ASIA MONTHLY

December 2022

株式会社日本総合研究所

http://www.jri.co.jp/english/periodical/asia/

This report is the revised English version of the December 2022 issue of the original Japanese version (published 29th Nov.).

Asia: Stable growth of ASEAN and India and decoupling from China

Regarding the Asian economy in 2023, China's adherence to a zero-COVID policy will delay its economic recovery, while ASEAN economies and India will continue to rebound, and are expected to become increasingly attractive as locations for companies exiting China.

1. Stable growth in the ASEAN and India will support the Asian economy

<Asian Economic Growth Rates>

(%)

	2021 (Actual)	2022 (Forecast)	2023 (Forecast)	2024 (Forecast)
Asia Total	7.2	4.2	4.8	5.1
Northeast Asia	7.7	3.1	4.5	4.7
China	8.1	3.3	4.9	5.1
South Korea	4.1	2.3	1.9	2.1
Taiwan	6.6	2.7	2.0	2.4
Hong Kong	6.3	-3.3	3.0	2.1
ASEAN	3.4	5.6	4.9	5.1
Indonesia	3.7	5.0	4.9	5.2
Malaysia	3.1	7.9	4.9	4.9
Philippines	5.7	6.8	5.7	6.1
Thailand	1.5	3.3	3.4	3.3
Vietnam	2.6	7.8	6.5	6.6
India	8.7	6.5	5.8	6.3

Source: JRI

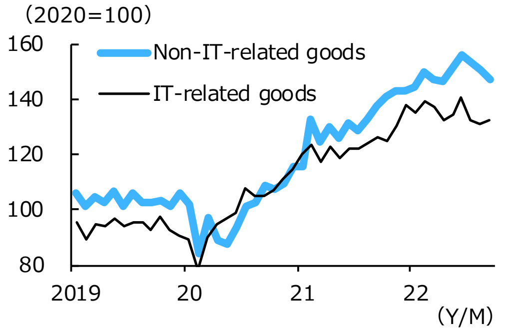
Overall, the economies of Asian countries have rebounded during 2022, but there has been significant variation among economies in the pace of recovery. In China, which is sticking to a zero-COVID policy, the economy deteriorated in early spring due to tighter activity restrictions imposed in response to rising infections, and the subsequent recovery has been weak. Hong Kong is also maintaining severe restrictions on activities, and its economy remains sluggish, especially in terms of domestic demand. Real growth in China and Hong Kong in 2022 is expected to have been much lower than originally projected, standing at +3.3% in China (+5.4% forecast in December 2021) and -3.3% in Hong Kong (+2.2%). In contrast, South Korea and Taiwan are predicted to have grown by 2.3% (+2.4%) and 2.7% (+2.8%), respectively, on par with the initial forecasts, having been supported by strong semiconductor demand in the first half of the year. In the ASEAN and India, domestic demand expanded as a result of the normalization of economic activity due to the relaxation of activity restrictions. As for foreign demand, exports of goods were firm, exports of services also picked up as inbound demand recovered due to the easing of entry restrictions. As a result, growth in 2022 is expected to have been strong. It is predicted to have been higher than initially forecast in the ASEAN5, at +5.6% (+5.2%), and only slightly lower in India, at +6.5% (+6.9%).

Moderate economic growth is expected to continue throughout Asia in 2023. However, regional differences remain, and the economic recoveries in China, where activity restrictions are still in place, and in South Korea and Taiwan, where exports are being pushed down by declining demand for advanced semiconductors, are expected to lack strength. In contrast, stable growth is projected for the ASEAN and India on the back of the following three factors:

The first is robust exports of goods. Non-IT goods exports account for 70% of Asian exports and have remained strong this year. In particular, resource exports have been strong due to the global tightening of energy supply and demand, particularly in European countries, as a result of sanctions against Russia by Western countries and Russia's retaliatory measures (such as natural gas supply cuts). In Indonesia and Malaysia, export volumes of mineral fuels are increasing, and this trend is expected to continue for the foreseeable future. Among IT-related goods, demand for advanced chips for PCs and smartphones has been sluggish, but old-generation semiconductors for automobiles and home appliances continues to be in short supply, so production is expected to expand going forward. With current auto production in major countries more than 10% lower than 2019 levels, strong demand for old-generation chips is expected to continue to boost Asian exports, especially from ASEAN countries.

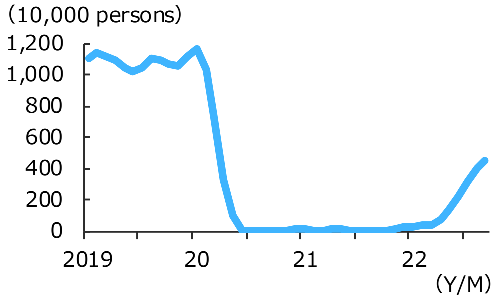
The second is the recovery in services exports. Starting in the spring of 2022, entry restrictions in Asian countries have been eased one after another, and the number of overseas tourists, especially from within Asia, is picking up. In September, the number of visitors to ASEAN countries recovered to about 40% of the 2019 level. Although it is difficult to see a recovery of tourists from China, where activity restrictions are still in place, the return of tourists from outside China is estimated to bring the number of visitors in 2023 up to 80% of the 2019 level, which is expected to boost services exports.

<Exports from Asia >
(Seasonally-adjusted Figures)



Source: Prepared by JRI based on data from CEIC
Note 1: Exports from China, South Korea, Taiwan, India, Indonesia, Malaysia, the Philippines, Thailand, and Vietnam.
Note 2: Figures for IT-related goods were calculated based on items that include semiconductors and electrical/electronic devices.

<No. of Visitors to ASEAN Countries>



Source: Prepared by JRI based on statistics from each country
Note: ASEAN figures are the total number of visitors to Thailand, Malaysia, Singapore, Indonesia, the Philippines, Vietnam, and Cambodia. Figures for Malaysia from August 2022 are JRI estimates. Figures are three-month trailing moving averages.

