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# *Topics* *Implied non-performing loans are increasing in China*

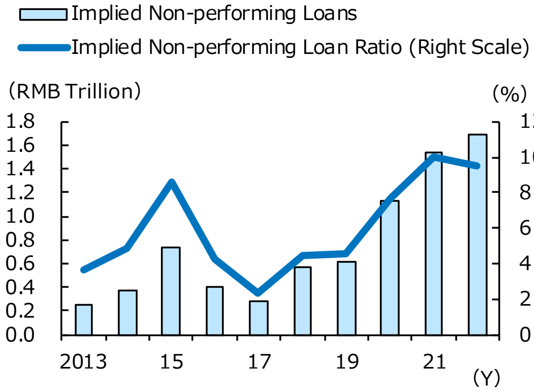
In China, implied non-performing loans (NPLs) have increased significantly. The zero-COVID policy and real-estate market correction have saddled financial institutions with loans likely to become non-performing.

## ■ Implied NPLs have increased substantially

Implied NPLs are on the rise in China. Implied NPLs are debts of companies whose earnings before interest, taxes, depreciation and amortization (EBITDA), a measure of cash flow from operating activities in the broad sense, are less than the interest payments. They are regarded as loans that are likely to fall into arrears.

Estimates based on financial data for about 3,800 companies listed on the Shanghai, Shenzhen, and Beijing stock exchanges (non-financial companies) for which data is available put these companies' implied NPLs at RMB 1,685.4 billion in mid-2022, meaning that implied NPLs make up 9.6% of all the loans. Particularly large increases were seen in 2020 and 2021, when the spread of the COVID triggered a rapid rise in implied NPLs.

<Implied Non-performing Loans at Chinese Listed Companies>



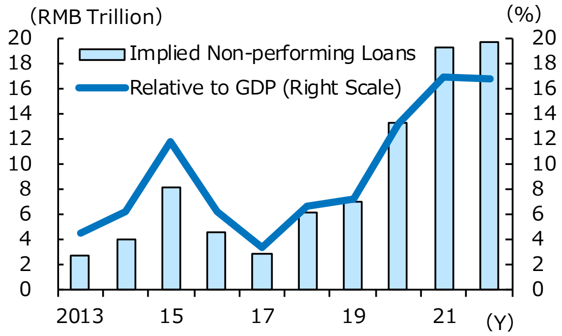

Source: Prepared by JRI based on data from Wind Database

Note: The most recent figures are for June 30, 2022.

Extrapolating from this sample data, implied NPLs across China were estimated to amount to RMB 19.7 trillion in mid-2022. This is equivalent to 16.9% of GDP, so NPLs Problem can be viewed as weighing on the Chinese economy.

It is difficult to ascertain from the statistics published by the Chinese government that the COVID pandemic has caused a significant increase in NPLs. According to government figures, NPLs on the books of commercial banks in mid-2022 stood at just RMB 3.0 trillion, and the NPL ratio (i.e., the proportion of NPLs to all loans) has been gradually declining after peaking in mid-2020.

<Implied Non-performing Loans in China as a Whole>




Sources: Prepared by JRI based on data from Wind Database, People's Bank of China, and National Bureau of Statistics

Note: The most recent figures are for June 30, 2022.

As a background factor, it can be pointed out that the government has pushed for an expansion of loans to support the economy. As an initial means of doing this, lenders have been asked to roll over existing loans. Since 2020, the government has called on financial institutions to maintain their proactive lending stance to shore up corporate finances, even though problems have emerged in borrowers' ability to repay their debts. As a result of the rollover of existing loans and the extension of new ones, the ratio to GDP of outstanding loans at all financial institutions rose from 155% at the end of 2019 to 176% by mid-2022. In addition, the government has tightened the criteria for recognizing NPLs, making it harder to classify loans as NPLs even when repayment status worsens. These measures have resulted in government statistics on NPLs no longer reflecting the reality of the situation.

