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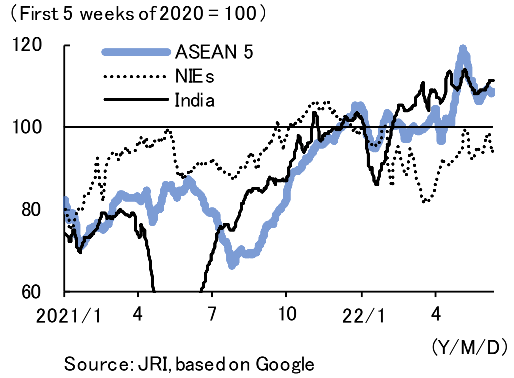
Asia: Asian economies are performing well, but facing financial risks

Stable economic growth is continuing in Asia, but at the same time, attention needs to be paid to the risk of capital flows becoming unstable due to the normalization of U.S. monetary policy and other exogenous factors such as COVID-19 and the Ukraine crisis.

1. Stable growth will likely continue in 2022

Overall, the economies of Asian countries had recovered since the early fall of 2021, but moving into 2022, the pace of the recoveries among the economies has varied. This is attributed to different actions by the governments on COVID-19. In China and Hong Kong, strict activity restrictions were imposed in response to a rebound of the number of cases. China, in particular, has remained steadfast in pursuing its zero-COVID strategy, and the imposition of a lockdown in Shanghai resulted in a sharp drop in private consumption and a halt in production activity. However, Asian economies other than China and Hong Kong have changed tack and adopted a policy of living with COVID-19. As such, they have not imposed strict activity restrictions as a means of combatting COVID-19. In Korea and Taiwan, the number of COVID-19 cases has surged since the beginning of the year, and domestic demand has stalled as people have pull backed from economic activities to avoid infection. Even so, their economies continue to pick up, supported by growth in exports, notably electronic components. Although the number of infected people also increased in ASEAN through spring, stagnation in economic activity was avoided as crowds in the shopping malls have returned, and strong recoveries in domestic demand supported the overall economy.

<Mobility Data (Retail & Recreation)>

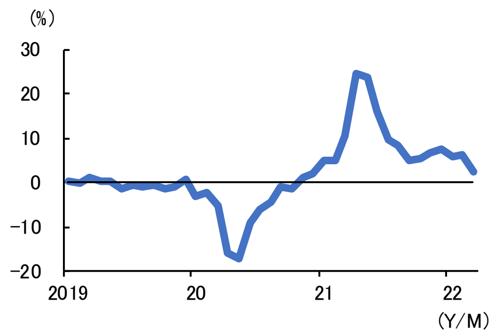


Source: JRI, based on Google
Note: Calculated by JRI, based on a weighted average of the population of each country/region. 5-day backward moving averages.

Looking ahead, Asian economies are expected to continue to recover thanks to the three factors: 1) easing of activity restrictions, 2) improvement of the Chinese economy, and 3) increase in external demand.

First, most economies are further relaxing restrictions on activities. Already, Asia except China has seen a significant increase in retail and entertainment crowds, which has pushed up consumer spending. With the easing of restrictions expected to continue, demand will likely recover, driven by the retail and service sectors.

<Volume of Global Goods Trade (YoY)>



Source: JRI, based on CPB Netherlands Bureau for Economic Policy Analysis

Second, the Chinese economy is picking up. In China, although the zero-COVID strategy is still in place, activity restrictions are being eased as the number of infected people declines, and consumption and industrial production is rebounding. In addition, the government has indicated that it plans to increase fiscal spending in response to the economic downturn caused by lockdowns. While it will not be easy to achieve the economic growth target for 2022 (around +5.5%), the government is seen as likely to come up with whatever measures it can take, with the bulk of these involving public investment. The Chinese economy is thus predicted to pick up, mainly led by public-sector demand, which will give a boost to the Asian economy as a whole.

Third, external demand will remain solid. Goods exports increased significantly last year, so a lull in this trend and slower growth are probably unavoidable this year. However, exports/imports should stay on its upward path as global demand for semiconductors will remain robust amid the penetration of high-tech products, such as IT equipment and servers for teleworking etc. In addition, Asian economies other than China are moving to ease entry restrictions for visitors from overseas. While the decline in tourism revenues has kept countries' services exports stagnant until now, the relaxation of entry restrictions could help boost total foreign demand going forward.

Given these factors, we expect real GDP for Asia in 2022 to grow by +4.7% year on year. This is lower than the 7.2% growth recorded in 2021, but on par with stable growth of +5.0% in 2019.

＜Growth Forecasts for Asian Economies＞

(%)

	2020	2021	2022 (Forecast)	2023 (Forecast)
Asia	－0.6	7.2	4.7	5.0
Northeast Asia	1.9	7.7	4.1	4.8
China	2.2	8.1	4.4	5.2
Korea	－0.7	4.1	2.2	2.0
Taiwan	3.4	6.6	2.7	2.1
Hong Kong	－6.5	6.3	0.3	3.4
ASEAN 5	－3.6	3.4	5.1	4.6
Indonesia	－2.1	3.7	4.9	4.8
Malaysia	－5.5	3.1	5.8	5.1
Philippines	－9.5	5.7	6.5	5.3
Thailand	－6.2	1.5	2.1	2.4
Vietnam	2.9	2.6	7.8	6.0
India (FY)	－6.6	8.7	6.5	5.8