The third is firm domestic demand. In the ASEAN and India, pent-up demand, released by the recent easing of activity restrictions, has boosted consumption. The employment environment is also improving due to the release of pent-up demand, which is expected to continue to support consumption through higher incomes in the future. In fact, the easing of restrictions on the operation of restaurants and entertainment establishments has led to a recovery in employment in the face-to-face service sector, resulting in a decline in unemployment rates.

Given these factors, the growth rate for the Asian economy as a whole in 2023 is expected to be +4.8%. China's growth is projected to be +4.9%, below the pre-COVID (2017-19 average) mid-6% range. The NIEs are expected to grow by 2.0%, also below the pre-COVID range of 2-3%. The ASEAN and India, on the other hand, are expected to see growth rates of +4.9% and +5.8%, respectively, which is stable growth on par with pre-COVID levels.

2. ASEAN and India increasingly attractive as destinations for relocating production bases from China

A prolonged Chinese economic slump could intensify moves to restructure supply chains. Vietnam, Malaysia, and Indonesia, in particular, are becoming increasingly attractive to companies from various countries as destinations for new investment and the relocation of production.

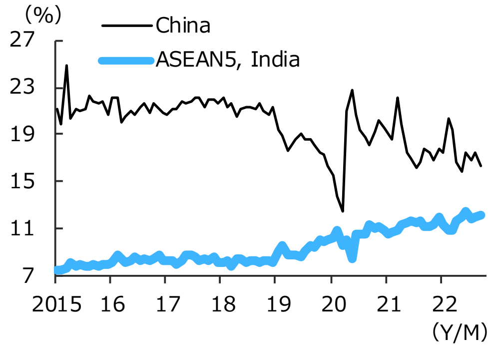
Since the 2000s, firms from around the world have been pursuing so-called China Plus One strategies, which involve diversifying investment beyond China into other economies and emerged from a background of soaring labor costs and frequent labor disputes in China. In addition to this, the U.S.-China trade friction of the late 2010s and China's zero-COVID policy since 2020 have accelerated a trend of decoupling from China. From the U.S. perspective, the economic relationship with China is weakening, while relationships with Asian countries around China are strengthening. As a reflection of this, the

ASEAN and India's share of total U.S. imports has been rising since 2019. Among countries, Vietnam's presence is growing, with its import share rising 2.3 percentage points from 1.7% in 2015 to 4.0% in 2022. Vietnam enjoys a considerable advantage over other Asian countries as a destination for relocating production because of its 1) inexpensive labor force, 2) proximity to China, and 3) trade agreements etc. that facilitate exports. Just recently, foreign companies have expressed their intention to expand production in Vietnam, and investment in the country is expected to continue to grow steadily.

Attention is also being paid to the fact that direct investment in Malaysia increased significantly through 2021. U.S.-China tensions were initially centered on trade friction, but after 2020, the issue shifted to control of transactions related to advanced technologies with potential military applications. In response, the U.S. is rapidly restructuring semiconductor supply chains, which are becoming increasingly important from an economic security perspective. Malaysia has long been successful in luring semiconductor companies to the Penang area, which is already home to a wide range of chip fabrication processes, from front-end to back-end. This well-developed electrical and electronics industry ecosystem is an advantage in attracting companies, and is spurring electrical and electronics-related investment in Malaysia from the U.S. and other countries.

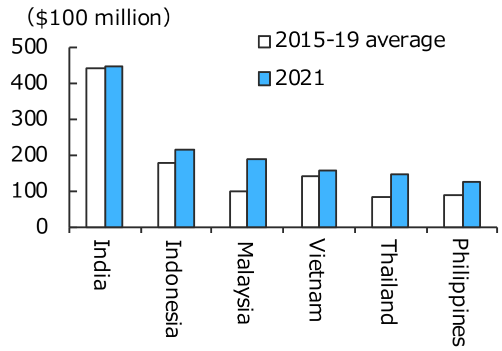
In Indonesia, resource-related investment could increase rapidly. As competition to secure natural resources intensifies worldwide, the Indonesian government has formulated an industrial strategy that takes advantage of the country's abundant reserves. Indonesia has the world's largest nickel reserves, and its government has set a goal of building a domestic supply chain covering upstream to downstream operations in the electric vehicle (EV) industry to make the most of these reserves. Specifically, the government has encouraged domestic smelting by banning the import of nickel ore since 2020, and this has led to major investments in the base metal industry, including nickel smelting. The government also aims to make the country a hub for EV production in the ASEAN region. The country is welcoming foreign investment related to lithium-ion batteries and EV production, and investment in the automotive industry is also expected to increase.

<Shares of Imports to the U.S. >
(Nominal, Seasonally-adjusted Figures)



Source: Prepared by JRI based on data from the U.S. Department of Commerce

<Inward Direct Investment >
(Based on Balance of Payments Data)



Source: Prepared by JRI based on data from the IMF

The ASEAN and India are therefore looking increasingly likely to succeed in attracting production facilities and further accelerating their economic growth. However, since such developments would exacerbate U.S.-China tensions, and the possibility that the governments of the countries concerned, wary of a deterioration in relations with the U.S. or China, could backtrack and become more reluctant to attract companies cannot be ruled out. The U.S. is trying to promote "friendshoring," a policy of strengthening supply chains by leveraging relationships with allies and friends, and accepting this policy could worsen relations with China. In addition, elections and other political events are coming up in ASEAN countries and India, and companies in each country need to pay attention to the risk of domestic political instability following elections. Since many countries have unstable governments, there is a possibility that social conditions may worsen or policy directions may change depending on the outcome of elections, which could make it harder than before for these countries to attract companies. In Malaysia, for example, since 2018, there have been repeated maneuvers aimed at securing parliamentary majorities by both ruling and opposition parties, resulting in frequent changes of prime minister. With no party able to win a majority in the November lower house elections on its own, the power struggle is expected to continue under a coalition government, and the political situation is likely to remain unstable. In Indonesia, President Joko, whose high approval rating and strong power base have allowed him to advance his policies aggressively, will finish his term in 2024. The presidential candidates of each party are expected to be decided in the second half of 2023, but it is unclear whether the next president will be able to demonstrate strong leadership and implement policies to accelerate growth in Indonesia, a country with a multiparty political system.

