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Asia: Acceleration of the U.S. rate hike threatens stable growth in Asia

The Asian economy is expected to enjoy stable growth of +5.4% in 2022. However, this could change if the current rate of soaring prices for natural resources and supply chain issues originating in Asia leads to an acceleration in interest rate hikes in the United States.

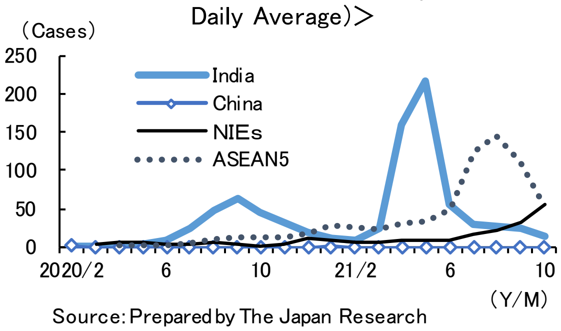
1. The pace of Asian economic recovery will return to cruising speed in 2022

In 2021, the Asian economy generally continued to recover, but the pace of recovery varied widely by country and region. In particular, the surge in the number of new COVID-19 cases for Q2 in India and Q3 in ASEAN led to a temporary deterioration in the economy. For these countries, the real growth rate in 2021 is expected to be much lower than initially projected, with ASEAN5 (Thailand, Malaysia, Indonesia, Philippines, and Vietnam) forecast to grow by 2.9% in 2021 (compared to JRI's forecast as of December 2020 of +5.7%), and India forecast to grow by 9.0% in 2021 (compared to JRI's forecast as of December 2020 of +11.0%) . On the other hand, in Northeast Asia, despite the negative impact of restrictions on activities caused by the resurgence of COVID-19, robust exports and other factors are expected to boost real growth in 2021 to +7.6%, which is higher than initial expectations (JRI's forecast as of December 2020 of +7.4%).

In 2022, growth momentum will likely slow. As the volume of global goods trade has been leveling off, it has become difficult for Asian exports to maintain their current rapid pace. Behind this is a pause in the rapid recovery in demand for goods in developed countries, as well as a decline in demand due to rising trade prices as a result of supply shortages and high prices of resources. In addition, the U.S. Federal Reserve (the Fed) has decided to begin tapering (reduction in asset purchases) in November and is considering raising interest rates in 2022. The pace of interest rate hikes in the United States is expected to be moderate in general, and the impact on Asian financial markets will likely be limited. However, as U.S. monetary policy normalizes, Asian authorities will have less room to support their economies through additional monetary easing and large-scale fiscal expansion.

But because of the increased rates of vaccination, severe restrictions on economic activities as seen in 2020 and 2021 will likely be avoided even in the case of a resurgence in COVID-19. For example, Vietnam set new restrictions on activities at each level of infection risk, but operation of cargo transportation was permitted at all levels. Removing major

＜Number of New COVID-19 Cases (Number of Cases Per Million Population, Daily Average)＞



Source: Prepared by The Japan Research Institute, Limited based on CEIC

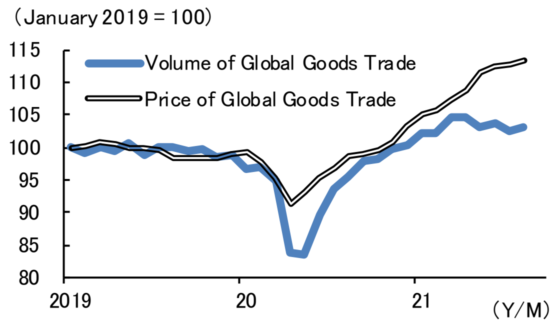
＜Economic Growth Forecasts for Asia＞

(%)

	2020	2021 (Forecast)	2022 (Forecast)	2023 (Forecast)
Asia	**−0.7**	**7.1**	**5.4**	**5.6**
Northeast Asia	2.0	7.6	5.0	4.9
China	2.3	8.0	5.4	5.3
Hong Kong	−6.1	6.5	2.2	2.1
Taiwan	3.1	5.8	2.8	2.5
South Korea	−0.9	3.9	2.4	2.4
ASEAN	−3.6	2.9	5.2	5.4
Thailand	−6.1	1.0	2.1	3.3
Malaysia	−5.6	3.1	6.1	5.5
Indonesia	−2.1	3.5	5.2	5.5
Philippines	−9.6	4.8	6.0	6.2
Vietnam	2.9	1.2	8.3	7.0
India (FY)	−7.3	9.0	6.9	7.9

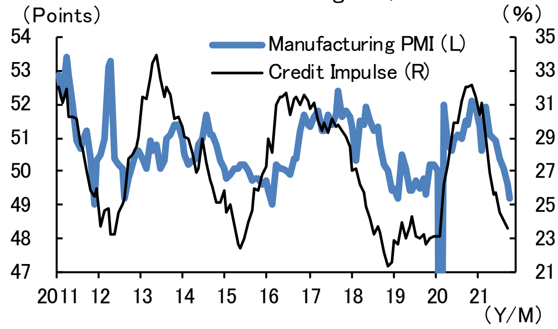
Source: JRI

＜Volume and Price of Global Goods Trade＞



Source: Prepared by The Japan Research Institute, Limited based on CPB Netherlands Bureau for Economic Policy Analysis constraints on domestic demand is expected to increase economic growth stability. The Chinese economy, which is now showing signs of slowing down, is a cause of concern for the Asian economy as a whole, but even after a high growth rate of +8.0% in 2021, stable growth of +5.4% is expected in 2022. The credit impulse (an increase in credit as a percentage of GDP), which is regarded as a leading indicator of the economy, has declined significantly in 2021, partly because the Chinese authorities took a more austere stance against the overheating economy, such as curbing the supply of funds by the People's Bank of China . China is expected to become more cautious about economic management ahead of the National Congress of the Chinese Communist Party next autumn, and the Chinese economy is expected to improve as the country eases its excessive monetary tightening.