## ■ The rise in implied NPLs is especially marked in the non-manufacturing sector

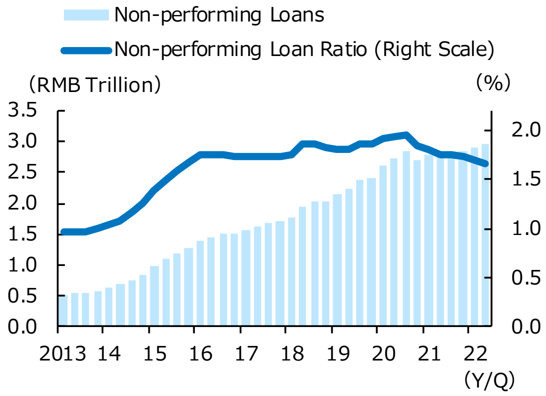
Looking at the implied NPLs of listed companies by industry, the non-manufacturing sector exhibited a conspicuous increase. Implied NPLs of listed non-manufacturing enterprises in mid-2022 stood at RMB 1,244.7 billion, a 4.9-fold rise from the end of 2019. As a result, the implied NPL ratio of listed non-manufacturing companies also jumped to 10.8%.

The following two reasons can be identified as providing the backdrop for this: The first is the so-called zero-COVID policy, under which even tiny outbreaks are not tolerated. In the areas where outbreaks have occurred, de facto lockdowns have been imposed, shutting down stores, public transportation, and highways, and restricting people from leaving their homes. This has caused many non-manufacturing firms to suffer a sharp drop in revenues.

In particular, the implied NPL ratio for transportation and warehousing has soared from 0.4% to 31.1%. According to the National Bureau of Statistics (NBS), the combined passenger traffic of trunk roads, railways, airplanes, and ships in the first six months of 2022 decreased by 68.5% from the same period in 2019. As a result, the number of firms in the transportation and warehousing sector that were unable to cover their interest payments with operating cash flow increased significantly.

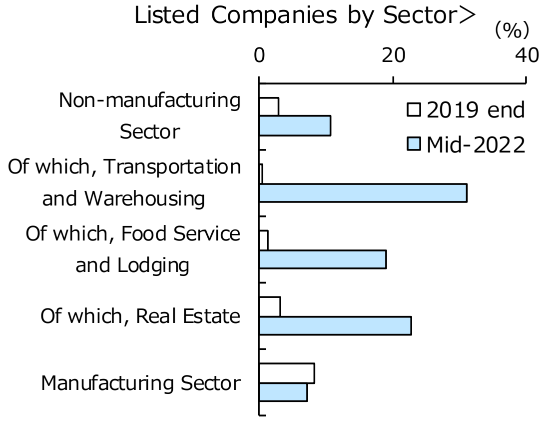
The implied NPL ratio in the food service and lodging industry also rose substantially from 1.2% to 18.9% over the same period. According to the Ministry of Culture and Tourism, domestic tourism revenue during the Chinese New Year holidays in 2022 dropped by 43.7% from the same period in 2019.

<Non-performing Loans of Commercial Banks (Government Statistics)>




Source: Supervisory Statistics of the Banking and Insurance Sectors, China Banking and Insurance Regulatory Commission

<Implied Non-performing Loan Ratio of Listed Companies by Sector>




Source: Prepared by JRI based on data from Wind Database

The second is the correction in the real-estate market. Wary of runaway housing prices and overinvestment by real-estate companies, the government has taken measures to curb overheating from both the demand and supply sides since 2020. Total mortgage loan limits and restrictions on home purchases were introduced as a means of dampening demand, and loans to real-estate firms were regulated as a means of curtailing supply. This has resulted in a significant decline in home sales. According to the National Bureau of Statistics, the floor area of homes for sale in the first six months of 2022 decreased by 12.3% from the same period in 2019. Some real-estate companies saw their cash flow dry up, forcing them to halt residential construction work, and the implied NPL ratio in the real-estate sector shot up from 3.2% at the end of 2019 to 22.9% in mid-2022.

Meanwhile, the implied NPL ratio for the manufacturing sector declined slightly from 8.3% at the end of 2019 to 7.2% in mid-2022. Although the supply chain disruptions caused by the zero-COVID policy have been a hindrance, the pandemic boosted demand for ICT equipment such as PCs, which led to a significant expansion in exports of goods to the rest of the world.

