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Topics *China's economy remains sluggish in 2022*

In January-March 2022, the Chinese economy slowed from the previous quarter. For the time being, the strict restrictions on activity associated with the government's zero-COVID policy are expected to remain in place. As a result, personal consumption and industrial production will stay flat, with the economy slump projected to continue.

■ The economy slowed due to tighter activity restrictions

In the January-March quarter, China's real GDP grew at an annualized rate of 5.3%, down from the 6.1% in the previous quarter. The Chinese economy is decelerating mainly because of tighter government restrictions on activities in response to the spread of the Omicron strain.

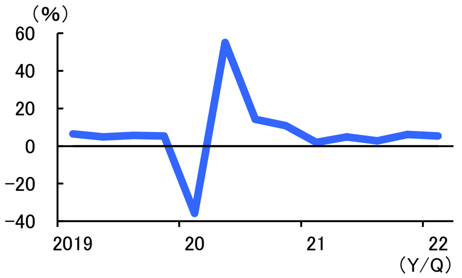
According to the government, the number of new COVID cases in the January-March quarter was 48,000, the second highest figure ever after the 81,000 cases recorded in January-March 2020. In Shanghai, outings were severely restricted in March as the number of infections began to rise sharply, and the number of subway passengers fell 54.0% year on year, resulting in a significant decrease in the number of people out and about in the city. Strict activity restrictions were also imposed in the cities of Shenzhen in Guangdong Province and Suzhou in Jiangsu Province, which are among the world's leading manufacturing centers.

Restricted economic activity in large cities led to a downturn in personal consumption at the macro level. Although supported by local government measures to stimulate consumption, such as the distribution of region-specific shopping vouchers, retail sales fell in March fell for the first time in eight months, slipping 1.9% from the previous month. The drop in services consumption has been particularly striking. Food service sales declined 16.4% compared with the same month a year earlier, widening from the 2.2% drop recorded December last year.

Negative effects of the tighter activity restrictions are also being seen in production activities in the manufacturing sector. For example, indicators for March show that automobile production dropped 4.9% year on year, the first year-on-year decline in four months, due to suspended factory operations and stalled logistics resulting from the activity restrictions. Output of semiconductors also turned downward, dropping 5.1%. Truck freight traffic also fell for the first time in four months, slipping 4.4%.

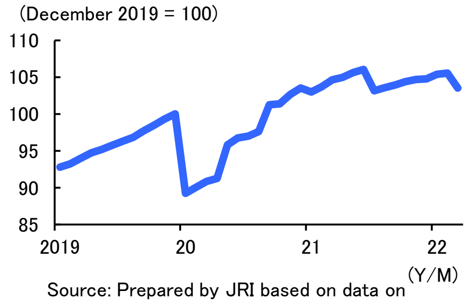
On the other hand, production of coal accelerated to +14.8% year on year in March from +7.2% in December last year, an example of increased output of resources and raw materials across the board. As a backdrop to this, it is worth noting that the Chinese government has instructed companies in the relevant fields to increase supply in order to boost the economy and keep a lid on energy and raw material prices. As a result, industrial production in March climbed 5.0% year on year, a slightly higher rate of increase than that seen around the end of last year. Industrial inventories in January-February also increased substantially, by 16.8% year on year.

＜Real GDP (Year-on-Year Change)＞



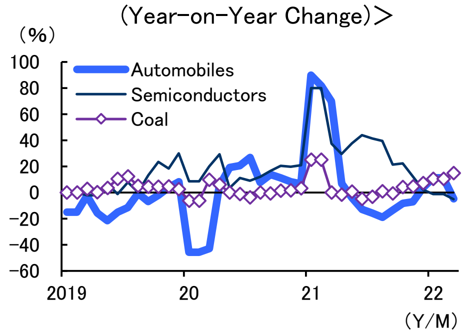
Source: Prepared by JRI based on data from the System of National Accounts (SNA) from the National Bureau of Statistics

＜Retail Sales (Seasonally Adjusted Figures)＞



Source: Prepared by JRI based on data on consumer goods sales from the National Bureau of Statistics
Note: Seasonally adjusted figures were prepared based on published figures for month-on-month changes in seasonally adjusted retail sales.