<Schedules of Key Elections in ASEAN Zone and India>

2022	
June	Philippines presidential election (Won by Marcos)
November	Malaysia lower-house general election (No single party secured a majority)
2023	
May	Thailand lower-house election (Government fragile due to factional infighting)
2024	
February	Indonesia presidential election (President Joko's term of office ending)
By spring	India parliamentary general election (Government does not currently have a majority in the upper house)

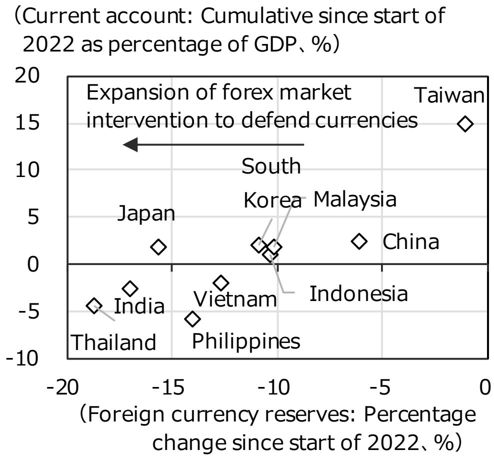
Source: Prepared by JRI based on data from each country

3. Financial risks call for vigilance

In Asian countries, the risk of financial instability continues to warrant attention. Since the start of 2022, the U.S. Fed's rapid monetary tightening policy has put downward pressure on all emerging market currencies. And in Asia, there are concerns that as a result of COVID-19 and the Ukraine issue, 1) deteriorating current account balances, 2) accelerating inflation, and 3) cumulatively increasing government debt will further destabilize markets, especially the foreign exchange market.

Specifically, with the exception of Indonesia and Malaysia, Asian countries rely on imports of food and mineral resources. Because the prices of these commodities have soared, current account balances have worsened across the board. The deteriorating current account balances have increased downward pressure on currencies via transactions based on actual demand, and foreign exchange reserves have been substantially depleted in the Philippines, Thailand, India, and Vietnam as these countries increasingly intervene in the forex market to defend their currencies.

<Current Account and Foreign Currency Reserves of Asian Countries>

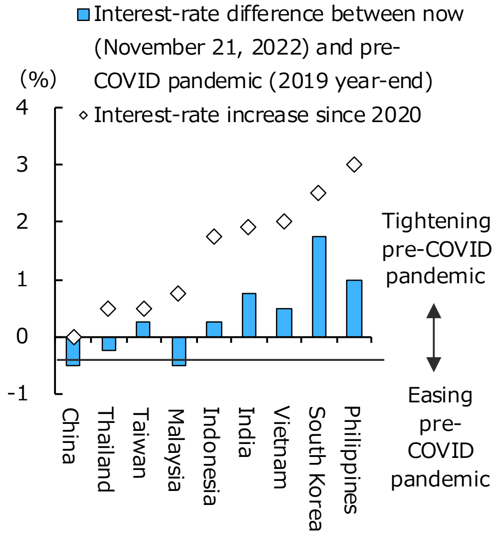


Sources: Prepared by JRI based on data from CEIC and the IMF

In addition, inflation is accelerating in Asian countries, and social conditions are becoming unstable in some of them. Consumer price inflation has exceeded inflation targets recently, reaching 6.8% in India, 7.7% in the Philippines, 6.0% in Thailand, and 5.7% in South Korea. In response, their central banks have been raising their policy rates at a rapid pace. In many countries, policy rates are above pre-COVID pandemic levels and monetary conditions are tight. In South Korea, for instance, the policy rate has gone up two percentage points since the arrival of COVID. With interest rates rising sharply, a major South Korean theme park operator has defaulted on its bonds, rapidly spreading alarm about credit risk.

Fiscal health has also deteriorated rapidly since COVID emerged. In response to COVID, fiscal spending to expand healthcare system capacity and shore up economies increased sharply in 2020. Later, in 2022, countries moved to tame rising prices by boosting measures to support households in the face of soaring energy prices, so the expansion of expenditures has not been contained. According to the IMF, the general government debt-to-GDP ratio rose from 57.2% in 2019 to 71.5% in 2021 in China. And even in the ASEAN5, it climbed by more than 10 percentage points from 38.4% in 2019 to 49.9%. If the problems of current account deficits, high inflation, and budget deficits worsen, there is a risk of financial markets being thrown into turmoil as capital outflows swell further.

＜Policy Interest Rates in Asia＞



Sources: Prepared by JRI based on data from CEIC

(Mitsuhiro Matsumoto)
(Minoru Nogimori)

NIEs Sluggish growth due to weak demand from chips and China

■ In 2022, growth in South Korea and Taiwan will slow, while in Hong Kong it will be negative

Real GDP growth in the NIEs (South Korea, Taiwan, and Hong Kong) in 2022 is expected to be +1.8%, far lower than the +5.2% recorded in 2021. In South Korea and Taiwan, exports, a growth driver, have lost momentum due to the weak semiconductor market. Furthermore, China, the NIEs' largest trading partner, has experienced an economic slowdown due to activity restrictions imposed under the zero-COVID policy. In particular, the Hong Kong economy, which has strong ties with the Chinese economy, is expected to see negative growth.