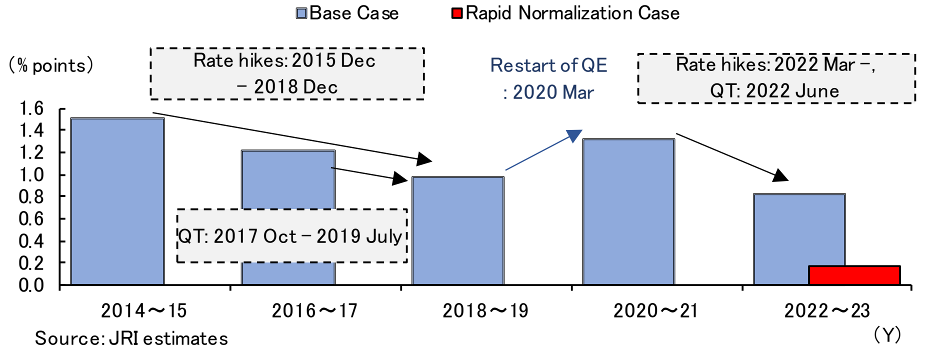
Source: JRI

2. Financial risks have been heightened by COVID-19 and the Ukraine crisis

Nevertheless, attention needs to be paid to the possibility of financial instability becoming a downside risk to the Asian economy. In March 2020, triggered by the spread of COVID-19, the U.S. FRB resumed large-scale monetary easing, which included a swift expansion of its balance sheet. This move has also supported economic growth in emerging countries through accelerated capital inflows and reduced liquidity risk. However, the easing phase has now ended and monetary policy is being rapidly normalized.

Estimates of the impact of the massive U.S. monetary easing on capital flows (% of GDP, including direct investment, securities investment and other investment) to emerging countries show that in 2020-21 U.S. monetary easing boosted capital flows to major emerging countries by an average of 1.3 percentage points per year. In 2022-23, however, the normalization of U.S. monetary policy should depress the effect by 0.5 percentage points to 0.8 points. This is comparable to the downward pressure on capital flows seen over the five-year period from 2015 to 2019, which was the last normalization (rate hike and quantitative tightening: QT) phase, suggesting that significant downward pressure on capital flows will be exerted in just a short period of time. Assuming that the U.S. policy rate and balance sheet size return to their pre-2008 global financial crisis levels (rapid normalization scenario), capital flows would be estimated to decline by 1.2 percentage points. Capital flows in emerging countries are influenced by U.S. monetary

＜Impacts of the US Monetary Policy on the Capital Flow (Net inflow) in Emerging Economies (% of GDP)＞



Source: JRI estimates

Note: Estimated impacts derive from the monetary policy factors in the model that is estimated based on the panel data of 9 major emerging countries (India, Indonesia, Malaysia, Philippines, Thailand, Brazil, Mexico, South Africa, Turkey). The model includes capital flows (% of GDP) of emerging countries as an explained variable and US monetary policy factors (interest rate differences and assets of the FRB), growth factors (growth rate gap), risk factors (VIX, etc.) as explanatory variables.

[Base Case] We use the outlook for the Fed's asset balance and FF rates based on the statement and median forecasts by the FOMC (as of June 2022).

[Rapid Normalization Case] We use the assumption that the US policy interest rate and the FRB's asset balance will return to the level of 2006 by the end of 2023 policy to quite a large degree, so depending on the speed and extent of its normalization, the downward pressure on Asian economies could be substantial.

In 2018, an acceleration of policy rate hikes in tandem with QT caused market turmoil, with many emerging country currencies falling. The risk of a similar situation occurring again is mounting. Argentina and Turkey experienced marked currency depreciations in the foreign exchange market in 2018. The current account is a key measure of economic fundamentals, and both countries were saddled with large deficits, which was a factor in the sell-off of their currencies. In Asia, the currencies of countries with current account deficits, namely India, Indonesia, and the Philippines, also saw relatively sharp falls in 2018. Recently, Indonesia's current account has moved into surplus due to high commodity prices, but India and the Philippines are still stuck with current account deficits, so downward pressure on their currencies is expected to intensify going forward.

Furthermore, given the impact of COVID-19 and the Ukraine crisis, there are concerns that Asian countries besides India and the Philippines will also face downward pressure on their economies due to the triple burden of 1) deteriorating current account balances, 2) accelerating inflation, and 3) cumulatively increasing government debt. The disruption of supply chains due to the COVID-19 pandemic and Russia's invasion of Ukraine have caused prices of primary commodities to skyrocket, driving up the prices of imported goods in many countries. With the exception of Indonesia and Malaysia, all Asian emerging countries are highly dependent on imports of food and mineral resources, so this will worsen their current account balances. In addition, inflation is accelerating throughout the Asia. Consumer prices in May 2022 were up 7.0% year on year in India, 5.4% in the Philippines, and 7.1% in Thailand, exceeding the inflation target in all these countries. Additionally, their fiscal situations have deteriorated rapidly since COVID-19 emerged. While fiscal spending such as improvement of healthcare system capacity and economic stimulus increased sharply in 2020. Moreover, the governments now have to take steps to support households in the face of soaring energy prices. General government debt (as a percentage of GDP) has swelled significantly in India (from 75.1% in 2019 to 86.8% in 2021) and the ASEAN5 (from 38.4% to 50.7%).

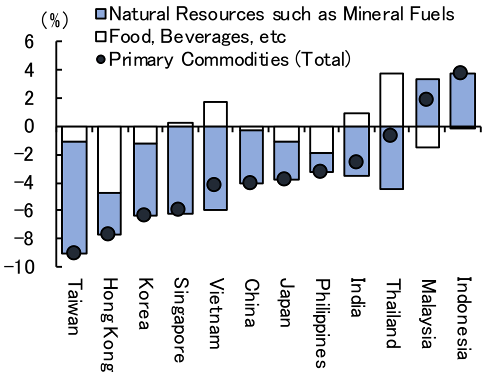
Current account deficits, high inflation, and budget deficits are making Asia economies more vulnerable to external shocks. If the triple burden grows at an accelerated pace, it could rapidly destabilize capital flows not only in India and the Philippines, but across Asia as a whole.