＜Increase/Decrease of China' s Credit and Manufacturing PM＞



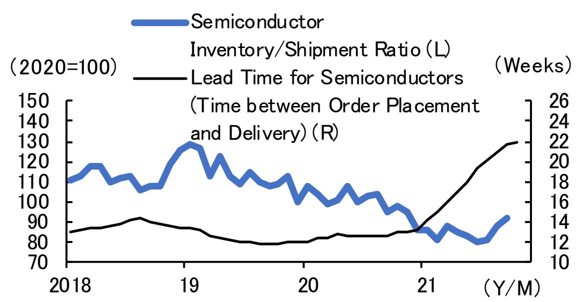
Source: Prepared by The Japan Research Institute, Limited based on Bloomberg L.P.
Note: Credit impulse is the percentage of new credit growth to GDP.

The growth rate of the Asian economy as a whole in 2022 is expected to be +5.4%, down from +7.1% in 2021, due to the strength of external demand and limited support from fiscal and monetary policies. However, due to the avoidance of strict restrictions on economic activities and the stabilization of the Chinese economy, stable growth is expected to be achieved at the level close to the average growth rate of +5.8% between 2017 and 2019 before the outbreak of the COVID-19 pandemic. Growth will likely slow in China, Northeast Asia, and India compared to the high growth rates seen in 2021, and ASEAN countries will not likely rebound significantly from their low growth rates in 2021. However, many countries and regions in Asia are expected to achieve growth at the same level as or exceeding their potential growth rates.

2. Global inflation caused by the supply shortage originating in Asia will remain as a risk threatening Asia's stable growth

As noted above, stable growth is expected in 2022, but downside risks may increase rapidly if the financial environment becomes unstable due to the acceleration of interest rate hikes in the United States. In particular, supply shortage originating in Asia are contributing to the acceleration of global inflation, which may lead to the acceleration of interest rate hikes in the United States and could threaten the stable growth in Asia. Attention should be paid to this possibility.

＜Inventory-Shipment Ratio of Semiconductors and Lead Time＞



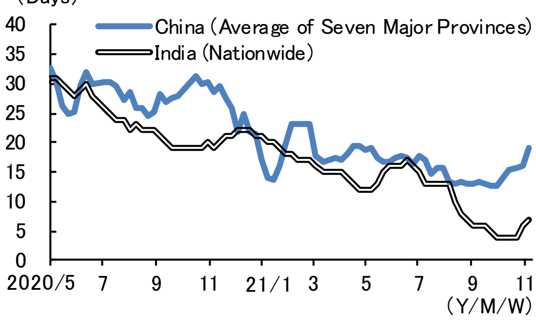
Source: Prepared by The Japan Research Institute, Limited based on CEIC and Bloomberg L.P.
Note: Semiconductor inventory/shipment ratio, which is calculated by dividing inventory index by shipment index, is the weighted average of exports by Japan, the United States, South Korea and Taiwan in 2020.

Since the outbreak of the COVID-19 pandemic, the global economic environment has rapidly changed, and the supply system for Asian manufacturers, which have not been able to adapt well to such changes, has become unstable. In particular, the response to the rapid expansion of demand in some fields such as high-tech is still insufficient. For semiconductors, whose main production bases are in Asia, including Taiwan and South Korea, the ratio of inventories to shipments bottomed out in the middle of 2021 and has gradually increased since then, but the level remains low. In October 2021, the lead time (time taken from order to delivery, based on the survey by the Susquehanna Financial Group) was 21.9 weeks, which was significantly longer than usual, and the supply-demand balance remained tight. Some semiconductors, such as memory chips, appear to have a supply system in place, but investment to increase production of so-called legacy semiconductors for automobiles has been sluggish, and the negative impact on the automobile industry may become prolonged.

In addition, electricity shortages are also a risk for the Asian economy. In China and India, inventories of coal, a major fuel, have plummeted as a result of power shortages between September and October. The decline in coal inventories in both countries has been attributed to coal shortages caused by floods and the shift to renewable energy as an environmental measure. While the power supply capacity has declined due to these movements, the increase in power demand caused by the rapid economic recovery has accelerated the confusion. Electricity shortages pose an alarming risk not only to China and India, but to all Asian countries and regions, amid growing global environmental pressure and opposition to the use of fossil fuels. Looking back, China in early 2020 and Southeast Asia in the latter half of 2021 experienced major problems with international supply chain disruption due to the restrictions on economic activities caused by the spread of COVID-19. As noted earlier, while the likelihood of severe activity restrictions being reimposed in Asia is greatly reduced, electricity shortages could cause new supply chain problems.

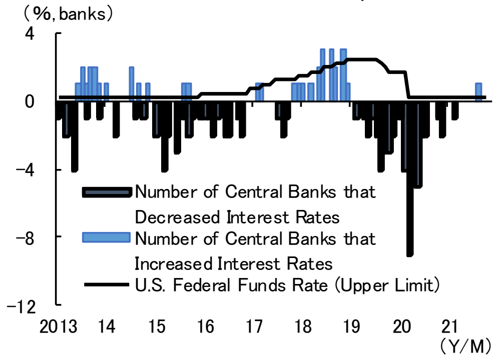
Asian countries and regions continue to struggle with economic restructuring amid the COVID-19 pandemic, including the issue of semiconductor shortages and supply chain disruptions caused by electricity shortages. If supply shortages become serious due to these factors, global inflationary pressure will increase along with persistently high prices for resources. In such a case, the worst-case scenario for Asia would be that the acceleration of global inflation would accelerate the pace of monetary tightening in developed countries, particularly the United States, and that a chain of rate hikes would occur in Asian countries and regions. The Japan Research Institute predicts that the Fed will begin raising rates in 2022, while monitoring the situation pertaining to full employment on a broad scale and the status of achieving an average inflation target of 2%. Of course, the Fed's interest rate hikes will not necessarily lead to immediate interest rate hikes by Asia's central banks. However, if the United States tightens monetary policy at a rapid pace, concerns about rapid rate hikes in Asia will increase. In fact, in 2018, when a total of four interest rate hikes were enacted within the year in the United States, seven Asian central banks, excluding those of Taiwan and Vietnam, followed the United States in the rate hikes. In 2020, major monetary easing was implemented throughout Asia, and the expansion of international liquidity through quantitative easing by developed countries, mainly in the United States, was a major support pillar for the Asian economy. If interest rate hikes are accelerated in the United States, liquidity would drop, leading to a major disruption in Asian financial markets and an increase in interest rates as a countermeasure, which could significantly dampen the momentum of economic recovery.