<Outlook for the NIEs' GDP Growth Rates>

(%)

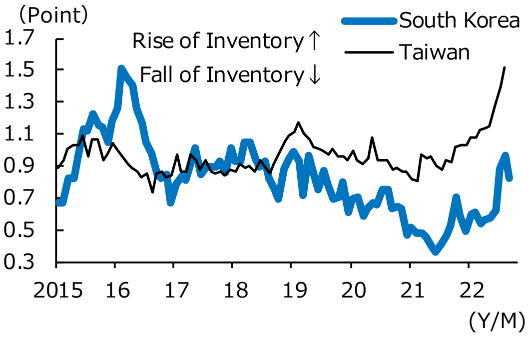
	2019	2020	2021	2022 F	2023 F	2024 F
NIEs	2.0	-0.0	5.2	1.8	2.0	2.2
South Korea	2.2	-0.7	4.1	2.3	1.9	2.1
Taiwan	3.1	3.4	6.6	2.7	2.0	2.4
Hong Kong	-1.7	-6.5	6.3	-3.3	3.0	2.1

Source: JRI

■ Deteriorating demand for semiconductors and the weak Chinese economy will also put downward pressure on economies in 2023.

Growth in the NIEs in 2023 is expected to remain tepid, though it will improve over the previous year to +2.0% thanks to a rebound in Hong Kong's growth rate following the previous year's sharp deterioration. In the background to this is the slump in the semiconductor market. In this market, inventories have built up, especially in Taiwan and South Korea, which mainly manufacture advanced chips and memory semiconductors. In these countries, sharp drop in demand for PCs and smartphones has caused the balance between inventories and shipments to worsen. In Taiwan, shipments of semiconductors and other electronic components fell 0.6% year on year (YoY) in August, while inventories surged by 63.2%. In South Korea, too, shipments dropped by 18.1% YoY, but inventories jumped 67.5%. Inventory adjustments are likely to continue at least through the first half of 2023, and are expected to be a drag on the Taiwanese and South Korean economies. Furthermore, China's economy is only recovering slowly, and will not be strong enough to bring about an upturn in exports from the NIEs. The zero-COVID policy, which has been weighing on the Chinese economy, is expected to be scaled back in around March 2023, but only in stages, so there is scant prospect of a rapid rebound for the Chinese economy.

<Inventory/Shipment Ratio for Semiconductor (Seasonally Adjusted) >



Source: JRI based on CEIC Note: Inventory-shipment ratio is calculated by dividing inventory index by shipment index.

It also needs to be noted that geopolitical risks are increasing in the NIEs. Regarding Taiwan, relations between the U.S. and China have become tenser in the wake of U.S. House Speaker Pelosi's visit to the island. And as for South Korea, tensions are also rising as a result of North Korea's repeated ballistic missile launches. Although neither is likely to see outright armed conflict, there is a risk that the growing uncertainty will blunt investment and lead to downturns in their economies. In Hong Kong, there have been no major developments since the introduction of the National Security Law. In 2021 the Chinese government shelved plans to extend application of the Anti-Foreign Sanctions Law (which subjects individuals and organizations involved in sanctions against China to potential countermeasures such as denial of entry and freezing of assets in China) to Hong Kong, but if its introduction starts being considered again, concerns about a worsening business environment will intensify, so caution is required.

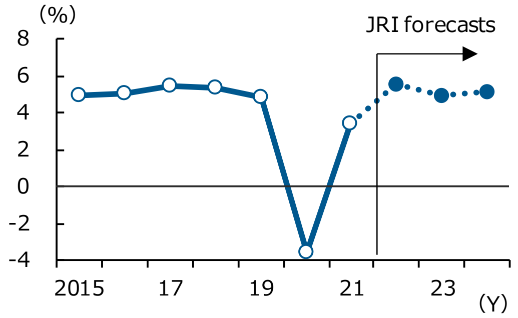
(Soichiro Tateishi)

ASEAN5 Stable economic growth is expected to continue

■ 2023 growth looks set to be on par with pre-COVID levels

Real GDP growth in the ASEAN5 (Indonesia, Malaysia, the Philippines, Thailand, and Vietnam) is expected to hit +5.6% in 2022, up from +3.4% in 2021. In the ASEAN5, activity restrictions have been steadily relaxed since this spring, when new infections fell to low levels. Crowds at retail and recreational facilities increased, and have now recovered to levels exceeding pre-COVID. Consumption has picked up as a result, especially for face-to-face services, so it is domestic demand that has been driving the economic resurgence. As for foreign demand, exports of goods have been firm thanks to the global economic recovery. Inbound demand has also increased since countries began substantially relaxing entry restrictions in the spring, and service exports have picked up accordingly.

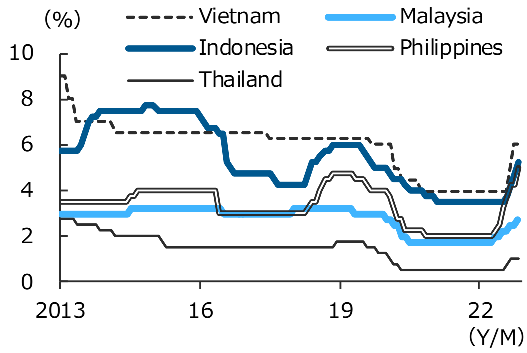
<Real GDP Growth Rate of ASEAN5>



Source: Prepared by JRI based on statistics from each country

In 2023, ASEAN economies are expected to continue to grow steadily, in terms of both domestic and foreign demand. Foreign demand will be driven by the expansion of service exports resulting from the recovery of inbound demand. As of September, the number of tourists to the ASEAN5 has already recovered to 40% of the monthly average of 2019, and is expected to reach to 80% of 2019 levels as non-Chinese tourists return. In 2019, the ASEAN5's international tourism revenues accounted for 4.3% of GDP, well above the global average of 1.7%, so the economic boost from the recovery in inbound demand will be significant. Goods exports are also expected to remain strong. There are major concerns about global energy shortages triggered by the Ukraine crisis, and strong demand for mineral fuels produced in the ASEAN looks set to continue for the foreseeable future. In addition, while demand for advanced chips for PCs and smartphones will fade, production of old-generation semiconductors for automobiles and home appliances, which have been in short supply, is expected to increase, which will prop up the ASEAN's exports. Domestic demand is also expected to hold firm. The employment environment appears set to continue to improve, especially in the face-to-face services space, and consumption is expected to be supported by higher household incomes. Moves to relocate production out of China as the clashes between the U.S. and China intensify could also lead to an increase in capital investment.