＜Output of Key Industrial Products (Year-on-Year Change)＞



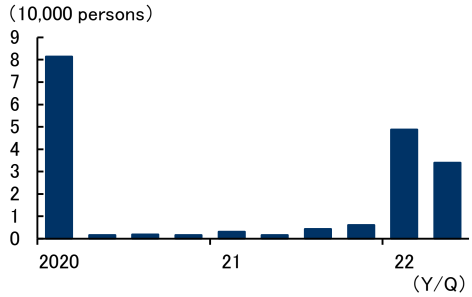
Source: Data on changes in industrial production from the National Bureau of Statistics

■ Economic stagnation is expected to continue going forward

Looking ahead, the economic slump is expected to be protracted, with sluggish personal consumption and industrial production.

Since the beginning of April, the Omicron strain has spread further. According to the government, the number of new COVID cases from April 1 to 17 was 34,000, already close to the total for the January-March quarter, and infections still show no signs of decreasing. This has led to tighter controls on activities, such as strict restrictions on outings and business operations. In Shanghai, the restrictions are even more severe than those implemented in February 2020 at the time of the initial COVID outbreak. The subway system, for example, has been shut down. And strict activity restrictions are not limited to Shanghai. They have also been imposed in about half of the country's 31 provinces, municipalities, and autonomous regions, where the disease has also been spreading.

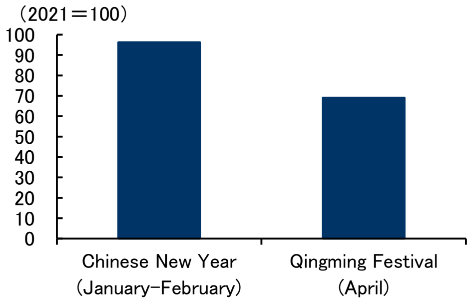
<No. of New COVID-19 Infections>



Source: Prepared by JRI based on data from the National Health Commission

Note: The most recent figures are for April 1-17, 20

<Domestic tourism revenue during Qingming Festival and Chinese New Year holidays (2022)>



Source: Prepared by JRI based on data from the Chinese Ministry of Culture and Tourism

The activity restrictions have created further downward pressure on personal consumption, and services consumption in particular. For example, domestic tourism revenue plunged 30.9% year on year during the Qingming Festival holiday period in April, a much higher decline than the 3.8% drop that occurred during the Chinese New Year holidays this year. The government also intends to impose travel restrictions during the Golden Week holidays in May, as it did with for the Qingming Festival.

While it is possible that some cities could relax their zero-COVID policies on a trial basis in the future, it is highly probable that China as a whole will continue to pursue zero COVID. At a meeting of the Politburo Standing Committee on March 17, President Xi Jinping reiterated his instructions to follow the zero-COVID policy and control outbreaks at an early stage. He also stated that he would hold local officials fully accountable if they neglected their duties and allowed the disease to spread. At least until the party congress in the fall, when decisions on leadership appointments, including the reappointment of Xi Jinping as general secretary, will be made, the government is expected to maintain its course of giving top priority to controlling infections and reducing the number of deaths by sticking to the zero-COVID policy.

The negative impact of the zero-COVID policy on industrial production will also become clearer in the statistics. PCR testing and travel restrictions have been ramped up in areas where infections have been reported, and companies are facing materials shortages and logistical delays. There has been a steep drop in truck freight traffic recently, and cargo handling capacity at the Port of Shanghai has been declining since the beginning of April. To make up for this, the nearby Port of Ningbo in Zhejiang Province has been accepting cargo from the Port of Shanghai, but is unable to handle it all.

Due to this sluggishness in personal consumption and industrial production, China's economy is expected to grow at a low rate of 4-5% in 2022. The government's target of "growth of around 5.5%" is becoming increasingly difficult to achieve, given the tightening of activity restrictions due to the spread of the virus.

