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Asia: Risks from the U.S. and China threaten stable growth in Asia

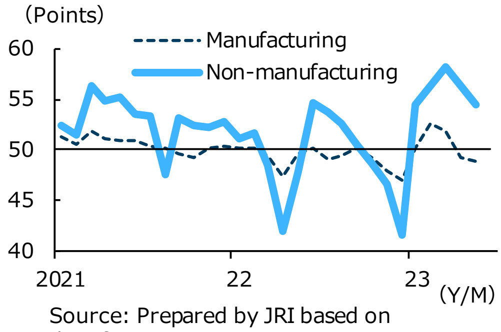
Asian economies are expected to continue to recover, driven by the service sector. However, caution is required as they are heavily reliant on the U.S. and Chinese economies, which are facing downturns. In addition, there are no signs of the U.S.-China confrontation abating, and the risk of the economic fragmentation deepening looms.

1. The services-driven Asian economic recovery will continue

(1) Asian economic performance varies according to differences in dependence on foreign demand and dependence on domestic demand

Overall, Asian economies are picking up, but the pace of recovery has varied greatly among countries/territories since the beginning of 2023. Economies that are highly reliant on foreign demand have been going through a rough patch as goods exports decline against a backdrop of sluggish global demand for high-tech products. Among them, Taiwan and Vietnam posted negative quarter-on-quarter (QoQ) real GDP growth in January-March 2023, with Taiwan falling into a technical recession (i.e., negative growth for two consecutive quarters). On the other hand, QoQ growth rates in the Philippines and Indonesia, where domestic demand accounts for a large share of total GDP, stayed in positive territory for the 11th quarter in succession, while India's growth rate was positive for the second consecutive quarter. In these countries, the positive impact of the normalization of economic activity has continued even since the lifting of COVID-related activity restrictions, and domestic demand, especially consumption, is climbing robustly. China’s economy is also rebounding at a fast pace, with growth of +2.2% QoQ registered in the January-March quarter as domestic demand bounced back thanks to the ditching of the country’s zero-COVID policy. In China, the reopening has given a major boost to the economy, though the driver is a sharp rebound in non-manufacturing activity due to a resurgence in demand for services such as travel and food service, which had been curtailed by activity restrictions. In contrast, demand for goods such as automobiles and home appliances remains tepid, and business confidence in the manufacturing sector is deteriorating. The fact that China's recovery has been skewed toward services has also slowed the pickup in the overall economy, which is highly dependent on foreign demand.

<China Purchasing Managers' Index: PMI>



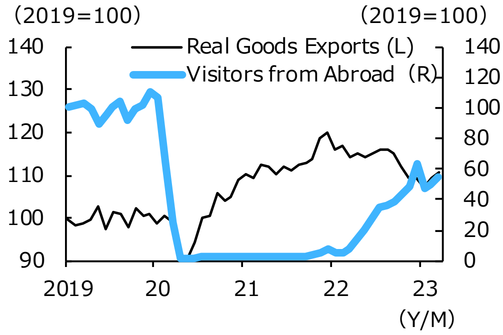
Source: Prepared by JRI based on data from CEIC

(2) The recovery is expected to continue, supported only by the service sector

Looking ahead, the overall Asian economic recovery is projected to continue due to three factors: 1) continued recovery in services exports, 2) improvement in the employment environment, and 3) a lull in upward pressure on interest rates.

First, inbound demand is expected to remain firm, offsetting the weakness in goods 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 March this year, the number of visitors to Asian countries recovered to about 50% of the 2019 level. Moreover, starting in February the Chinese government has been doing away with its bans on group travel to ASEAN countries. Thailand and Malaysia, which have suffered from sluggish exports of goods, should see further increases in Chinese tourists starting in the second half of the year, so

<Overseas Demand in Asia>



Source: Prepared by JRI based on data from CEIC
Note: Totals for ASEAN5, South Korea, and Taiwan

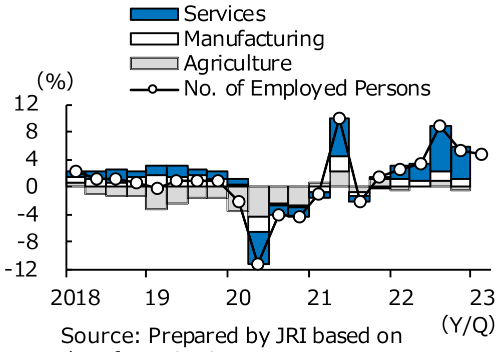
services exports are likely to give a fillip to their growth rates.