<Coal Inventory Days in Power Plants in China and India>



Source: Prepared by The Japan Research Institute, Limited based on CEIC and the Central Electricity Authority (India)

<U.S. Policy Rate and the Movements of Central Banks in Asia>

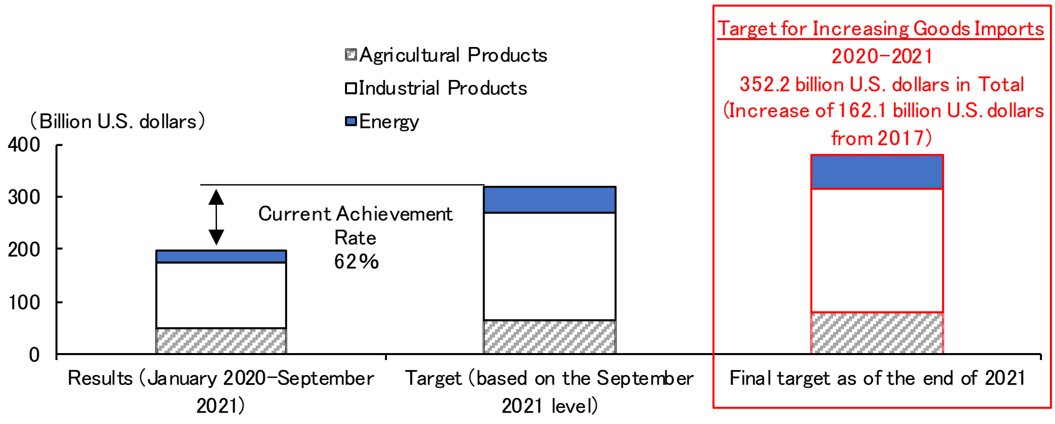


Source: Prepared by The Japan Research Institute, Limited based on CEIC
Note: Calculated as +1 if central banks in nine Asian countries and regions (China, South Korea, Taiwan, India, Indonesia, Philippines, Malaysia, Thailand, and Vietnam) raise interest rates, and −1 if they lower rates.

3. The recurrence of the U.S.-China conflict heightens uncertainty in the Asian region

It will also be necessary to pay attention to political risks in 2022, such as the recurrence of the U.S.-China conflict. The phase one agreement of U.S.-China trade negotiations, which took effect in 2020 under the administration of former U.S. President Donald Trump, will expire at the end of 2021, but China's expansion of imports is expected to fall far short of the agreed-upon targets. In a telephone conversation held on October 8 between United States Trade Representative, Katherine Tai, and Vice Premier of the People's Republic of China, Liu He, the two sides agreed to examine the status of implementation of the U.S.-China trade agreement and to discuss outstanding issues. There is also a possibility that talks on the phase two agreement, which includes measures to subsidize domestic industries in China, will begin, which could increase U.S. pressure on China. With the National Congress of the Chinese Communist Party and midterm elections in the United States to be held in the autumn of 2022, the two countries cannot afford to show a weak stance on this issue. The entanglement of relations between the two countries could heighten uncertainty about businesses that are tethered to both countries and depress the Asian economy, including a decline in corporate investment.

＜China's Target for Increasing the Import of Goods from the United States＞



Source: Prepared by The Japan Research Institute, Limited based on PIIE: US-China phase one tracker
Note: Target for increasing goods imports based on the 2017 level is 162.1 billion U.S. dollars in total between 2020 and 2021, but when service imports are included, it is 200 billion U.S. dollars.

China's formal application to join the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP, or TPP 11) in September 2021 is another source of uncertainty. China's moves to open its markets internationally following the Regional Comprehensive Economic Partnership (RCEP) agreement which will enter into force in January 2022 appear to be having a positive impact, with Thailand and South Korea gaining momentum to join the CPTPP. However, China, which has been criticized for subsidies to state-owned enterprises and forced labor, has little chance of joining the CPTPP. Among existing members, Japan, Canada, Australia and other countries are showing a cautious attitude toward China's participation, while New Zealand and some Southeast Asian countries support China's participation, highlighting differences in opinion among members. Furthermore, the CPTPP, which is supposed to strengthen mutual economic relations along with the RCEP, has become increasingly chaotic due to China's forceful application for participation in the CPTPP, with China strongly opposing Taiwan, which applied for membership at almost the same time, and this could increase uncertainty in Asia.

China is also attracting attention in terms of political events planned in 2022. In autumn, at the National Congress of the Chinese Communist Party, held once every five years, reinforcement of the foundations of domestic politics will likely be demonstrated as the Xi Jinping administration enters its third term. In March, the election of Hong Kong's Chief Executive will be held for the first time since the election system was changed, which will lead to the elimination of the pro-democracy camp. This is expected to highlight the advance in Hong Kong's Sinicization. In addition, South Korea and the Philippines will hold presidential elections. The former is scheduled to be voted on and counted on March

9, and the support of both the ruling and opposition parties will likely be evenly divided, with real estate policies to be at issue. The latter is scheduled to take place on May 9, and people are talking about the candidacy of former Sen. Ferdinand Marcos Jr., the eldest son of the late President Marcos, and former boxer Sen. Manny Pacquiao. Attention will focus on whether the current administration's policy will be maintained, but whether it will change its policy toward China will also be an important factor in judgment.

＜Challenges Concerning China's Participation in the CPTPP＞

Point at issue	Provisions of the CPTPP	China's response	Issues
State-owned enterprises	Chapter 17	Reform has been implemented with an awareness of the CPTPP's rules related to the chapter on state-owned enterprises based on the "Three-Year Action Plan for Reform of State-owned Enterprises."	The use of state-owned enterprises to secure national economic security and the promotion of business combinations among state-owned enterprises may violate the rules of the CPTPP. China may assume to be exempted from application of the rules.
Labor	Chapter 19	With regard to the ILO Declaration on Fundamental Principles and Rights at Work, China has ratified the abolition of child labor, and the elimination of employment and occupational discrimination, but has not ratified the recognition of freedom of association and the right to collective bargaining and the elimination of forced labor.	China does not guarantee the right to form a labor union, and forced labor is suspected of occurring. It is highly questionable whether China is prepared to accept work-related rules.
Electronic commerce	Chapter 14	China has accepted the RCEP provisions that prohibit cross-border information transfer restrictions and prohibit data localization.	Under the RCEP, exceptions are made where the country "deems it necessary to achieve legitimate public policy objectives." China may be considering making extensive use of security exceptions.