<ASEAN5 Policy Interest Rates>



Source: Prepared by JRI based on data from Bloomberg L.P.
Note: As of November 17, 2022. Figures for Vietnam are refinancing rates.

In light of the above, the real GDP of the ASEAN5 is expected to grow at +4.9% in 2023, meaning that growth will stay on par with pre-COVID levels (2017-19 average: +5.2%).

Against this main scenario, the risk is of a situation developing in which monetary tightening in the U.S. and runaway resource prices bring further inflation. Interest rate hikes are in full swing in the ASEAN5 to tame inflation and defend currencies. If inflation rises further due to higher import prices resulting from additional currency depreciation or higher resource prices, central banks will be forced to raise interest rates even more, and the ASEAN economy could falter.

(Mitsuhiro Matsumoto)

India Economic expansion is slowing, but stable growth will continue

■ The growth rate in FY2022 will reach to +6.5%

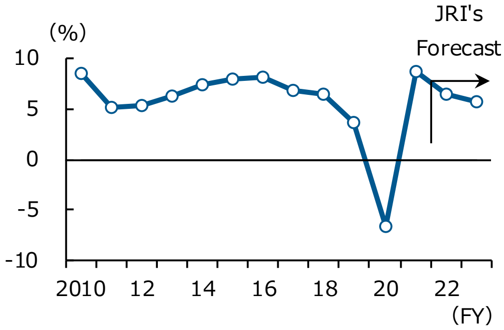
India's economy is continuing to expand. In FY2021 (April 2021-March 2022), activity restrictions were reimposed in areas with severe COVID outbreaks, but a nationwide lockdown was avoided, so while the economy took a hit, the downturn was only temporary. As a result, real GDP grew by 8.7%, returning the economy to its pre-pandemic level.

Economic expansion continued in the first half of FY2022 as COVID-induced downward pressure on the economy eased. The PMI (Purchasing Managers' Index) continues to hover above 50, the threshold for a positive assessment of market conditions, and monthly indicators such as GST (Goods and Services Tax) revenues and vehicle sales also indicate that the economy is continuing to expand.

However, the downward pressure on the economy being exerted by inflation is intensifying. Wholesale price inflation remains in the double-digit range due to the surge in resource prices. Action such as reducing fuel-related taxes and increasing imports of cheap oil from Russia have kept consumer price inflation in check, though it is still above the upper limit of the Reserve Bank of India's target range. In addition, monetary tightening in the U.S. and other foreign countries has led to a decline in the inflow of investment funds from abroad. This has caused the rupee to depreciate, which has exacerbated inflationary pressures. Although the Reserve Bank of India has also been tightening monetary policy to stabilize prices and exchange rates, the India-U.S. interest rate differential has narrowed due to the large U.S. interest rate hikes, and the rupee has weakened to the 80 rupee per dollar level.

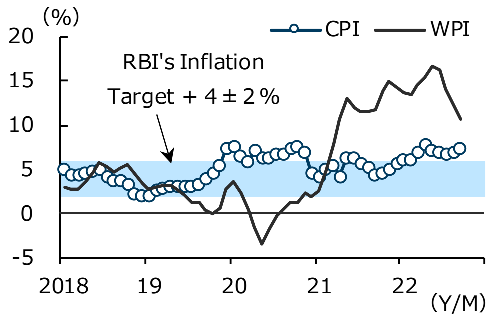
Looking ahead to the second half of FY2022, inflation is expected to gradually slow against a backdrop of 1) rainfall during the monsoon season (June through to the end of September), which affects agricultural production, having been normal, and 2) weakening crude oil prices due to concerns about a global economic slowdown. As a result, the downward pressure on the economy due to inflation is expected to decrease in the future, and real GDP in FY2022 is expected to have continued to grow at a higher rate (+6.5%) than other Asian emerging countries.

<Real GDP（Y o Y）>



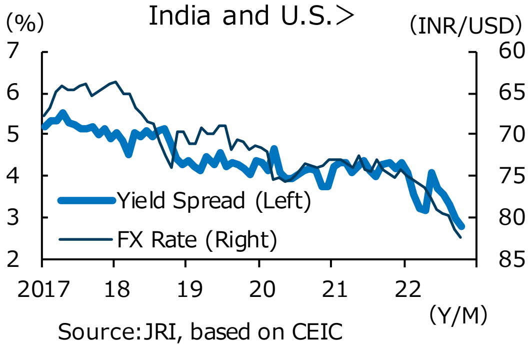
Source:JRI, based on Ministry of Statistics and Programme Implementation

<CPI and WPI (Y o Y)>



Source:JRI, based on Reserve Bank of India

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



Source:JRI, based on CEIC

■ Growth will slow to +5.8% in FY2023

In FY2023, the pace of economic expansion is expected to weaken, with real GDP growth slowing to +5.8%. for the following three reasons: The first is that the release of pent-up demand from the COVID pandemic will top out. Retail and entertainment crowds, which were severely impacted by activity restrictions, have recovered to pre-pandemic levels, and the boost to consumption from the normalization of economic activity is expected to peter out before long.