Second, the employment environment is improving. The normalization of economic activity is progressing, with operating restrictions on restaurants and entertainment venues being relaxed, while employment is recovering and unemployment rates are declining. Particularly in ASEAN countries, the number of people employed in the service sector has increased significantly, and the recoveries in inbound demand are driving this trend. This improved employment environment will lead to higher incomes, which should keep consumption firm.

Third, downward pressure on domestic demand caused by interest rate hikes is easing. Many central banks in Asia have followed the U.S. in continuously raising policy rates since 2022. However, an increasing number of them have stopped raising rates recently. According to the IMF's commodity price indices, the surge in food and beverage prices is coming to a halt, and energy prices have also fallen sharply. Inflation in some countries, such as South Korea and the Philippines, is well above their central banks' targets, but in general, inflationary pressures are weakening across Asia. Furthermore, the currencies of Asian countries/territories, which lost value during 2022, have been stable on the whole since the beginning of 2023. This is because the pace of U.S. interest rate hikes has slowed and the outflow of capital from Asia has been halted. With inflationary pressures abating and exchange rates stabilizing, Asian central banks are expected to maintain neutral monetary policy stances or shift to easing in the near term.

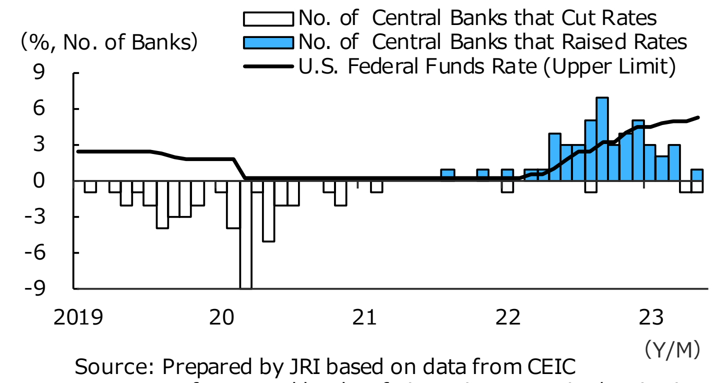
In view of this outlook, our forecast is for stable economic growth for Asia as a whole in 2023. We expect it to come in at +5.3% year on year (YoY), on par with pre-COVID 2019 (+5.0%). This latest growth forecast marks an upward revision from the +4.8% we predicted in November last year. It reflects a faster-than-expected recovery in China (+0.7

<No. of Employed Persons in Major Southeast Asian Countries (YoY) >



Source: Prepared by JRI based on data from CEIC
Note: Totals for the Philippines, Thailand, and Vietnam

<U.S. Policy Interest Rate and Asian Central Bank Moves>



Source: Prepared by JRI based on data from CEIC
Note: Data for central banks of nine Asian countries/territories (China, South Korea, Taiwan, India, Indonesia, Philippines, Malaysia, Thailand, and Vietnam) was used, with the calculation performed as +1 for each central bank that raised rates and -1 for each central bank that cut rates.