Source: Prepared by The Japan Research Institute. Limited based on RIETI Policy Discussion Paper Series 21-P-016 "China and CPTPP", https://www.rieti.go.jp/en/publications/summary/21090002.html

(Minoru Nogimori)

NIEs The robust recovery led by demand from high-tech and China

■ Growth in 2021 will be high at +4.8%

＜Outlook of the NIEs Real GDP Growth Rate＞

(%)

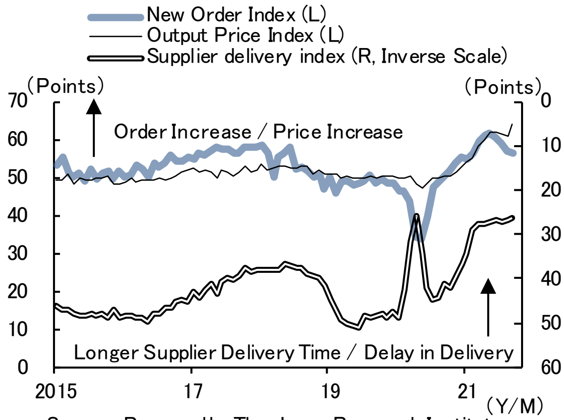
	2018 (Results)	2019 (Results)	2020 (Results)	2021 (Forecast)	2022 (Forecast)	2023 (Forecast)
NIEs	2.9	2.0	−0.2	4.8	2.5	2.4
South Korea	2.9	2.2	−0.9	3.9	2.4	2.4
Taiwan	2.8	3.0	3.1	5.8	2.8	2.5
Hong Kong	2.8	−1.7	−6.1	6.5	2.2	2.1

Source: Prepared by The Japan Research Institute, Limited based on the statistics bureaus and central banks of each country and the IMF

Although economic activity has been restricted due to the spread of COVID-19, the NIEs (South Korea, Taiwan, and Hong Kong) continued to enjoy strong business conditions in 2021, recovering at a faster pace than other Asian countries including ASEAN. In particular, the rapid growth in demand for semiconductors amid the COVID-19 pandemic has contributed greatly to the increase in exports from Taiwan and South Korea. In addition, the Chinese economy, the NIEs largest trading partner, recovered strongly in the first half of the year. The recovery in exports of goods to China has been supporting the economy, although service exports have been sluggish due to a lack of leisure travel. In the second half of the year, both demand for semiconductors and the Chinese economy stagnated somewhat, but the real GDP growth rate of the NIEs for the full year 2021 is expected to increase by 4.8% year on year, up from -0.2% year on year in 2020.

■ Stable growth is expected to continue in 2022, and the growth rate will rise to +2.5%

＜Global Electronics PMI＞



Source: Prepared by The Japan Research Institute, Limited based on HIS Markit

Although the growth rate of the NIEs in 2022 will decline from the 2021 level, the NIEs are expected to show stable growth of 2.5% over the previous year on the back of strong demand for semiconductors and the robust Chinese economy. Semiconductor exports are unlikely to continue to grow at the rapid pace seen in the first half of 2021, but exports from Taiwan and South Korea are likely to continue on an upward trend to address global supply shortages. In addition, although the recent slowdown in the Chinese economy has been a cause of concern for the Asian economy as a whole, the economy is expected to pick up in the run-up to the National Congress of the Chinese Communist Party scheduled in 2022 thanks to government support measures such as monetary easing. The number of new COVID-19 cases has been on a slightly increasing trend in South Korea, but the percentage of the population fully vaccinated was high at 78.3% as of November 15. Hong Kong and Taiwan, on the other hand, have seen modest increases in the percentage of the population fully vaccinated, at 59.3% and 42.1%, respectively, although the number of new cases has been controlled. Restrictions on activities are expected to be eased going forward, and the accompanying recovery in domestic demand is also expected to support the economy.

It should be noted that if the global shortage of semiconductors becomes more serious, the negative impact on the semiconductor industry will expand, adversely affecting the NIEs economy. Looking at the Global Electronics PMI in October 2021, the Suppliers' Delivery Times Index (below the 50.0 level indicates longer delivery times) declined, and the Output Price Index rose, while the New Orders Index declined. This suggests that demand is beginning to slow down due to rising prices amid continuing supply shortages of electronics-related products caused by the shortage of semiconductors. The New Orders Index stood at 55.6, well above the threshold of 50.0, but continued semiconductor shortages could further depress demand and shake the NIEs economic pillar.

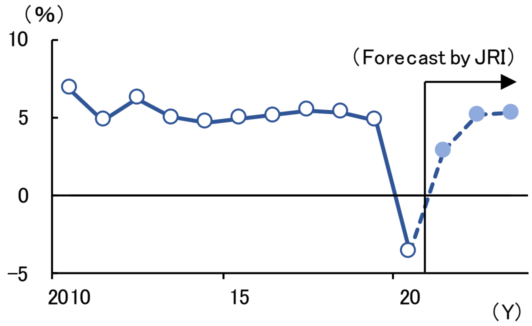
(Minoru Nogimori)

ASEAN5 The economy will recover as economic activity normalizes

■ The economy will likely get on a truck to recovery in 2022 and beyond although downside risks remain

The real GDP growth rate of the ASEAN5 (Indonesia, Malaysia, Philippines, Thailand, and Vietnam) in 2021 is expected to increase by 2.9% from the previous year, up from -3.6% in 2020. In ASEAN there were intermittent outbreaks of COVID-19 from early spring to summer, and severe restrictions on activities, including lockdowns and plant shutdowns, were implemented in each country, which had a significant negative impact on the economies at home and abroad. The gradual easing of activity restrictions in each country is expected to lead to a moderate economic recovery toward the end of the year, but real GDP of the ASEAN5 in the 2021 calendar year is expected to fall below the level seen in 2019 before the COVID-19 outbreak. It can be said that the economic recovery was lost momentum throughout the year.