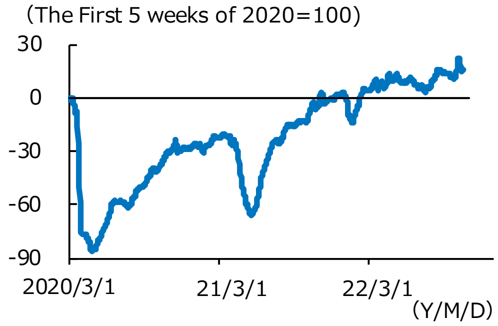
The second is that higher real interest rates will pile downward pressure on durable goods consumption and capital investment. The Reserve Bank of India will continue to raise interest rates to contain inflationary pressures, and the real policy rate (nominal policy rate minus inflation) is expected to rise by 1-2 percentage points above current levels through mid-2023, taking it into positive territory. As a result, real interest rates in the market are projected to rise as well. According to the Reserve Bank of India, a one percentage point increase in real interest rates depresses real GDP growth by 0.2 percentage points, and given this, a rise in real interest rates would slow growth in the next fiscal year by between 0.2 and 0.4 percentage points.

The third is that the slowdown in the world economy will put downward pressure on exports of goods and services, which account for about 20% of GDP. India's exports to the West account comprise around 40% of its total exports, so exports are greatly affected by economic conditions in developed countries. In 2023, rich-world economies are expected to see slowdowns, and export growth is likely to stutter correspondingly.

Downside risks to this main scenario include prolonged global inflation and further monetary tightening. If inflation remains high against a backdrop of high resource prices due to an increasingly tense international situation and reduced crude output from oil-producing countries, as well as supply constraints due to instability in exports from China as it continues with its zero-COVID policy, countries would be expected to step up the pace of interest rate hikes. This would compel the Reserve Bank of India to pursue additional interest increases, and higher interest rates of various kinds would put downward pressure on the Indian economy.

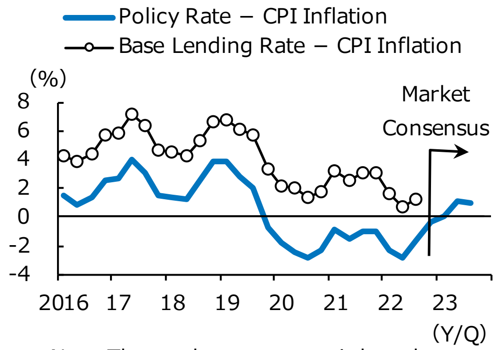
Upside risks to the economy include lower resource prices due to an easing of international tensions and increased fiscal spending for low-income individuals, farmers, and microenterprises ahead of the lower-house general election scheduled for 2024. However, the situation in Russia/Ukraine, which is having a big impact on international food and energy prices, remains unpredictable, and the urgent task of reducing government debt, which has swelled significantly due to the COVID pandemic, would make any major fiscal spending moves difficult. Therefore, the downside risks to the Indian economy should be viewed as greater than the upside risks.

<Mobility Data (Retail & Recreation)>



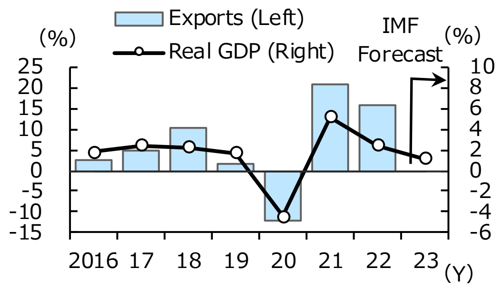
Note: 7-day backward moving averages.
Source:JRI, based on Google

<Real Interest Rate>



Note:The market consensus is based on Survey of Professional Forecasters (As of 30th Sep 2022)
Source: JRI, based on Reserve Bank of India

<India's Real Exports and Advanced Economies' Real GDP (Y o Y)>



Note:Exports in 2022 is calculated from the data in the first half of the year.
Source:JRI, based on Ministry of Commerce and Industry and IMF

(Shotaro Kumagai)

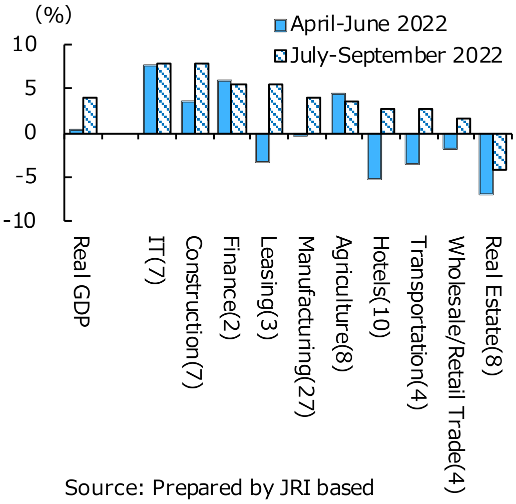
China *The pace of economic recovery has slowed*

■ The worst is over, but growth will have failed to reach the government's target in 2022

11Real GDP growth in the July-September quarter stood at a +3.9% YoY, an increase from the figure of +0.4% recorded for the previous quarter. By industry, growth in the manufacturing sector turned positive, hitting +4.0% compared with -0.3% in the quarter before. The increase reflected a rebound from the slump in the previous quarter, which saw a spate of plant shutdowns during the two-month lockdown that began in March 2022. Similarly, service industries such as hotels, transportation, and wholesale/retail trade, which were affected by activity restrictions in the previous period, also saw positive growth as the restrictions were scaled back.