(Shinichi Seki)

Topics Sri Lanka crisis highlights risks for Asian economies

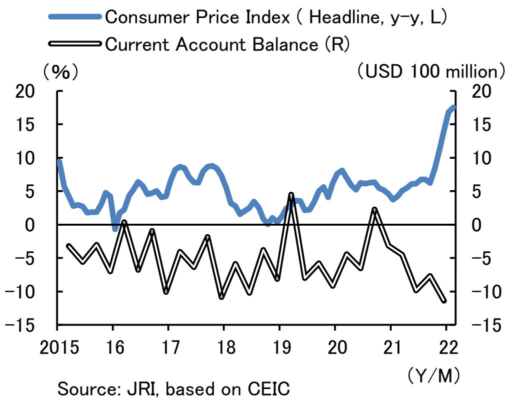
Sri Lanka is facing a serious economic crisis with a growing current account deficit and accelerating inflation. While it is unlikely that major Asian countries will experience a similar crisis, caution needs to be exercised concerning the risks posed by imported inflation.

■ Imported inflation hits the Sri Lankan economy

A serious economic crisis is unfolding in Sri Lanka. It stems from difficulty importing resources and foodstuffs due to a shortage of foreign currency. Long lines are forming at gas stations and an increasing number of restaurants are being forced to shut their doors. Add to that the restrictions on activity caused by the rolling blackouts that began in late February, and the negative impact is being felt throughout the economy. Society is also becoming increasingly unstable, with protests against the government spreading. On April 12, the government announced that it would temporarily suspend payments on foreign debt in order to prioritize the use of foreign currency to pay for imports of daily necessities. It is seeking to restructure its debt in accordance with an IMF-supported plan, but default is seen as inevitable.

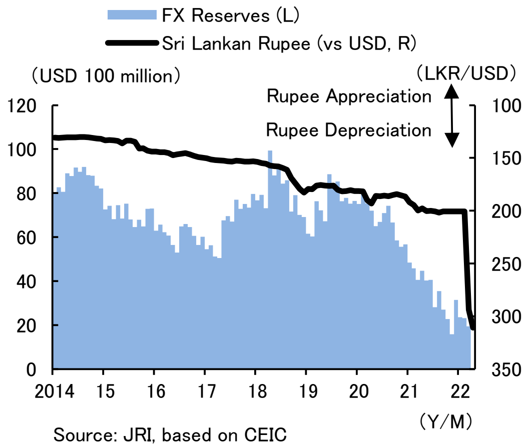
Sri Lanka has long been noted as having a fragile economic structure, in that it is heavily indebted, that could push it into a crisis at any time. Since the 2000s, Sri Lanka has aimed for high growth by investing in infrastructure through increased foreign borrowing. However, in 2017, it fell into the so-called "debt trap," as it was forced to hand over the right to operate the port of Hambantota to a Chinese company for 99 years after struggling to repay its loans. And more recently, the 2019 Easter bombings and the subsequent COVID pandemic have led to a slump in tourism, a key sector for the economy, which has made it even harder to obtain foreign currency. Last December the shortage of foreign currency saw the government strike a deal with the Iranian government to pay for oil with tea leaves, a product that Sri Lanka is famous for.

＜CPI Inflation and Current Account Balance in Sri Lanka＞



Source: JRI, based on CEIC

＜Sri Lankan Rupees and FX Reserves＞



Source: JRI, based on CEIC

Coupled with rising import prices triggered by the war in Ukraine, the difficult economic environment has resulted in an economic crisis. Rising import prices have led to a widening current account deficit and accelerating inflation, which have devastated the economy. The current account deficit has made it difficult not only to service foreign debts but also to pay for imports by foreign currency. Inflation rose to +17.5% year on year in February, adding to the turmoil in the domestic economy. On April 8, the Sri Lankan central bank raised its policy rate by seven percentage points to tackle inflation and defend the currency, but this is expected to further increase downward pressure on the economy going forward.