The zero-COVID policy and real-estate market correction have saddled financial institutions with more and more implied NPLs. If China can switch to a strategy of living with the virus, the business environment in the non-manufacturing sector would likely improve. However, General Secretary Xi Jinping stated at the recent party congress that he would continue to control the spread of the disease, and expressed his desire to keep the zero-COVID policy in place. With the zero-COVID policy to be maintained and the real-estate market correction set to drag on, implied NPLs are expected to remain at high levels going forward.

**(Shinichi Seki)**

# Topics Foreign direct investment in Malaysia is growing rapidly

Foreign direct investment (FDI) in Malaysia is increasing sharply against a backdrop of digitalization and U.S.-China tensions. However, political unrest is also growing in the country, and the upcoming general election is a cause for concern.

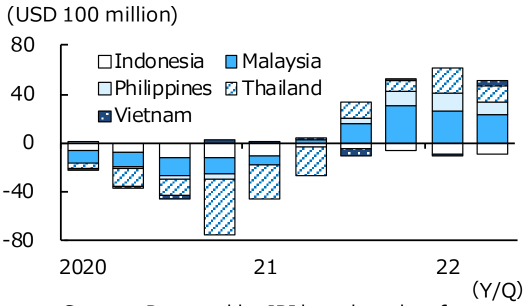
## ■ Investment in Malaysia is surging as firms leave China

FDI into ASEAN countries is on the rise. Since the 2000s, ASEAN countries have been attracting attention as candidates for production facilities under so-called China Plus One strategies, which emerged from a background of soaring labor costs and frequent labor disputes in China. Since the late 2010s, trade friction between the U.S. and China has intensified this trend, and FDI inflows to the ASEAN-5 (Indonesia, Malaysia, the Philippines, Thailand, and Vietnam) averaged USD 56.1 billion per year in the 2010s, a threefold increase from the USD 18.6 billion in the 2000s. Foreign investment declined in 2020 due to COVID, but began to increase again in 2021. This is a consequence of the growing risk of supply chain disruptions resulting from China's zero-COVID policy, and the growing trend among companies to move away from China.

Within the ASEAN zone, the amount of direct investment in Malaysia has increased significantly. In particular, direct investment in the electrical and electronic components industry, especially semiconductors, is rising rapidly. Of the total amount of foreign investment approvals for manufacturing in Malaysia in 2021, approvals in this industry accounted for more than 80% of the total, a large increase of approximately 11 times from the previous year. The following three points can be cited as contributing factors:

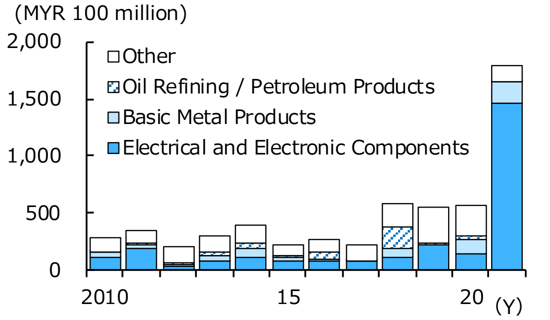
The first is the worldwide acceleration of digitalization. The COVID pandemic saw a global surge in online communication and services. This led to increased demand for telecommunications equipment and the rapid construction of infrastructure such as 5G mobile communication systems and data centers. To meet this global demand, Malaysia's capacity to supply a wide range of electrical and electronic component-related products, including semiconductors, has been strengthened.

<Breakdown of Inward Direct Investment in ASEAN-5>
(Flow, Comparison with 2019 Average)




Source: Prepared by JRI based on data from the IMF
Note: Change from 2019 average in each country. Three-quarter moving average.

<Amount of Approved Foreign Investment in Manufacturing in Malaysia>




Source: Prepared by JRI based on data from the Malaysian Investment Development Authority

The second is the intensification of U.S.-China tensions. The U.S.-China confrontation was initially centered on trade friction, but after 2020, the issue shifted to control of exports and investments related to advanced technologies with military applications. In particular, the U.S. government is accelerating the restructuring of supply chains for semiconductors, which are becoming increasingly important from an economic security perspective, and Malaysia is raising its profile as a destination for fab relocation. Malaysia has succeeded in luring semiconductor companies to the Penang area, and has an advantage over other ASEAN countries in terms of attracting these firms because it already has a wide range of semiconductor fabrication processes, from front-end to back-end, available. In fact, it is already one of the most important centers in the world for the back-end processes of packaging and testing. According to a