<Asian Growth Rate Forecasts>

(%)

	2021 (Actual)	2022 (Actual)	2023 (Forecast)	2024 (Forecast)
Asia Total	**7.3**	**4.3**	**5.3**	**5.0**
Northeast Asia	7.7	2.8	5.1	4.4
China	8.1	3.0	5.6	4.7
South Korea	4.3	2.6	1.5	2.3
Taiwan	6.5	2.4	1.8	2.5
Hong Kong	6.4	▲ 3.5	3.5	2.9
ASEAN 5	3.4	6.0	4.9	5.2
Indonesia	3.7	5.3	4.9	5.2
Malaysia	3.1	8.7	4.6	4.9
Philippines	5.7	7.6	5.8	6.1
Thailand	1.6	2.6	3.2	3.5
Vietnam	2.6	8.0	6.2	6.6
India (FY)	9.1	7.2	6.3	6.7

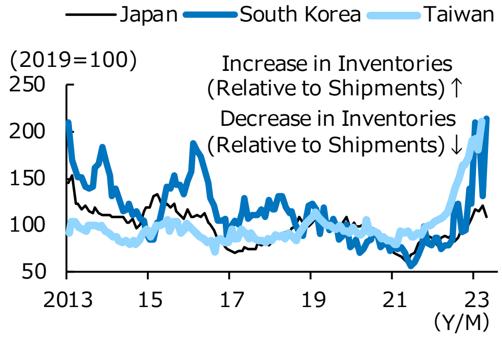
Sources: Prepared by JRI based on data from national statistical bureaus, central banks, and the IMF percentage points compared with our previous forecast), and other economies where the uplift effect of domestic demand is substantial. In the second half of 2023, however, we expect the Chinese economy to lose momentum as the rebound in consumption of services such as travel and food service runs its course. The driving force for the Asian economy looks likely to shift to the ASEAN5, where growth rates will rise on the back of higher domestic demand. For 2024, we predict that growth will decelerate to +5.0%, which is still a relatively high rate. Although the Chinese economy will lack momentum, our view is that stable growth will be maintained in Asia overa, with factors such as resurging exports from Taiwan and South Korea pushing up the growth rate.

(3) Potential economic downturns in the U.S. and China pose a risk

Nevertheless, there is growing uncertainty surrounding the U.S. and Chinese economies, and depending on what happens, Asian economies could be at risk. If the U.S. and Chinese economies, the two giants of the world economy, were to undergo sudden changes, Asian economies would also be massively impacted.

The U.S. has managed to maintain a solid economic recovery so far, but that momentum is slowing as interest rates rise rapidly. Moreover, financial risks are smoldering, following a string of bankruptcies of regional banks and other financial institutions, and wariness about an economic downturn is growing. In China, meanwhile, services consumption, which had been curtailed by the COVID pandemic, is strong, but demand in other areas is flaccid. Housing demand is notably sluggish, and in rural areas, the real-estate market correction could become more serious due to a combination of structural problems, such as the accumulation of excess housing inventory and declining birthrates. If financial and real-estate markets take a turn for the worse, there is a risk of a more punishing economic backslide.

<Ratio of Semiconductor Inventories to Shipments (Seasonally-adjusted)>



Source: Prepared by JRI based on data from CEIC
Note: Ratio of inventories to shipments = inventory index ÷ shipment index

The impact on the chip sector, where demand has been stagnant since last year, is also a worry. As of the midpoint of this year, the semiconductor market has yet to see sufficient progress in trimming inventories, and it remains unclear when the industry will be able to start producing again. Economic downturns in the U.S. and China, major demand centers for high-tech products, would further delay any recovery of demand for smartphones and PCs, which has stalled due to such factors as the fading out of stay-home-related consumption. Furthermore, economic deterioration in the U.S. and China could put downward pressure on demand in new fields that are expected to grow in the future, such as AI. In Taiwan and South Korea, prolonged stagnation in demand for semiconductors, which is the core industry for both of them, would likely lead to significant downturns in their economies and, consequently, in the Asian economy as a whole.

2. Asian economies are being shaken by the U.S.-China confrontation

The importance of the U.S. and Chinese economies to Asia goes beyond the short-term business cycle. If the tension between the two countries, which shows no signs of subsiding, escalates, it ultimately risks splitting the world economy and causing serious harm to Asian economies.