<Currency Performance and Current Account Balance in Emerging Economies>

	Changes of Currency against USD (%)	Current Account Balance (% of GDP)	
	2018	2016-18 ave.	2020-22 ave.
Argentina	-50.5	-4.2	0.9
Turkey	-27.6	-3.6	-4.1
Brazil	-14.6	-1.7	-1.6
South Africa	-13.9	-2.7	2.3
India	-8.3	-1.5	-1.2
Indonesia	-6.4	-2.1	1.4
China	-5.4	1.1	1.5
Philippines	-5.3	-1.2	-0.4
Korea	-4.1	5.2	3.9
Taiwan	-3.2	12.9	14.0
Malaysia	-2.1	2.5	3.9
Vietnam	-1.8	0.5	1.3
Thailand	0.8	8.6	0.7

Source: JRI, based on IMF and CEIC
Note: Current account balances for 2022 are forecasts from IMF.

<Trade Balance of Primary Commodities (% of GDP, 2020)>



Source: JRI, based on WITS(World Integrated Trade Solution)
Note: Primary commodities consist of section 0 (Food and live animals), 1(Beverages and tobacco), 2(Crude materials, inedible, except fuels), 3(Mineral fuels, lubricants and related materials), 4(Animal and vegetable oils, fats and waxes), 68(Non-ferrous metals) in the Standard International Trade Classification (SITC).

3. De-coupling from China and “friend-shoring” by the U.S. are accelerating

The COVID-19 and the Ukraine crisis are increasing financial risks, and pushing the world to de-coupling from China. These developments are also increasing the likelihood of structural changes in Asian economic area. With China still sticking with its zero-COVID strategy, there is a risk that strict activity restrictions will be imposed again there in the near future, so foreign companies operating in China have to consider the possibility of disruptions similar to those that occurred in the past. Michael Hart, AmCham China president, predicts a massive decline in investment in China for some years from now because no new projects are being teed up. Indeed, a May 2022 survey conducted by AmCham China found that 52% of companies could delay or reduce their investments in China, up from 46% in April. According to a survey by the European Chamber of Commerce (conducted in April 2022), 77% of European companies reported that the measure have made China less attractive as an investment destination, and 23% reported they are considering moving their investments in China to other countries. Also, 14% of respondents to a poll by the Shanghai Japanese Commerce & Industry Club (conducted in May 2022) said they would be either reducing or postponing their planned investments in China.

When U.S.-China tensions escalated from 2017, and also following the emergence of COVID-19 from 2020, fears of a shift away from China mounted, but in fact, the large-scale shift from China never truly materialized. However, a large-scale de-coupling from China may have now begun, prompted by Russia’s commencement of military action against Ukraine in February of this year. China's response has differed from those of Western countries. As an example, it has remained outspoken and steadfast in its opposition to economic sanctions against Russia. Western countries, with China at the forefront of their minds, are concerned that countries extending economic support to Russia are providing a “backdoor” for evading sanctions. They have also hinted at imposing “secondary sanctions” on foreign individuals and companies that conduct business dealings with Russia. For foreign companies, the risks of doing business in China are higher than ever.

As a result, Western manufacturers in particular are becoming more active in seeking out alternative locations outside China for their production facilities. Moreover, U.S. foreign policy may serve as an additional spur for de-coupling from China. U.S. Treasury Secretary Yellen mentioned in her speech that she supports “friend-shoring” which involves developing supply chains in friendly countries. In May, President Biden visited Asia to discuss strengthening collaboration in semiconductor production in Japan and Korea. He also announced the launch of the Indo-Pacific Economic Framework for Prosperity (IPEF) as a new framework vision for economic cooperation among nations. It can thus be seen that the U.S. is ready to build a robust international cooperative structure with friendly countries in the realm of economic security. The de-coupling from China and the U.S.-led efforts to strengthen supply chains, such as the IPEF, could provide a tailwind for manufacturing industries in Asian countries other than China.

＜Four Pillars of the IPEF＞

<table>
<tr><td colspan="2">14 countries agreed to join the IPEF negotiations, which include the U.S., Australia, Brunei, Fiji, India, Indonesia, Japan, Malaysia, New Zealand, the Philippines, Singapore, Korea, Thailand, and Vietnam. (as of June 2022)</td></tr>
<tr><td rowspan="2">Trade</td><td>Building high-standard, inclusive, free, and fair trade commitments</td></tr>
<tr><td>Cooperation in the digital economy</td></tr>
<tr><td rowspan="2">Supply Chains</td><td>Improving transparency, diversity, security, and sustainability in our supply chains</td></tr>
<tr><td>Ensuring access to key raw and processed materials, semiconductors, critical minerals, and clean energy technology</td></tr>
<tr><td rowspan="2">Clean Energy, Decarbonization, and Infrastructure</td><td>Accelerating the development and deployment of clean energy technologies</td></tr>
<tr><td>Deepening cooperation on technologies, on mobilizing finance, including concessional finance, and on seeking ways to improve competitiveness and enhance connectivity by supporting the development of sustainable and durable infrastructure and by providing technical assistance.</td></tr>
<tr><td>Tax and Anti-Corruption</td><td>Enacting and enforcing effective and robust tax, anti-money laundering, and anti-bribery regimes</td></tr>
</table>

Source: Ministry of Foreign Affairs of Japan

However, unlike the TPP and RCEP, the IPEF does not include a trade agreement. It is a loose, non-legally binding, cooperation-based framework involving countries that have opted to be a part of it, and no concrete measures, such as subsidies for the relocation of companies and infrastructure development etc, have been announced. There are also many countries, especially among ASEAN member states, that have strong economic ties with China, and it is currently unknown whether the IPEF will actually function to form a strong coalition against China. Specific future developments related to the IPEF will be closely watched going forward, as they will help provide clues as to the structural changes that will occur in Asian economic area in the future.