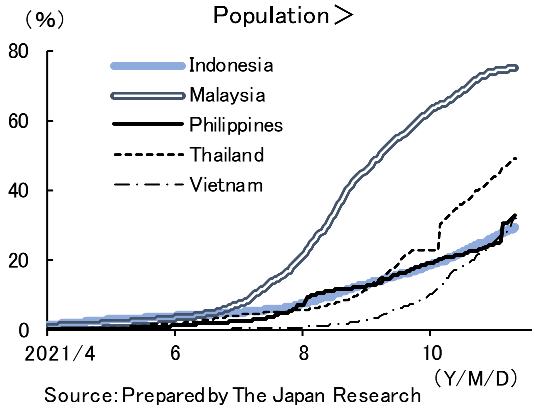
＜Real GDP Growth Rate of ASEAN5＞



Source: Prepared by The Japan Research Institute, Limited based on statistics from each country, the IMF and CEIC
Note: Growth rate of each country is weighted by GDP (PPP)

In 2022, the ASEANs economy is expected to continue to recover as a whole, with economic activity returning to normal through the gradual easing of activity restrictions. The percentage of the population who have been fully vaccinated remains low in ASEAN countries, except for Malaysia, but the vaccination rate is expected to accelerate going forward due to the increase in the daily vaccination rate and the start of domestic vaccine supply in each country. As basic infection control measures continue, it will take time for face-to-face service consumption to fully recover. However, each country has begun to ease restrictions on activities for those who are fully vaccinated, and economic activities are expected to gradually pick up. As a result, the real GDP of the ASEAN5 is expected to return to its pre-COVID-19 growth rate of +5.2% in 2022, and +5.4% in 2023.

＜Percentage of Fully-vaccinated Population＞



Source: Prepared by The Japan Research Institute, Limited based on Our World in Data

However, problems such as supply chain disruptions and the shortage of semiconductors continue to smolder, and a recurrence of various supply constraints is cited as a risk. If supply constraints lead to higher energy prices and inflationary pressure rises more than expected, the United States may decide to raise interest rates early and accelerate the pace of rate increases. In such a case, there is a high possibility that the pressure of capital outflow from ASEAN, which continues its accommodative monetary policy, will intensify, forcing ASEAN countries to tighten their monetary policy. In addition, ASEAN countries are continuing to significantly expand their fiscal expenditure as economic stimulus measures in the wake of the COVID-19 pandemic, and there is a possibility that they will be forced to accelerate fiscal reconstruction, particularly in Indonesia and Malaysia, which have a high percentage of foreign investors holding their government bonds. If the pace of normalization of U.S. monetary policy accelerates without a full-fledged economic recovery in ASEAN, central banks in each ASEAN country will be forced to make difficult choices.

(Mitsuhiro Matsumoto)

India Downside risks remain high

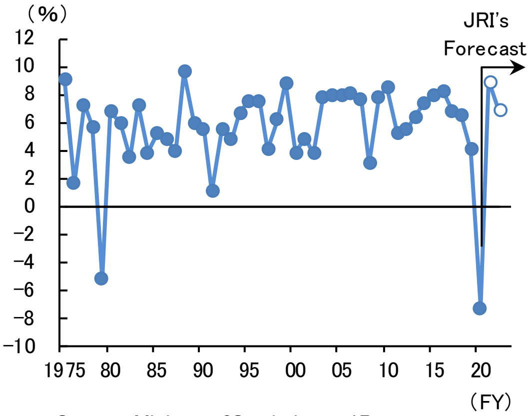
■ India’s growth rate for fiscal 2021 is expected to be +9.0%

India's economy took a nosedive in the first half of 2020, largely because of strict lockdowns to curb the spread of COVID-19. Thereafter, the economy started to pick up along with the gradual easing of activity restrictions, but in fiscal 2020 (April 2020 to March 2021), India’s real GDP declined 7.3% from the previous year, marking the largest negative growth in about 40 years, exceeding the time of the oil shock.

After the beginning of fiscal 2021, India’s economy deteriorated again toward the middle of the year due to an outbreak of the virus, mainly caused by the Delta variant. India’s real GDP in the April-June 2021 quarter rose 20.1% year on year, surging from +1.6% in the same period last year in reaction to last year's decline.

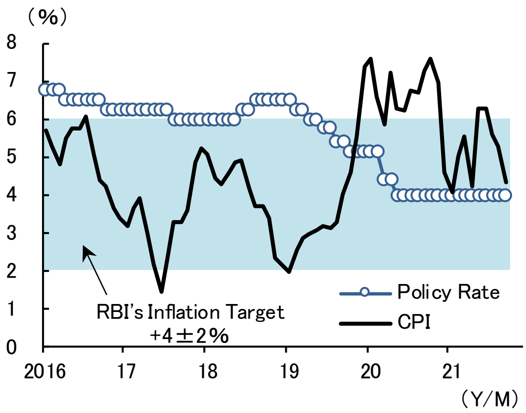
Since the summer, the economy has returned to a recovery trend with the resumption of economic activities following the subsidence of community-acquired infections. The cumulative number of vaccinations in India has reached 1 billion, and it is estimated that the vast majority of unvaccinated people have antibodies, as a large number of citizens, well above official statistics, have actually been infected with the virus. As a result, the risk of another outbreak, such as the one in early spring, is expected to be low. Reflecting this view, SENSEX, a leading stock index, hit all-time highs on consecutive days through October.

<Real GDP (YoY)>



Source: Ministry of Statistics and Programme Implementation

<CPI(YoY) and Policy Rate (Repo Rate)>



Source: Reserve Bank of India

Looking ahead, although the economic recovery will continue, there is little hope for an accelerated recovery in the second half of the fiscal year due to the following factors. First, soaring prices of crude oil and other resources bring negative pressure on the economy. In the first half of 2021, the price of crude oil was around 60 dollars per barrel, but by mid-November, the price had risen to above 85 dollars. As a result, domestic gasoline prices have risen more than 20% from the beginning of the year. Rising transport costs reduce household purchasing power through widespread inflationary pressures and reduce consumption, which accounts for about 60% of India’s GDP. The economic recovery will also be hampered by power supply constraints stemming from coal shortages. Coal-fired power generation accounts for about 70% of the nation's total power generation, but coal stocks fell to a level lower than the nation's five-day supply in late October. Inflation has recently slowed, particularly for food prices, but is likely to increase in the future due mainly to rising energy prices and various supply constraints. Consequently, the Reserve Bank of India is expected to lean toward a tightening monetary policy

Based on the above, India’s real GDP growth for fiscal 2021 will be high at +9.0% year on year due mainly to the rebound from the previous fiscal year. However, the actual state of the economy is expected to remain stagnant.

