1% over the same period of the previous year.

In this regard, there seems to be no need to be overly concerned about the negative impact on the economy due to the tighter restrictions on activities and self-restraint on returning to hometowns during the holidays. Consumer spending is expected to remain firm.

On the other hand, capital investment by state-owned enterprises is expected to slow down, especially in areas where excess capacity and debt are a problem, reflecting the government's conservative stance. Already, the government's partial approval of default on corporate bonds of state-owned companies has put the brakes on the rapid expansion of fund-raising by state-owned companies through the issuance of corporate bonds.

In particular, in the second half of 2020, several corporate bonds with higher ratings defaulted. In October 2020, Brilliance Auto Group (rated AA-), a joint venture with Germany's BMW AG, defaulted on its corporate bonds, and in November 2020, Yongcheng Coal & Electricity Holding Group (AAA), a major coal-mining company, and Tsinghua Unigroup (AAA), a leading semiconductor manufacturer, defaulted on their corporate bonds. All of these companies were overburdened with debt.

The factor behind these defaults was the reduction in government funding support for state-owned enterprises with excessive debt. With the economy and corporate profits improving, the government has once again embarked on a deleveraging (debt reduction) policy, which had been suspended amid the COVID-19 pandemic.

Since the default rate for corporate bonds is still low, the possibility of systemic risk is low, but the cost of raising funds for state-owned enterprises is rising and capital investment is expected to be restrained.

Investment in the overheated property market is also expected to slow down. In an effort to curb the overheating real estate market, the government has been restricting the total amount of housing loans since December 31, 2020. In Shanghai, Guangzhou and Shenzhen, some banks have already reached their lending limits and have suspended their mortgage operations.

In terms of interest rates, the People's Bank of China has raised market interest rates, which could be reflected in the rise in mortgage rates. In January 2021, Ma Jun, a member of the Monetary Policy Committee of the People's Bank of China, said, "asset bubbles are relatively large," which has further reinforced the view that interest rates will continue to rise in the future.

Given this situation, housing sales are expected to be curbed going forward, and the overheated state of real estate prices and development investment will ease.

In this way, the consumption stimulus measures are expected to ease the downward pressure on the economy due to activity restrictions, while the investment control measures are anticipated to gradually calm overheated economic activity in certain areas. The Chinese economy will likely continue growing at a moderate pace in the future through policy guidance that takes into account the balance between consumption and investment. For the full year of 2021, China is projected to achieve a slightly higher annual growth rate of +8.0% due to the reaction to the lower growth rate of the previous year.

(Shinichi Seki)

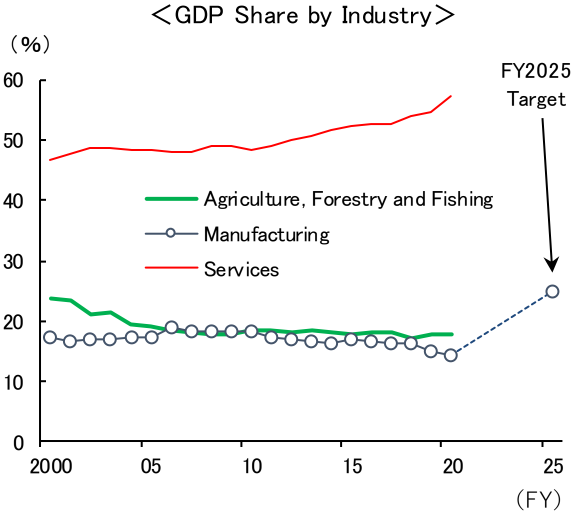
Topics The Make in India initiatives have entered a new stage

As the reorganization of Asian supply chains progresses, the Indian government is developing new measures to promote the manufacturing industry, both from the hardware and software perspective. However, many difficulties lie ahead.

■ What is the status quo of the Make in India initiatives?

Since September 2014, under the slogan "Make in India," India has been developing industrial promotion measures for 25 industries, including transportation machinery, electronic equipment, pharmaceuticals, food and textiles. In order to improve the business environment, various economic reforms have been implemented, including simplification of the tax system through introduction of the goods and services tax (GST), streamlining of administrative procedures such as investment approval and licensing, relaxation of foreign capital regulations, establishment of bankruptcy and insolvency laws, and reduction of corporate tax. The Indian government has also promoted competition among states to improve the business environment through the publication of a business environment assessment report in each state. As a result, in the World Bank's "Ease of Doing Business" rankings, India was ranked 63rd in 2020, up from 142nd in 2014. However, manufacturing is not growing at the pace expected by the government, as delays in the development of logistics infrastructure, strict restrictions on layoffs, and complex labor laws which vary among states, continue to impede manufacturing activities. The manufacturing sector's share of GDP declined under the Modi administration, making it difficult to achieve the target of increasing the share to 25% by fiscal 2025.