(Minoru Nogimori)
(Mitsuhiro Matsumoto)

NIEs *Chip exports are supporting the economy despite uncertainty*

■ We expect stable growth of +2.2% in 2022

Economic trends in the NIEs (Korea, Taiwan, and Hong Kong) are uneven as Korea and Taiwan continued to pick up, while Hong Kong remained stagnant. This is attributed to the differences in actions by the governments on COVID-19. Korea and Taiwan have lifted many of their activity restrictions as they transition to living with COVID-19. Meanwhile, Hong Kong continues to impose strict curbs on activity, which is putting significant downward pressure on its economy. Korea, Taiwan, and Hong Kong were all faced with weak demand for China due to the Shanghai lockdown, which had led to sluggish trade. However, strong demand for semiconductors continues to drive exports from Korea and Taiwan, contributing to economic stability.

In the second half of 2022, strong semiconductor demand and a pickup in China's economy following the lifting of its strict restrictions is expected to support the NIEs. We expect real GDP for the full year of 2022 to grow by 2.2%, on par with 2019 (+2.0%) before the COVID-19 pandemic. Regarding semiconductors, while demand is increasing worldwide, the chips themselves continue to be in short supply. To help alleviate the supply shortages, Korea and Taiwan should increase their production and exports. In the Global Electronics PMI for May, while the New Orders Index remained above 50, the Supplier Delivery Time Index remained low at 32.7 (a figure below 50 means longer delivery times), indicating that deliveries are being delayed. Inventories in the major semiconductor-producing economies (Japan, the U.S., Taiwan, and Korea) are gradually increasing, but are still at low levels, suggesting it needs to take some time to resolve the delays.

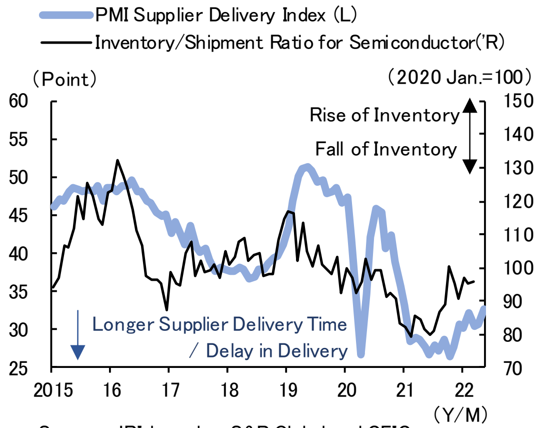
＜Outlook for the NIEs' GDP Growth Rates＞

(%)

	2018	2019	2020	2021	2022 F	2023 F
NIEs	2.9	2.0	0.0	5.2	2.2	2.2
Korea	2.9	2.2	−0.7	4.1	2.2	2.0
Taiwan	2.8	3.1	3.4	6.6	2.7	2.1
Hong Kong	2.8	−1.7	−6.5	6.3	0.3	3.4

Source: JRI

＜PMI Supplier Delivery Index (Global Electronics) and Inventory/Shipment Ratio for Semiconductor＞



Source: JRI, based on S&P Global and CEIC
Note: Semiconductor inventory/shipment ratio is the weighted average of exports by Japan, the United States, Korea and Taiwan in 2020.

On the demand side, downside risks related to China remain. In China, the government has reiterated its intention to maintain its zero-COVID strategy, so there are no plans to change the current COVID-19 measures in the immediate future. If a new strain starts spreading, strict activity restrictions should again be imposed, meaning that demand in China could slump.

There are also concerns about the risks posed by the Ukraine crisis. While Western countries are strengthening economic sanctions against Russia, China is maintaining a distinctly different stance by remaining opposed to sanctions. Western countries are concerned that a country extending economic support to Russia could provide a "backdoor" for evading sanctions. We cannot rule out they may impose "secondary sanctions" on foreign individuals and companies that conduct business dealings with Russia. If China were to be subject to secondary sanctions, the NIEs economies could be adversely affected.

(Minoru Nogimori)

ASEAN5 Economies are recovering, but inflation concerns remain

■ 2022 will see a recovery on the back of recovering domestic demand and easing of entry restrictions

Real GDP growth in the ASEAN5 (Indonesia, Malaysia, the Philippines, Thailand, and Vietnam) for the January-March quarter of 2022 was +4.8% year on year. In the ASEAN5 countries, COVID-19 spread rapidly through the early spring, but these countries did not invoke strict activity restrictions because they were all pursing a policy of living with COVID-19, and the drop in the number of people out and about was limited. As a result, private consumption has remained strong, driving economic recoveries. Foreign demand also continues to be robust. In addition to firm demand related to semiconductors and electronic components, rising demand for primary commodities in Indonesia and Malaysia also contributed to export growth. It should be noted that ASEAN5 nominal exports increased overall in April, with significant rises to places such as the U.S., offsetting a slowdown in exports to China, which has been maintaining its zero-COVID strategy.

＜Growth Forecasts for ASEAN5 Economies＞

(%)

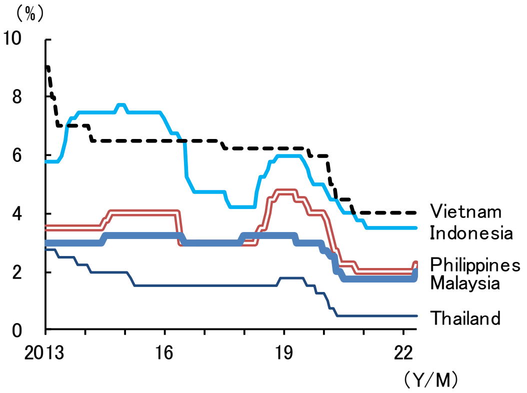
	2019	2020	2021	2022 F	2023 F
ASEAN 5	4.8	− 3.6	3.4	5.1	4.6
Indonesia	5.0	− 2.1	3.7	4.9	4.8
Malaysia	4.4	− 5.5	3.1	5.8	5.1
Philippines	6.1	− 9.5	5.7	6.5	5.3
Thailand	2.2	− 6.2	1.5	2.1	2.4
Vietnam	7.2	2.9	2.6	7.8	6.0