Since 2020, the COVID pandemic and Russia's invasion of Ukraine have disrupted trade transactions and hastened discussion of economic security worldwide, and also triggered moves to restructure supply chains. The U.S.-led trend toward “de-risking” with respect to China is accelerating. At the same time, moves to promote “friendshoring," the aim of which is to complete transactions within friendly countries so as to make supply chains more resilient, are ongoing. In May, the 14 participating countries of the IPEF (Indo-Pacific Economic Framework) struck a deal called the Supply Chains Agreement, and discussions through frameworks such as the APEP (Americas Partnership for Economic Prosperity), QUAD (Japan-US-Australia-India Quadrilateral Security Dialogue), and AUKUS (a trilateral security pact between the U.S., U.K., and Australia) are also underway.

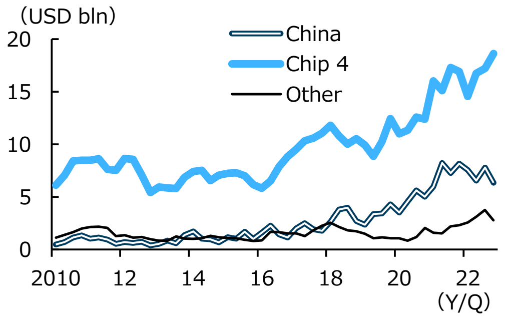
Among these developments, the ramping up of moves to restructure semiconductor supply chains is making the environment for China increasingly harsh. In recent years, the U.S. has been tightening its rules on semiconductor business with China with the goal of forestalling any expansion of China's chipmaking capacity. Moreover, discussions are proceeding among members of the Chip 4 semiconductor alliance (Japan, the U.S., South Korea, and Taiwan) to strengthen coordination in semiconductor production in a way that shuts out China. The U.S. has passed the CHIPS-Plus Act (budget: $52.7 billion) while Japan has earmarked around one trillion yen in government funds to "secure domestic production sites for advanced semiconductors." With these moves, the two nations are looking to encourage foreign semiconductor companies to build facilities in their countries. Furthermore, Taiwan has amended the Act for Industrial Innovation (產業創新條例, Taiwan's version of the CHIPS-Plus Act) to increase tax credits for high-tech firms (from 15% to 25% for R&D expenses and from 0% to 5% for capital investment), while South Korea is aiming to invest over 340 trillion won through infrastructure support, deregulation, tax incentives, and other measures as part of a strategy to become a semiconductor powerhouse, with a view to bringing its semiconductor industry back home. In fact, while chip-related capital investment has stalled in China, it has risen dramatically within the Chip 4, where the expansion of manufacturing capacity is accelerating.

<Friendshoring-related Frameworks>

IPEF (14 countries)	APEP (12 countries)	Chip 4
Australia	Barbados	Japan
Brunei	Canada	South Korea
Fiji	Chile	Taiwan
India	Colombia	U.S.
Indonesia	Costa Rica	**QUAD**
Japan	Dominican Republic	Australia
South Korea	Ecuador	India
Malaysia	Mexico	Japan
New Zealand	Panama	U.S.
Philippines	Peru	**AUKUS**
Singapore	Uruguay	Australia
Thailand	U.S.	U.K.
U.S.		U.S.
Vietnam		

Source: Prepared by JRI based on various media reports

<Sales of Semiconductor Manufacturing Equipment by Location of Sale>



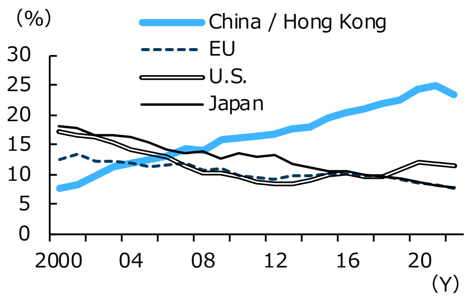
Source: Prepared by JRI based on data from the Semiconductor Equipment Association of Japan

However, the impacts on Western nations and U.S. allies of this burgeoning enthusiasm for friendshoring and reshoring will not necessarily all be positive. Particularly in Asia, which plays a central role in the manufacturing supply chain, attention must be paid to the risk of adverse effects such as 1) economic division and resulting moves toward exclusion and 2) impeded development of emerging countries emanating from industrial relocation that ignores economic efficiency.