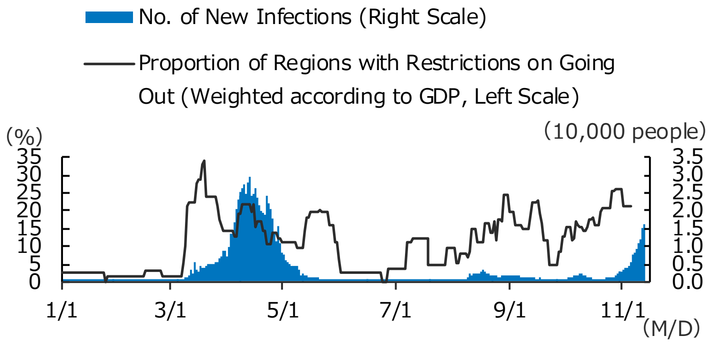
The economy bottomed out in the April-June quarter and has continued to pick up, but since October, both domestic and foreign demand have lacked vigor and the pace of recovery has slowed. With the number of new COVID cases on the rise, government restrictions on activities are being tightened once again, though large-scale lockdowns have yet to occur. Retail sales were hit by a sharp decline in transactions, though online transactions were an exception, and fell by 0.4% YoY in October, the first month in five months to register a negative figure. Despite increased government-supported infrastructure investment and capital investment by state-owned enterprises, fixed asset investment in October slowed to +4.3% YoY from the previous month's figure of +6.7%. Real-estate investment has also continued to decline, dragging down the overall figure. In addition, nominal exports dropped 0.4% YoY for the first fall in two years and five months. The Chinese real export index published by the Netherlands Bureau for Economic Policy Analysis also seems to be plateauing, and the momentum of external demand may also be weakening as "stay home" demand runs its course and European economies deteriorate.

<Real GDP Growth Rate >
(By Sector, Annualized)



Source: Prepared by JRI based on data from CEIC
Note: Figures in parentheses indicate the share of GDP in 2021.

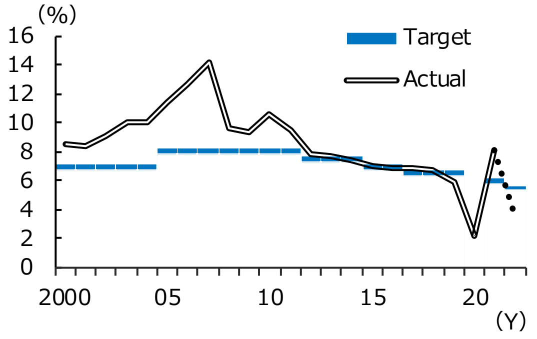
<Restrictions on Going Out in China (2022)>



Sources: Prepared by JRI based on data from OxCGRT and CEIC
Note: Of 31 provinces, municipalities, and autonomous regions, the proportion of provinces etc. that have reached the strictest level for the "stay-at-home requirements" component of the University of Oxford's Stringency Index was calculated.

In March of this year, the government set the economic growth target for 2022 at around +5.5%, but the October-December quarter is expected to see only +4.0% YoY growth, far below the +12% that would be needed to achieve the target. Growth for the full year is expected to come in at +3.3%, meaning that the target will have been missed by an unprecedentedly large margin.

<Chinese GDP Growth Rate Targets and Actual Figures>



Source: Prepared by JRI based on data from CEIC and various media reports
Note: The figure for 2022 (+3.3%) was estimated by JRI. No target was set for 2020, when COVID first began to spread.

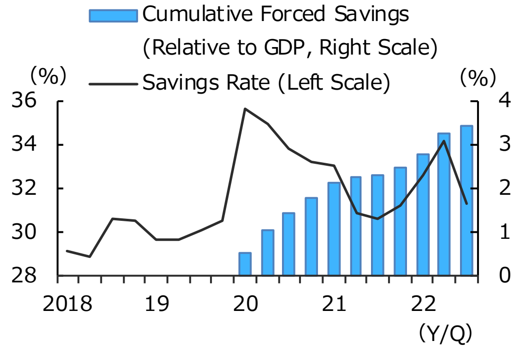
■ COVID, the real-estate market, and U.S.-China tensions will hinder recovery in 2023

The pace of economic recovery is expected to remain slow in 2023, with growth projected to be just +4.9%. It will not be possible to adequately address the following three issues, which are expected to impede the economic recovery.

The first is maintenance of the zero-COVID policy. At the National People's Congress in March of next year, the economic growth rate target for 2023 will be presented, and the zero-COVID policy will likely be reworked around that time to ensure that the target is not missed again as it was in 2022. Chinese households have accumulated excess savings due to activity restrictions, and rebound consumption can be expected to result from the policy shift.

However, the zero-COVID policy is unlikely to be fully abandoned soon. Rather, measures will be eased in phases, so any boost to consumption will probably be limited. The downside risk of strict activity restrictions being maintained for a long period, even at the expense of the economy, cannot be completely ruled out, and much will depend on what happens with COVID.

<Estimates of Saving Rates and Forced Savings in China>



Source: Estimated by JRI based on data from CEIC
Note: Calculated by comparing actual consumption with expected consumption if the average propensity to consume in 2019 had been maintained.

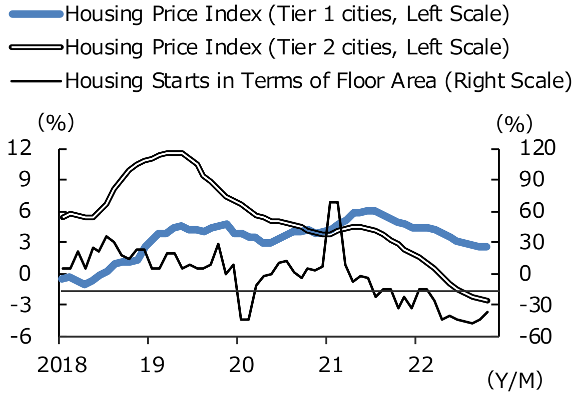
The second is the floundering real-estate market. Housing starts, in terms of floor area, have declined significantly, especially in regional cities, where the supply-demand imbalance is worsening and home prices are falling. The financial sector, which is closely linked to the real-estate industry, has also been hit hard. During the summer, regional cities saw a surge in incidences of real-estate companies running out of funds and finding themselves forced to halt housing construction. A number of homebuyers rebelled against the substantial delays in property delivery by refusing to make payments on their loans.