Source: JRI

Rebounds in domestic demand are expected to continue to boost these economies through the second half of 2022, and the ASEAN5 real GDP growth rate for the full year of 2022 is projected to increase to +5.1%, up from +3.4% of the previous year. In the ASEAN5 countries, more and more people have been getting out and about since April thanks to the easing of activity restrictions. Domestic consumption activity has been increasing, and domestic demand is expected to continue to recover, mainly in the realm of face-to-face services consumption. Strong foreign demand will also be a source of support for the economies. Exports of goods climbed significantly last year, but this growth is expected to slow. However, demand for semiconductors, electronic components, and primary products remains firm, and looks set to continue rising. In addition, the ASEAN5 countries are relaxing entry restrictions, and the number of foreign tourists is gradually increasing. Service exports are also expected to contribute to economic recovery in the future.

However, the pace of economic recovery is predicted to gradually ebb away through 2023 against the backdrop of high inflation. Food and energy prices are soaring, and core inflation is also on the rise. There will be a downward swing in consumption resulting from the decline in real purchasing power, and policy rate hikes by the central banks are also expected to depress domestic demand. In the ASEAN5, where monetary easing continued during the COVID-19 pandemic, Malaysia and the Philippines raised interest rates by 0.25% in May, so ASEAN5 monetary policy is shifting to a normalization phase. This is a reflection of upward pressure on prices as well as downward pressure on ASEAN countries' currencies due to higher U.S. interest rates. In the ASEAN5, interest rate hikes are expected to begin in earnest in the second half of the year, and the impact of these rises is expected to exert more downward pressure on economic recovery.

＜Policy Rates of ASEAN5＞



Source:JRI based on Bloomberg L.P.
Note: Data for Vietnam are Refinancing rate.

(Mitsuhiro Matsumoto)

India Inflation is putting downward pressure on growth

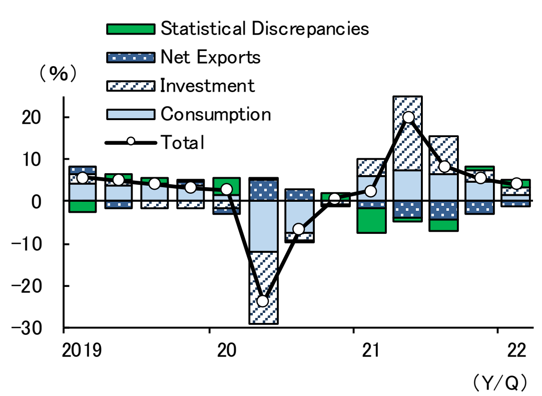
■ **Economic expansion was barely maintained in the first half of 2022**

India's economy continues to be affected by the COVID situation. After a rapid deterioration in the economy in the first half of 2020, which was mainly due to a strict lockdown, the economy began to pick up as the lockdown was gradually relaxed. During the phases of rapid spread of the Delta strain last year and the Omicron strain earlier this year, state government restrictions on activities were reintroduced in areas where the virus was running rampant. However, the situation did not reach a point where the central government might have imposed another nationwide lockdown, and a significant deterioration in the economy like that seen in early spring 2020 was avoided. As a result, real GDP in FY2021 (April 2021-March 2022) returned its pre-pandemic level. Real GDP growth slowed for the third consecutive quarter in January-March 2022 to +4.1% YoY, due to the spread of COVID, and the Omicron variant in particular, which put downward pressure on the economy, and also because the economic upturn phase, which had been a rebound from the previous decline, had run its course.

Recently, COVID-related downward pressure on the economy has eased, while inflation-driven downward pressure has intensified. With the situation in Ukraine deadlocked, and Western countries imposing an embargo on Russian oil, crude oil prices are frequently exceeding $100 per barrel, and international prices for food, fertilizer, and other commodities have also soared. As a result, year-on-year growth in wholesale prices has reached the 10% level, and consumer price growth has also exceeded the Reserve Bank of India's target.

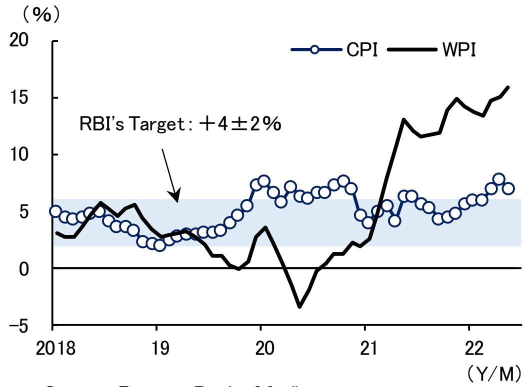
Compounding high resource prices, the narrowing of the interest rate differential between India and the U.S. in conjunction with the normalization of U.S. monetary policy has also brought inflationary pressure through the depreciation of the rupee. In an effort to stabilize prices and the exchange rate, the Reserve Bank of India held an extraordinary meeting in May and raised its policy rate (repo rate) by 0.4 percentage points. And at its regular meeting in June, it decided to raise rates by an additional 0.5 points, and hinted that it may pursue further monetary tightening in the future.