■ India’s growth rate for fiscal 2022 is expected to be +6.9%

As the COVID-19 pandemic winds down in India and abroad, economic expansion is expected to continue in fiscal 2022 as more activity restrictions are eased. India’s real GDP for fiscal 2022 is expected to grow at a relatively high rate of +6.9%, but given the aforementioned energy-related downward pressure on the economy and the following three points, it should be noted that downside risks remain high.

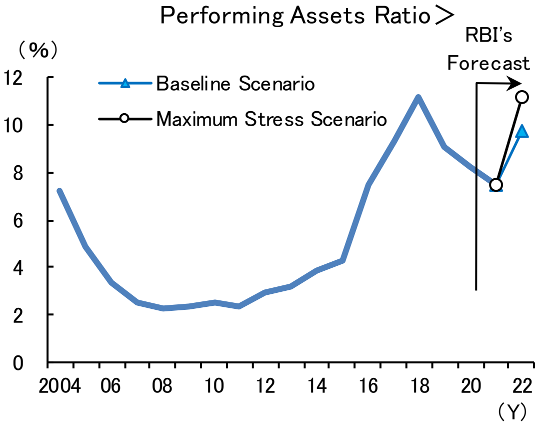
The first point is the outflow of funds from India following the U.S. interest rate hikes. In November 2021, the United States decided to gradually reduce its quantitative easing policy, and there is a prevailing view in financial markets that the United States will raise interest rates from around the summer of 2022. If the circulation of funds to the United States increases the risk that the Indian economy will fall into a vicious cycle of rupee depreciation and inflation, the Reserve Bank of India may tighten the monetary policy to stabilize the exchange rate and prices. In mid-2013, when the United States was widely expected to raise interest rates early, the Reserve Bank of India raised interest rates to defend the currency against the rapid depreciation of the rupee despite the economic downturn, which put pressure on durable goods consumption and investment.

The second point is the growing problem of nonperforming Assets (NPAs) held by commercial banks. While the rise in the NPA ratio of commercial banks has so far been prevented thanks to the government's measures to defer the repayment of debts from individuals and companies, the NPA ratio is likely to rise as the special measures come to an end. According to the Financial Stability Report published in July 2021, the Reserve Bank of India predicts that the NPA ratio of commercial banks would rise to around 10% through 2021 and that some banks would fall into capital deficiency. If the business environment concerning commercial banks deteriorates, it will affect the management of nonbanks, which depend on investment and loans from commercial banks for most of their funds. If defaults by nonbanks increase, financial institutions' lending attitudes will become stricter amid the growing credit uncertainty throughout the financial markets, as we experienced in 2018 and 2019, and economic growth may become constrained in terms of fund supply.

The third point is a policy shift toward fiscal reconstruction. India’s General Government Deficit in fiscal 2020 expanded to more than 10% of nominal GDP, mainly due to a decrease in tax revenues resulting from the economic downturn caused by the COVID-19 pandemic, and the outstanding debt increased to more than 90% of nominal GDP. At the time of the announcement of the fiscal 2021 budget, the government announced plans to revise the Fiscal Responsibility and Budget Management Bill (FRBM Bill) to allow for a larger budget deficit than in the past. However, Once the COVID-19 pandemic is under control, the government is expected to step up pressure to cut spending to rehabilitate its finances.

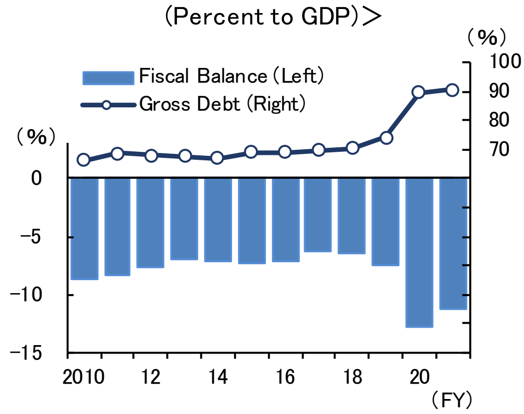
Under these circumstances, in order for India to enhance its economic growth stability, it is essential to accelerate structural reforms such as the facilitation of land expropriation, relaxation of restrictions on dismissal, and reform of state-owned banks, which are necessary to promote inward direct investment in the manufacturing industry.

<Commercial Bank’s Gross Non-Performing Assets Ratio>



Source: Reserve Bank of India

<General Government’s Fiscal Situtaion (Percent to GDP)>



Source:IMF "World Economic Outlook 2021 October"

(Shotaro Kumagai)

China *The economy is expected to pick up in 2022 on Policy Easing*

■ The Chinese economy has slowed due to power shortages and increased activity restrictions

In China, real GDP in the July-September quarter was +0.8% on an annualized quarter-on-quarter basis, recording a significant decline from +4.9% in the preceding quarter. Compared to the same period last year, the growth rate slowed to +4.9% from +7.9% in the preceding quarter, indicating that economic growth has clearly slowed down.

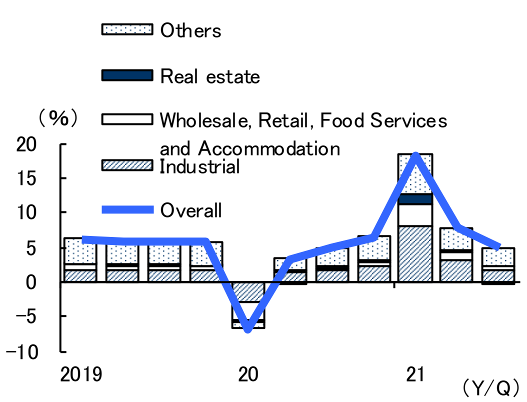
The following three points can be stated as the background for this decline. The first is the stagnation of manufacturing production due to power shortages. The amount of electricity generated in the summer slowed significantly due to a sharp rise in coal prices. The amount of power generated is usually determined passively in accordance with the amount of power to be used, such as production amount by manufacturers. However, in China, the limit in power generation has been a factor in restricting production amount by manufacturers. Since many manufacturers were forced to reduce their plant operations due to rolling blackouts, production of steel, nonferrous metals and cement, which consume large amounts of electricity, fell from the previous year. As a result, the contribution of the industrial sector to GDP declined significantly.