＜GDP Share by Industry＞



Source:Ministry of Statistics and Programme Implementation

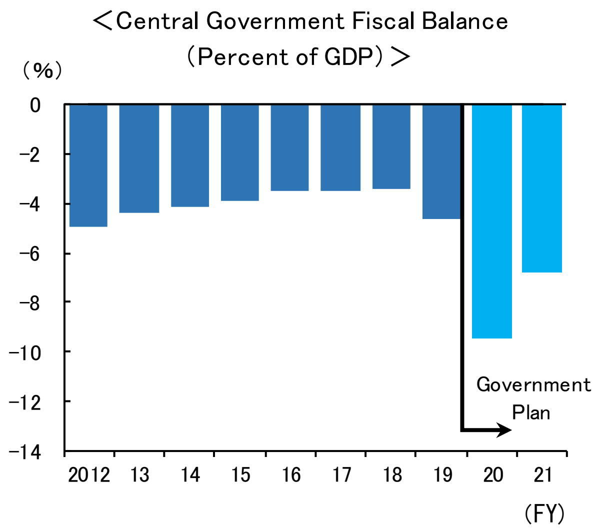
Under these circumstances, the Indian government has been developing new measures for the promotion of the manufacturing industry, using a "carrot and stick" approach by regarding intensification of the China-U.S. confrontation and restructuring of the supply chain amid the COVID-19 pandemic as opportunities to revitalize the manufacturing industry.

In terms of incentives, the Production-Linked Incentive Scheme (PLI Scheme), which provides a certain amount of incentives in accordance with the amount of sales increase from the base year, is attracting a great deal of attention. Initially, the PLI Scheme was introduced for mobile phones and medical equipment. However, in November 2020, the scheme was expanded to include automobiles, white goods and renewable energy-related equipment, and the government plans to spend about 2 trillion rupees over the next five years. In addition, the Indian government announced policies such as the Scheme for Promotion of Manufacturing of Electronic Components and Semiconductors (SPECS), which provides subsidies for capital expenditures needed to produce electronic components; and the Modified Electronics Manufacturing Clusters (EMC 2.0) Scheme, which provides subsidies for projects that will lead to the creation of an ecosystem for manufacturing electronic equipment.

On the other hand, the government has tightened regulations on imports to foster domestic industries by increasing import tariffs on mobile phone parts, semi-finished LCD panels, and solar power generation equipment; banning the import of air conditioners that use refrigerants; and introducing a licensing system for the import of vehicle tires.

■ There are some pitfalls associated with the new Make in India initiatives

Through such efforts, the government aims to create jobs and reduce the trade deficit. However, in light of the following three points, it is deemed difficult to successfully implement the measures to revitalize the manufacturing industry, which depends on the strengthening of subsidies and protectionism.



Source: Ministry of Finance

The first point is a lack of funds due to the fiscal deficit. In order to improve macroeconomic stability, the government aimed to reduce the ratio of the central government's fiscal deficit to nominal GDP to about 3% by fiscal 2023. However, the fiscal deficit in fiscal 2020 increased significantly due to a sharp drop in tax revenues caused by the COVID-19 pandemic. As the government is expected to tighten its stance in order to turn around ailing finances, it will not be easy to further expand the budget for subsidies to revamp the manufacturing industry. On the contrary, as subsidy expenditure nears the upper limit of the current budget, it may be possible for the government to adopt more restrictive operations, such as narrowing down the types of industries eligible for subsidies and adopting stricter requirements.

The second point is that import restrictions on intermediate goods and higher tariff rates may hinder the entry of assembly-type export industries into India. ASEAN countries are currently attracting attention as an export base to replace China due to their proximity to China and their signing of the Regional Comprehensive Economic Partnership (RCEP) agreement. Against this backdrop, India's growing protectionism will further strengthen the orientation of foreign companies toward ASEAN countries. India also faces the risk that the supply of cheap intermediate goods from China will become unstable as its relations with China deteriorate due to the border issue. China's exports to the world are nine times as large as those of India's. If the transfer of production from China progresses, India will have a great deal of room to expand its exports. However, unless institutional hurdles such as delays in deregulation and high tariff rates are addressed, the transfer of production to India will not progress and it will be difficult for India to achieve targets such as job creation and reduction of the trade deficit.

The third point is that there are still many hurdles to overcome, such as complicated labor laws and reform of the land expropriation law. With regard to labor legislation, the government plans to enact a new law that consolidates and simplifies related laws in the near future. Even after enforcement of the revised labor-related legislation, however, many state-specific regulations will remain. Efforts to reform the land expropriation system have stalled since 2015, when the law was temporarily revised by the promulgation of the Presidential Decree.

With regard to the manufacturing of smartphones, which have a high percentage of sales in India, industrial accumulation progressed to a certain degree during the past few years, but close watch will be necessary to determine whether similar trends will expand to other industries.

(Shotaro Kumagai)