＜Real GDP（YoY）＞



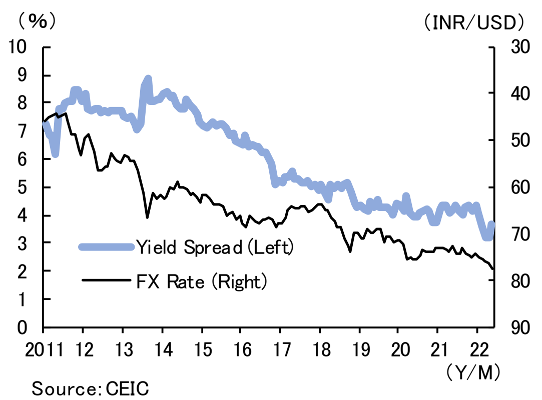
Source: Ministry of Statistics and Programme Implementation

＜CPI and WPI（YoY）＞



Source: Reserve Bank of India

＜2-Year Government Bond Yield Spread and FX Rate between India and U.S.＞



Source: CEIC

■ Gradual economic expansion is expected to continue going forward

Looking ahead, the economy is expected to maintain its expansionary trend as activity restrictions are eased against a backdrop of declining COVID infections. The Stringency Index, which quantifies the degree to which policy measures have been taken to control infections, has fallen, indicating that there has been a significant easing of activity restrictions recently. As the cumulative number of vaccinations approaches two billion, the government is considering further relaxation, which is expected to give a boost to face-to-face services consumption, which has been suppressed by the restrictions in place up to now.

However, the pace of economic expansion is likely to be moderate given the mounting downward pressure on the economy from inflation and monetary tightening.

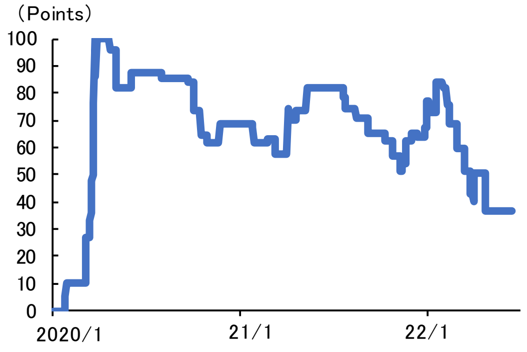
Future inflation trends are expected to be driven by food prices, which account for about 40% of the Consumer Price Index (CPI). It is almost certain that the current surge in fertilizer prices will be reflected in the selling prices of the crops that will be harvested in the future. In addition, rainfall during the monsoon season (June-September) is expected to be lower than usual in some areas, and shortages in crop supplies due to weather factors may accelerate food inflation.

In addition, the pace of OPEC-plus and U.S. shale oil production increases has remained moderate, and prices of crude oil and other energy resources are likely to stay high. In an effort to keep a lid on prices of petroleum products, the government is increasing imports of Russian crude, which is cheaper because Western economic sanctions have reduced the pool of buyers. And in May it reduced excise duty on gasoline and diesel fuel. It is also considering taking additional economic measures in the future. However, the effect of its attempts to control inflation will be limited because 1) Russia's share of India's crude oil imports in 2021 was only 2%, and 2) the scale of measures the government can take is limited due to the urgent need to restore public finances, which have deteriorated significantly due to the COVID pandemic.

In addition, with inflationary pressures persisting, the Reserve Bank of India is predicted to follow the U.S. with additional interest rate hikes. The accompanying increases in various commercial bank lending rates are also expected to weaken the resilience of durable goods consumption and investment.

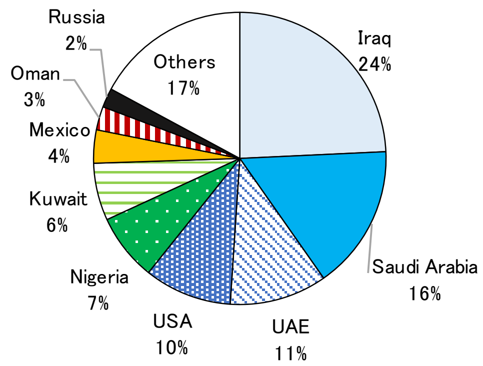
(Shotaro Kumagai)

<Stringency Index>



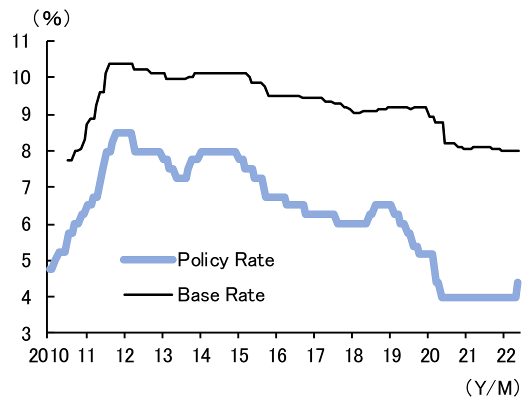
Source: University of Oxford

<India's Crude Oil Imports (2021)>



Source: United Nations

<Policy Rate (Repo Rate) and Major Bank's Base Rate>



Source: Reserve Bank of India

China The economy will grow less than the government's target

■ Economic activity contracted temporarily

In China, the government severely restricted economic activities in Shanghai and many other cities as the number of people infected with the COVID increased. In the January-March quarter, China's real GDP grew at an annualized rate of 5.3%, down from the +6.1% recorded in the previous quarter. Subsequently, the problem of suspended factory operations and stalled logistics expanded, and in April, industrial production dropped year on year for the first time since the Omicron variant appeared. Retail sales in April also fell by double digits year on year due to restrictions on people leaving their homes.

The negative impact of the zero-COVID policy also spread beyond China to other countries via supply chains. Automakers from many countries halted production as China's lower output stalled exports of vehicle components.

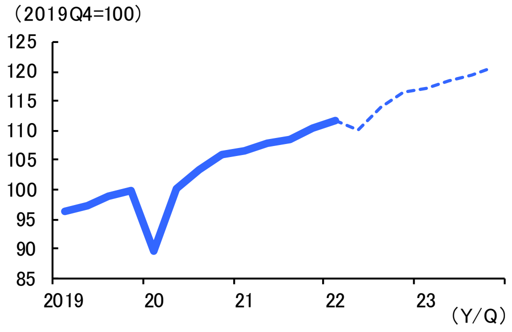
Since May, the number of infections has dropped significantly, and in many cities restrictions on activities have been relaxed, easing the downward pressure on the economy.