JETRO report on Malaysia's electrical and electronics industry (2022), a “well-developed electrical and electronics industry ecosystem” is the most frequently cited factor for companies deciding to invest in Malaysia, and the chip industry ecosystem in Malaysia is regarded by foreign companies. 2021 saw a wave of announcements of major semiconductor-related investments in the country, including expansion/construction of an advanced semiconductor plant by Intel (U.S.) and construction of a high-performance printed circuit board and IC plant by AT&S (Australia).

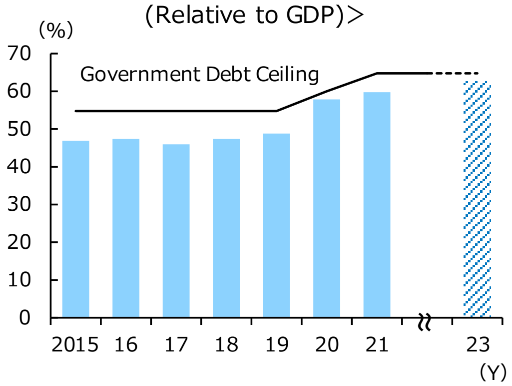
The third is government support. The Malaysian Investment Development Authority offers tax incentives to foreign manufacturing companies setting up in the country. For companies that meet certain requirements, 70% of statutory income is not subject to taxation, and in some cases, such as in the high-tech sector, firms may be granted a full income tax exemption for 10 years. In addition, the Malaysian government's focus on protecting intellectual property rights is thought to be another factor behind the increase in FDI. The Special 301 Report on intellectual property from the Office of the U.S. Trade Representative (USTR) puts Indonesia on the priority watch list and Thailand and Vietnam on the watch list, but Malaysia is not on either list, something which is also believed to be working in its favor.

## ■ An unstable political situation and fiscal risks call for caution

However, political unrest in Malaysia could dampen its FDI boom.

Following Prime Minister Ismail Sabri's dissolution of Parliament on October 10, it was announced that a general election will be held on November 19. In the short period since the inauguration of the Mahathir administration in May 2018, there have been two changes of government, in February 2020 (Muhyiddin administration) and August 2021 (Ismail Sabri administration), against a backdrop of intense conflict within the ruling coalition. Victory in the next general election is crucial if the current administration is to solidify its power base. However, it is uncertain whether the United Malays National Organisation (UMNO), to which the current prime minister belongs, will win a majority. The general election will be a contest between five or more ruling and opposition forces. Among the major parties that make up the current coalition government, the UMNO has indicated that it will not cooperate with the Malaysian United Indigenous Party (PPBM) or the Malaysian Islamic Party (PAS) in the election campaign. As a result, there is a strong sense of uncertainty surrounding the political situation going forward, including the possibility that the UMNO may form a new coalition government through post-election maneuvering to obtain a majority.

<Outstanding Government Debt (Relative to GDP)>




Source: Prepared by JRI based on data from the Ministry of Finance (Malaysia)
Note 1: Outstanding government debt is the total of outstanding Malaysian Government Securities, Malaysian Government Investment Issues, and Malaysian Islamic Treasury Bills
Note 2: Figure for 2023 is a government projection

The government's proposed budget for FY2023, released in October, was drawn up with the election in mind. It includes numerous preferential measures for individuals and SMEs, including tax cuts for the latter, cash handouts to a wide range of people, higher salaries for public employees, and the postponement of the reintroduction of the consumption tax. Expenditures, excluding COVID-related spending, will increase by 3% from 2022, and the budget deficit will remain high at 5.5% of GDP. In addition, outstanding government debt is expected to reach 63% of GDP at the end of 2023, and the statutory debt ceiling, which has been temporarily raised until the end of 2022, is expected to be extended. If the instability in terms of the government’s power base continues after the election, fiscal consolidation may be delayed and fiscal risks may increase due to the adoption of populist policies designed to serve party interests. In that event, there is a risk of financial market instability, which could discourage foreign firms from investing in Malaysia.

**(Mitsuhiro Matsumoto)**