The second point is the strengthening of restrictions on activities in July and August. As the number of new COVID-19 cases rose again, activity restrictions were tightened, and crowds declined in many cities. As a result, the contribution of the wholesale, retail, and accommodation sectors to GDP declined.

The third point is adjustment in the real estate market. Triggered by the introduction of the so-called "three red lines," stricter funding conditions for real estate companies as well as a decline in housing demand, some real estate companies, such as Evergrande Group, faced a management crisis, and real estate development investment slow ed down. Consequently, the real estate industry's contribution to GDP turned negative.

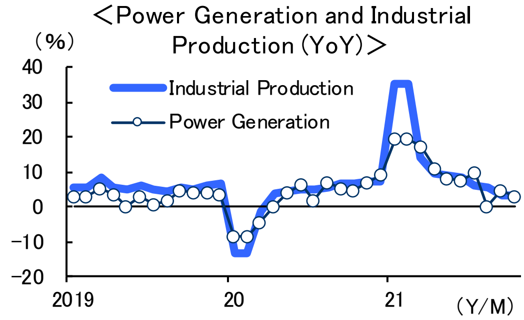
In addition, there are supply constraints that center on semiconductors. Domestic auto production has slumped as semiconductor production in Southeast Asia fell due to the resurgence of COVID-19. In addition, investment in infrastructure and fixed asset investment by state-owned enterprises slowed due to the government's measures to curb investment, which also weighed on the economy.

<Real GDP by Industry (YoY)>



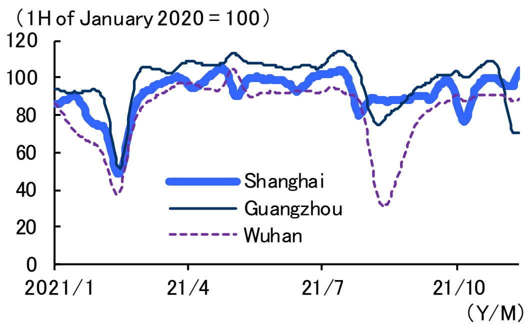
Source: Prepared by The Japan Research Institute, Limited based on "System of National Accounts" by the National Bureau of Statistics of China

<Power Generation and Industrial Production (YoY)>



Source: "Increase in Industrial Production by Enterprises of a Certain Size" by the National Bureau of Statistics of China

<Number of Subway Passengers (HP Filter)>



Source: Prepared by The Japan Research Institute, Limited, based on "Subway Passenger Volume" by Wind Database

■ The Chinese economy is expected to pick up thanks to increased investment and the resolution of electricity shortages

The pace of economic growth in the future is expected to accelerate due to the expected expansion of investment and the resolution of power shortages.

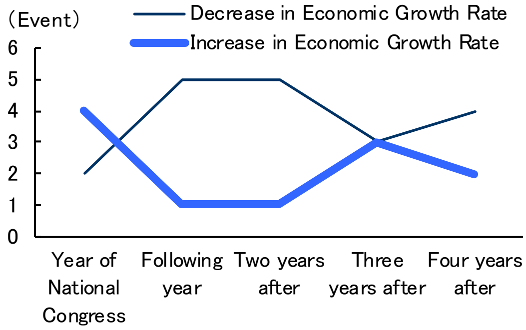
The government is expected to take measures to boost the economy ahead of the National Congress of the Chinese Communist Party in the autumn of 2022. The National Congress is held once every five years, but a rule of thumb is that the economy improves during the year in which the National Congress is held. In fact, in the 30 years from 1991 to 2020, the economic growth rate in the year of the National Congress increased from the preceding year four times, exceeding the two times it declined. On the other hand, attention should be paid to the fact that the growth rate tends to decline as a result of the reaction in the years following the National Congress.

The contribution of gross capital formation to GDP has recently declined to almost zero. However, the easing of the government's policy to restrain investment is expected to lead to further expansion of investment and boost the economy. As a concrete measure, the government will ease restrictions on issuing local government bonds to finance infrastructure investment, which is expected to lead to further expansion of infrastructure investment such as for railways and roads. It is also likely that the government will encourage state-owned enterprises to invest in fixed assets through bank loans. In particular, investment in digital and environmental fields is anticipated to grow.

Next, the power shortages are expected to be resolved in the future with government support such as resumption of the operation of suspended coal mines and expansion of coal imports. Although the government had suspended operations of coal mines due to stricter safety standards, stronger environmental measures, and cases of corruption, it allowed them to resume production since August. The government also boosted coal imports by supporting power and coal companies through the expansion of loans. As a result, coal stocks at thermal power plants across the country rose from 40 million tons at the end of September to 117 million tons by November 6, with domestic coal prices peaking in mid-October.

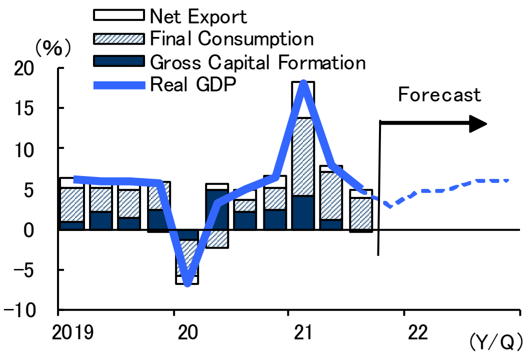
Relaxation of restrictions on activities will also help to pick up the pace of economic growth. Since the number of people on the street overall has increased since September, the PMI in the non-manufacturing sector recovered to a level exceeding the 50-point mark, indicating a general expansion trend. Recently, the government has been trying to minimize negative impacts by dividing

＜Relationship Between Political Events and Economic Changes＞



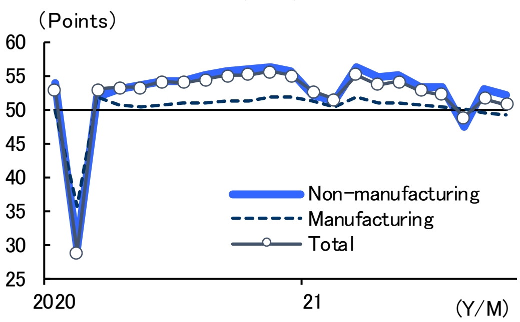
Source: Prepared by The Japan Research Institute, Limited based on "System of National Accounts" by the National Bureau of Statistics of China
Note: Data between 1991 and 2020. Real GDP growth rate for the year in which the National Congress was held increased from the previous year four times in total.