With factories resuming operations and supply constraints for components and the like beginning to ease, May saw industrial production turn upwards, rising by 0.7% YoY. By industry sector, electrical machinery production increased 7.3% YoY, accelerating from the previous month (+1.6%), while output of raw and processed chemicals climbed 5.0% YoY, regaining ground after a decline of 0.6% the previous month. The drop in automobile production was 7.0%, much smaller than the previous month's drop of 31.8%.

With the recovery of output in the manufacturing sector, exports (in monetary terms) in May also recovered to the level of the end of last year, with automobiles (including components) playing a large part in the upswing. All this data shows that the supply chain disruptions caused by lockdowns are on their way to being resolved.

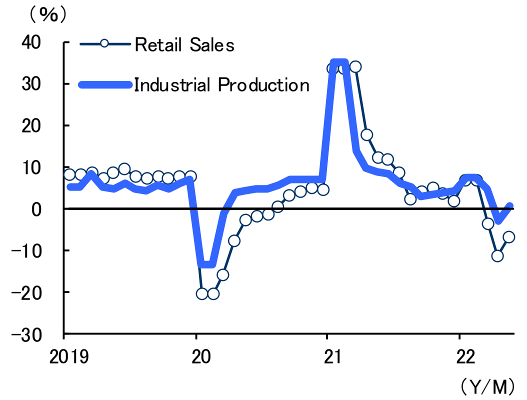
Personal consumption has also bottomed out. Retail sales in May were down 6.7% YoY, a narrower contraction than the 11.1% fall registered in the previous month. In particular, automobile sales recovered to an annualized 23 million units in May after plunging to 15 million in April. This can be attributed to the easing of supply constraints, as demonstrated by the resumption of operations at factories in the cities of Shanghai and Changchun in Jilin Province, which are auto industry hubs, and to a recovery in demand following the easing of restrictions on going out.

<China's Real GDP (Seasonally Adjusted)>



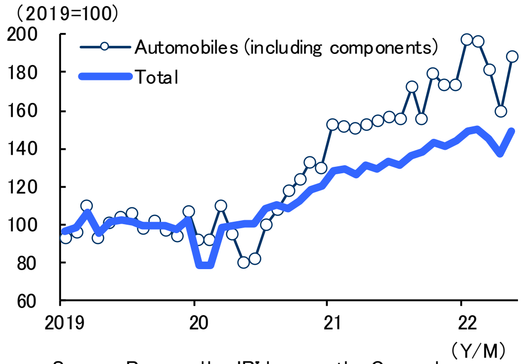
Source: Prepared by JRI base on the National Bureau of Statistics
Note: The dotted line indicates projections.

<Industrial Production and Retail Sales (YoY)>



Source: National Bureau of Statistics

<Exports (Seasonally Adjusted)>



Source: Prepared by JRI base on the General Administration of Customs

However, because of the large decline in economic activity in April, even if economic activity recovers steadily in June, the real growth rate for the April-June is expected to be negative compared with the same quarter the previous year.

■ The economy is picking up

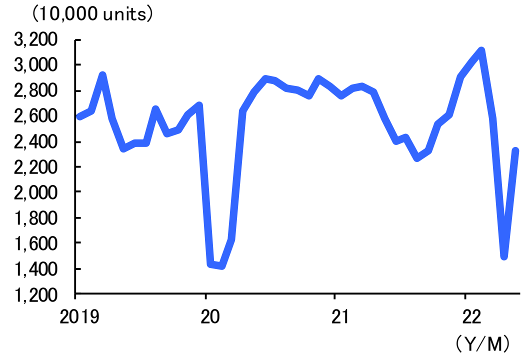
Looking ahead, the Chinese economy is expected to pick up for the following three reasons:

The first is the recovery of personal consumption in response to the easing of activity restrictions. The government plans to gradually ease restrictions on activities, such as limits on commercial operations and leaving one's home, while remaining vigilant against an upsurge in infections. In Shanghai, the crowds have been steadily returning since the June 1 complete lifting of restrictions on going out. The number of subway passengers, which had been zero from April to May, increased to 50% of pre-lockdown levels in mid-June.

Restrictions on activities in other spheres are also in the process of being eased. In Beijing, subway ridership fell in May to 20% of the level of the first half of January 2020, which was just before the COVID pandemic struck, but increased to 50% of the pre-pandemic level in mid-June. Subway passengers are also increasing in many other cities, including Suzhou in Jiangsu Province, Wuhan in Hubei Province, and Zhengzhou in Henan Province. However, it is likely that the crowds will not get completely back to normal, as many areas still have some activity restrictions in place. An example is Guangzhou in Guangdong Province, which was actually ahead of Shanghai and Beijing in moving to ease its activity restrictions.

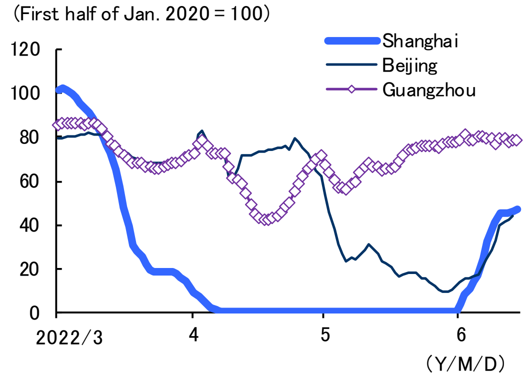
With this ongoing relaxation of restrictions, personal consumption is expected to pick up, especially in services. In fact, tourism demand is already recovering steadily. Domestic tourism revenue during the string of Labor Day-related public holidays from the end of April to the beginning of May declined to 60% of the previous year's level, but revenue during the Dragon Boat Festival holiday period in June recovered to nearly 90% of the previous year's level. Tourism demand is expected to recover further as people book their summer vacations. According to a major Chinese travel booking website operator, airline ticket reservations for summer vacations have recovered significantly, with Shanghai, Sanya in Hainan Province, Guangzhou in Guangdong Province, Beijing, and Urumqi in Xinjiang Uyghur Autonomous Region being the most popular destinations. As for food service sales, given that May sales were down 21.1% YoY, there is plenty of room for recovery going forward.