Depreciation of Sri Lanka's currency, the rupee, had been kept to a modest level by intervention in the forex market, but since March the value of the rupee has plummeted. This is largely due to the fact that foreign exchange reserves decreased by 67% compared to the end of 2019, leaving little room for additional intervention. In addition to this, another factor has been Sri Lanka's need to demonstrate flexibility in exchange control as it seeks IMF assistance.

■ Other countries also need to be wary of imported inflation

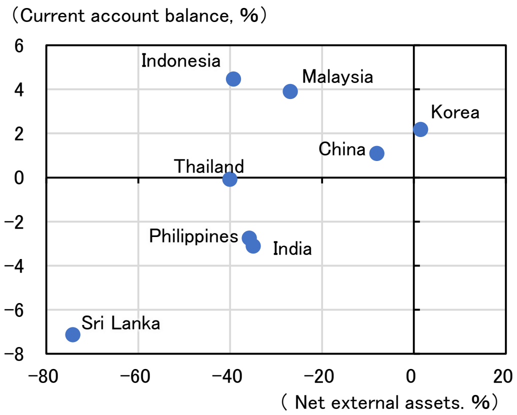
Sri Lanka's nominal GDP is only 0.1% of the world total, limiting the impact of the country's economic crisis on other nations. Furthermore, Sri Lanka is saddled with a huge amount of debt, suggesting it is unlikely that a similar crisis would occur in a major Asian country such as China, India, or a Southeast Asian country.

However, with the U.S. normalizing its monetary policy, financial risks stemming from the return of investment money to the U.S. are increasing. Sri Lanka is an example, albeit an extreme one, of how recent changes in the financial environment can have major knock-on effects on economies. In particular, the soaring prices of energy, food, and other commodities that triggered the current crisis have, to varying degrees, heightened the economic risk for some countries by causing current account deficits to widen and inflation to accelerate.

In fact, according to the IMF's economic outlook for this year, which it released on April 19, resource-exporting countries like Indonesia and Malaysia are expected to run current account surpluses, while resource-importing countries like India and the Philippines are expected to see current account deficits. A current account deficit increases the downward pressure on the domestic currency and raises the burden of external debt servicing. India and the Philippines, in particular, will need to be on guard against financial instability.

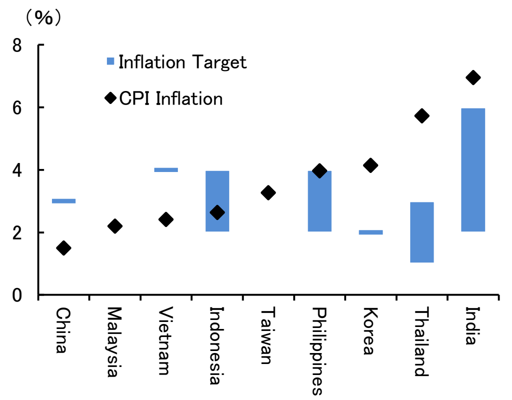
Additionally, inflation has risen rapidly in a number of countries recently, exceeding the targets set by central banks in India, Thailand, and South Korea. The rapid rise of inflation could lead to domestic economic turmoil and social instability like that seen in Sri Lanka. Against the backdrop of the COVID pandemic, budget deficits are widening as costs associated with healthcare and economic stimulus packages have soared throughout Asia, making it difficult to counter inflation through measures such as subsidies. Going forward, monetary tightening through higher interest rates is expected to be the main response to inflation. Depending on the pace of acceleration in inflation, some countries may be forced to move swiftly in raising interest rates, which could exert more downward pressure on the economy than had been predicted.

＜Current Account Balance and Net External Assets in Major Asian Countries (% of GDP)＞



Source: JRI, based on IMF
Note: Net external assets consist of direct investment, portfolio investment, and other investments in 2020. Current account balance is IMF forecast for 2022.

＜Inflation in Asia : Actual Rates and Targets＞



Source: JRI, based on CEIC
Note: Inflation rate is y-y of the latest headline data. 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.

(Minoru Nogimori)