The slump in the real-estate market has been in some part due to the concept of "common prosperity" articulated by the Chinese leadership in 2021. The government is reluctant to step in to prop up the real-estate market as it is seeking to bring housing prices down to more affordable levels. A vicious cycle has emerged in which the government allows property prices to fall, causing the performance of real estate-related companies to deteriorate, which in turn leads to further price declines. While measures of some sort to stimulate demand will be needed to revitalize the real estate market, the government is likely to prioritize "common prosperity" and refrain from implementing large-scale policies, making a prolonged market slump a strong possibility.

The third is the intensification of the U.S.-China clash. Recently, frictions in the area of semiconductors, which are of great economic and military importance, have intensified. The U.S. government, in particular, has been tightening related regulations, and new rules announced on October 7 require U.S. companies to obtain prior approval from the U.S. government when exporting equipment used in the manufacture of advanced semiconductors to China. In addition, while the U.S. government had already prohibited dealings with some Chinese chipmakers because of their ties to the Chinese military, it has recently extended such bans to cover a large number of companies. In response to these measures, several U.S. semiconductor-related companies have announced that they will stop doing business with Chinese firms. Furthermore, since the new regulations prohibit U.S. engineers from being involved in semiconductor production and development in China, there have been reports of U.S. workers in the Chinese chip industry being forced to leave their jobs. However, some non-Chinese semiconductor manufacturers with fabs in China have been given a grace period of one year, during which they will not need to comply with the new rules. In the future, however, semiconductor-related transactions within China, including those by non-U.S. foreign companies, are expected to become more difficult.

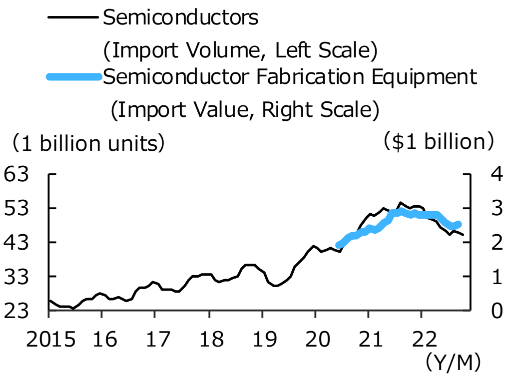
Since mid-2021, China's imports of semiconductors and semiconductor fabrication equipment have followed a downward trend. In addition, China's domestic self-sufficiency rate for semiconductors is just 16.7% (as of 2021). Further U.S. restrictions on semiconductor-related business with China could deal more blows to China's manufacturing industry. The Chinese government has not changed its confrontational stance toward the U.S., and there is no indication that it will consider concessions or compromises to get the regulations lifted.

<Housing Prices and Housing Starts in Terms of Floor Area in China (YoY Change)>



Source: Prepared by JRI based on data from CEIC
Note: Tier 1 cities are Shanghai, Beijing, Shenzhen, and Guangzhou.

<Chinese Semiconductor and Semiconductor Equipment Imports>



Source: Prepared by JRI based on data from CEIC
Note: Figures are six-month trailing moving averages.

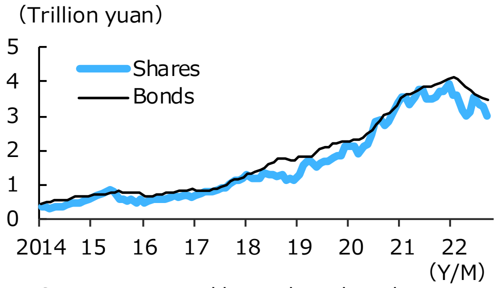
■ Long-term growth potential is a concern as moves to exit China accelerate

Failure to overcome these three challenges, namely COVID, the real-estate market issues, and U.S.-China tensions, will not only depress the economy over the short term, but may also speed up moves away from China and weaken medium- to long-term growth potential.

The balance of direct investment in China by foreign firms began to increase from the April-June 2020 quarter as the country recovered from its initial COVID outbreak, but then started to decline in the April-June 2022 quarter. The zero-COVID policy, in particular, has significantly damaged the business environment in China, forcing foreign companies to rethink their strategies. Since mid-October, the Zhengzhou plant of Apple's supplier Hon Hai Precision Industry (Foxconn) has been grappling with massive production delays due to tighter activity restrictions, increasing concern about a possible drop in iPhone shipments. In response, Foxconn is reportedly planning to quadruple the workforce at its replacement Indian plant over the next two years.

There have also been changes in investment in financial assets in China by foreign investors. Investment by overseas investors in shares and bonds had expanded rapidly in recent years, contributing to the growth of the Chinese economy, but started to decline at the beginning of 2022. There is a lot of business in China related to Russia, and increase in the risks posed by such business due to the Ukraine issue is one factor. Indeed, it has been reported that foreign investors are selling bonds issued by two of China's so-called "policy banks," namely the China Development Bank and the Export-Import Bank of China, because they have extended loans in connection with Russian energy development projects.

<Value of Mainland China Securities Held by Overseas Investors>



Source: Prepared by JRI based on data from the PBOC

The face-off between China and the West is deepening, triggered by the Ukraine issue, and its impact may spread beyond portfolio investment to trade and other areas in the future. In May, the U.S. announced the launch of the Indo-Pacific Economic Framework (IPEF), and is poised to build a robust international cooperative framework for economic security with friendly countries with a view to countering China. If the zero-COVID policy and the Ukraine issue further accelerate the decoupling of the West and China, this could spur companies and investors to flee China, which would put downward pressure on China's growth potential over the medium to long term.

(Minoru Nogimori)