＜Real GDP by Expenditure (YoY)＞



Source: Prepared by The Japan Research Institute, Limited based on CEIC and "System of National Accounts" by the National Bureau of Statistics of China

＜PMI＞



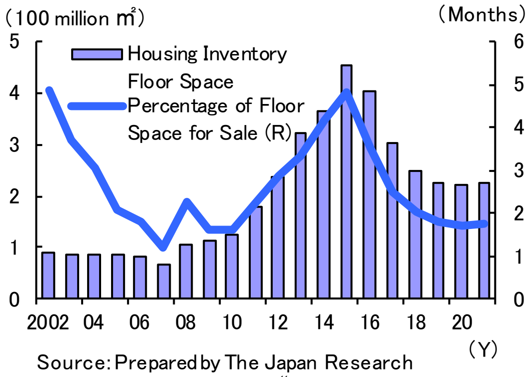
Source: "Manufacturing Purchasing Managers Index" and "Non-manufacturing Business Activity Index" by the National Bureau of Statistics of China cities into smaller areas and restricting activities in designated areas where the virus has been detected. As a result, China's zero-COVID policy is expected to have a limited downward effect on the economy compared to activity restrictions in other countries.

In addition, automobile sales are expected to increase as semiconductor shortages are gradually resolved. Automobile sales in October were down 9.4% from a year earlier, and down from the 19.4% decline seen in the previous month, reflecting a slight easing in the semiconductor shortage.

■ The real estate market is headed for a soft landing

In China, credit rating agencies and other organizations released a list of companies believed to be greatly impacted by the "three red lines" in the summer of 2020, raising concerns about the future of the real estate industry. Since then, Evergrande Group, with a risk of excessive debt, has been attracting the most attention, and its shares and corporate bonds have been sold, resulting in a significant increase in funding costs. Although significant adjustments have been seen in the stock markets of major countries due to the Evergrande Group financial crisis since the beginning of September this year, the Shanghai Composite Index and the Chinese Real Estate Index have remained firm, indicating that the Evergrande Group financial crisis has already been factored into the Chinese stock market.

<Real Estate Inventory>



Source: Prepared by The Japan Research Institute, Limited based on "National Real Estate Development Investment and Sales Report" by the National Bureau of Statistics of China
Note: The latest figure is as of the end of September 2021.

Looking at the situation objectively, the following four points indicate that serious adjustments such as a sharp drop in real estate prices and a drastic decline in investment in real estate development are unlikely to occur. First, there is no excess inventory in the real estate industry overall. Housing inventory floor space was 220 million square meters at the end of 2020, a significant decrease from the 450 million square meters at the end of 2015, as overdevelopment of real estate has generally been restrained in recent years.

Second, housing prices on a national average have been restrained in line with income growth. Although housing prices have been soaring in the center of large cities such as Shanghai, in the rest of the nation, the trend has been calm. The national average price of newly built houses is 773,000 yuan (approximately 13 million yen in 2019). This is 6.2 times the average household income and is within reasonable limits.

Third, urbanization is expected to underpin strong growth in housing demand. In recent years, the influx of people from rural areas into urban areas has continued at a scale exceeding 10 million people per year. The United Nations predicts that the urban population will increase by 200 million from the present level by 2040. In this sense, the Chinese real estate market is still growing.

Fourth, measures to curb real estate investment are going in the direction of easing. In August, the government began to ease regulations by ordering the expansion of loans to the real estate industry, and housing sales in 30 major cities began to expand once again after the Chinese National Day holiday. Housing demand is expected to recover going forward, and investment in real estate development is likely to pick up sooner or later.

■ Downward pressure on the economy remains

On the other hand, the possibility that economic activity will continue to stagnate due to the prolonged COVID-19 pandemic cannot be completely eliminated. Outbreaks of COVID-19 variants may again require extensive activity restrictions.

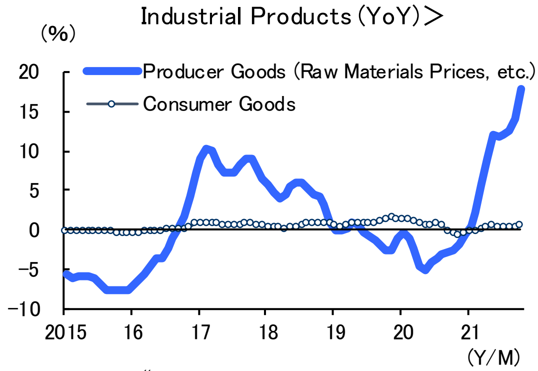
If the prices of energy and manufactured goods do not stop rising, corporate profits may be squeezed, and capital investment and production activities may decline. At present, however, corporate willingness to invest in plants and equipment remains strong, and the easing of monetary policy, such as a reduction in the deposit reserve ratio, and tax cuts for small- and medium-sized enterprises have also been working positively.

As a policy risk, the government may use regulations and antitrust laws to intensify market intervention in a situation where it has not sufficiently explained circumstances to all parties, which may cause confusion.

Continued risk aversion by foreign investors could worsen the funding environment for Chinese real estate companies. According to Bloomberg, Chinese real estate developers had 207 billion dollars in dollar-denominated debt outstanding as of October 2021. That's more than 10% of loans to real estate companies extended by commercial banks in China.

The introduction of a real estate tax (fixed asset tax) is also a cause for concern. The government plans to introduce a real estate tax to rectify disparities and restore fiscal health. If real estate taxes are levied on all properties nationwide at a time when housing demand has not fully recovered, disruption in the real estate market is expected to occur.

＜Producer Price Index (PPI) for Industrial Products (YoY)＞



Source: "Producer Price Index for Industrial Products" by the National Bureau of Statistics of China

As described above, the Chinese economy is likely to pick up despite some downside risks. The real growth rate for 2021 is expected to be +8.0%, recording higher growth in reaction to the previous year's decline. The real growth rate for 2022 is expected to be +5.4%, similar to the potential growth rate, thanks to increased investment and the resolution of power shortages.

(Shinichi Seki)