＜No. of Automobiles Sold (Seasonally Adjusted Annual Rate)＞



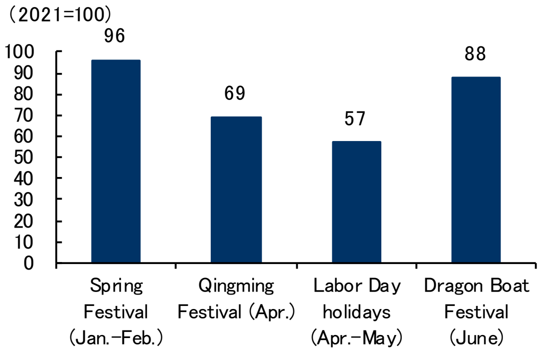
Source: Prepared by JRI based on the China Association of Automobile Manufacturers

＜Subway Ridership＞



Source: Prepared by JRI based on Wind database
Note: Moving average of previous seven days

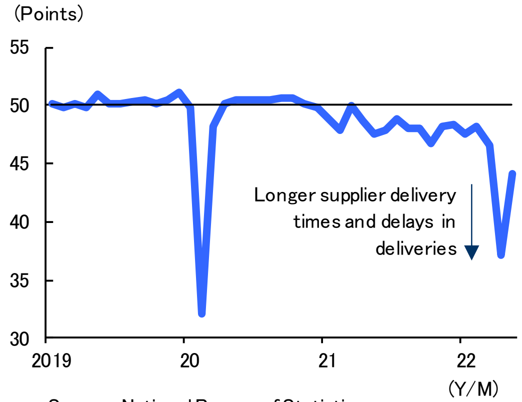
＜Domestic Tourism Revenue (2022)＞



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

The second is the normalization of manufacturing output. Industrial production, which recovered in May, has not yet reached full capacity due to supply constraints, such as logistical disruptions. Truck freight traffic is still below the previous year's level. The Supplier Delivery Time Index of the Manufacturing PMI for May stood at 44.1 points, well below the 50 mark, the benchmark for good/bad performance, indicating longer delivery times and delays in deliveries. However, industrial production is expected to accelerate soon as the supply constraints caused by activity restrictions gradually abate.

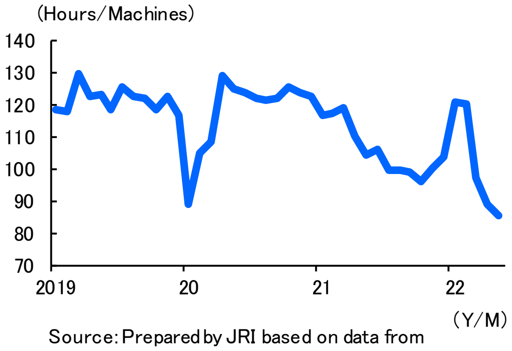
＜Manufacturing PMI Supplier Delivery Time Index＞



Source: National Bureau of Statistics

The third is the manifestation of the effects of economic stimulus measures. The government has set this year's growth target at "around +5.5%," while adhering to its zero-COVID policy. Although fixed asset investment has been sluggish due to local governments being short on funds, the government has increased the policy banks' credit line by RMB 800 billion to support infrastructure investment, and with the same goal in mind, it has directed that the annual quota of RMB 3.65 trillion in special local government bond issuance be used up by August. Construction activity has been sluggish, with construction equipment operating hours at low levels over the past few months, but once the government support begins to bite, there is a strong possibility that construction-related investment will pick up.

＜Construction Machinery Operating Hours (Seasonally Adjusted)＞



Source: Prepared by JRI based on data from Komatsu Ltd.'s KOMTRAX system

In addition, the effects of consumption stimulus measures such as tax breaks on passenger vehicles and the distribution of local gift vouchers are expected to become apparent in the second half of the year. The government has set aside a budget of RMB 60 billion for a passenger vehicle purchase tax reduction program that will run from June 1 to December 31 of this year. Meanwhile, the city of Shenzhen in Guangdong Province has budgeted RMB 500 million for the distribution of gift vouchers and RMB 100 million for subsidies for the purchase of home appliances, while Shanghai will provide a subsidy of RMB 10,000 per vehicle for purchases of electric vehicles. Auto sales are expected to steadily recover on the back of these tax incentives and subsidies, and the release of pent-up demand will provide an additional boost.

In short, although the Chinese economy is predicted to pick up going forward, the decline in economic activity in the April-June period will drag down the full-year real growth rate for 2022 to just +4.4%, which is low by Chinese standards. In 2023, real growth is expected to improve to +5.2% as the economy continues its return to normal in the wake of the COVID pandemic.

■ Downside risks to the economy remain

As an adjunct to the main scenario described above, caution needs to be exercised with respect to the following three risks: The first is a recurrence of suppression of economic activity in line with the zero-COVID policy. While it is unlikely that the Chinese government will impose complete lockdowns like the one in Shanghai this spring, it remains possible that the government will again ramp up PCR testing and impose targeted restrictions on going out, as it did in Beijing in May. If this happens, an economic slowdown is inevitable.

Second, accelerating inflation is a concern. In China, low inflation has persisted even as resource prices have soared, as companies have refrained from passing on their higher costs to customers through price hikes. However, if high inflation becomes the norm worldwide, there is a risk that companies will be forced to raise prices. In that case, accelerating inflation could lead to households and businesses curbing their spending.

And third, there is a risk of the real estate market adjustment being prolonged. Sentiment toward homeownership could fall away if home prices continue to fall. A deteriorating real estate market could result not only in a slump in real estate development investment, but also in the curtailment of infrastructure investment by local governments suffering reduced revenues from the sale of land use rights.

(Shinichi Seki)