First, if the world economy were to decisively split into rival camps, the adverse impact on Asian economies would be enormous. Estimates from the European Central Bank indicate that friendshoring resulting in economic division could depress global GDP by as much as 5.3%, with the pain being especially felt in Asian countries such as Singapore, Vietnam, and South Korea. This estimate assumes a fairly extreme division, with countries mechanically divided into a Western bloc and Eastern bloc based on voting patterns at the U.N. General Assembly, tighter regulations, and other non-tariff barriers imposed, but it is undeniable that amplification of the current confrontation would ultimately lead to such a situation. Developing and emerging countries, which comprise the so-called Global South, are likely aware of such economic disadvantages, and harbor misgivings about cooperating with the U.S.-led reworking of supply chains. In Asia, ASEAN's reluctance to get involved in the U.S.-led realignment is due in part to its members' strong economic ties with China, which accounts for the largest share of

ASEAN's trade transactions. In addition, as the fissures deepen, there are moves by the U.S. and China to exclude the other country's companies from their own markets. In May, the Chinese government banned domestic key infrastructure operators from procuring products from U.S. semiconductor giant Micron. With smartphone sales in China accounting for more than 20% of the global total, China is a major demand center for high-tech devices. The damage incurred by companies, especially high-tech device makers, from Western nations and countries that are friendly toward them as a result of the loss of China demand will be substantial.

<Regional Shares of ASEAN Trade>



Source: Prepared by JRI based on data from CEIC
Source: Trade is the total of imports and exports. ASEAN data is for the five countries of Indonesia, Malaysia, Philippines, Thailand, and Vietnam.

Second, the emphasis on economic security as the objective of supply chain restructuring is also leading to production being relocated without any consideration being given to economic efficiency. Both Western countries and China are ratcheting up their efforts to attract foreign companies and shield domestic enterprises through subsidies, particularly in the semiconductor industry. So far, though, subsidies for companies relocating to emerging economies have remained small, in part because the Global South has shown scant enthusiasm for the friendshoring concept. Until now, based on so-called China Plus One strategies, which involve diversifying the locations of overseas facilities to encompass countries/territories other than China, global companies from various countries have opted to build their new plants in emerging economies such as ASEAN countries, as they constitute good substitutes for China, and this has helped emerging economies to grow. However, if Western countries and China employ subsidies to accelerate transfers that are economically inefficient, countries such as ASEAN members will no longer enjoy the benefits of globalization, and may not be able to develop their economies as they have done in the past.

NIEs Signs of exports bottoming out; watch out for U.S.-China conflict

■ In 2023, growth will recover to the same level as the previous year

Economic trends in the NIEs (South Korea, Taiwan, and Hong Kong) are uneven. The economies of South Korea and Taiwan are slowing, while that of Hong Kong is rebounding. Hong Kong's economic recovery has been largely down to a rapid resurgence in consumption and inbound demand since mainland China scrapped its zero-COVID policy. Meanwhile, the slowdowns in South Korea and Taiwan are partly due to an ongoing export slump caused by lackluster global demand for semiconductors. In addition, weak demand for goods in China, the NIEs' largest trading partner, has also put downward pressure on exports.

Looking ahead, the growth rate of the NIEs for the full year of 2023 is expected to be +1.8% YoY, remaining on par with the previous year (+1.9% YoY) as exports pick up and consumption and inbound demand continue to recover. Specifically, inbound demand should continue to increase in the second half of the year, and the recovery in consumption, particularly travel and food service, is projected to stay on track as governments are taking measures to boost consumption. Exports are also likely to bottom out soon and gradually pick up toward the end of the year. In the semiconductor market, which holds the key to export trends, we expect to see progress with inventory adjustment in the second half of the year, and a clear recovery to become evident in 2024. Notably, the semiconductor sectors in South Korea and Taiwan have maintained their production capacity even in the face of tepid demand. Aiming to stay competitive, they have not significantly reduced imports of semiconductor production equipment. So as demand recovers, they will benefit from having sufficient supply capacity on hand.

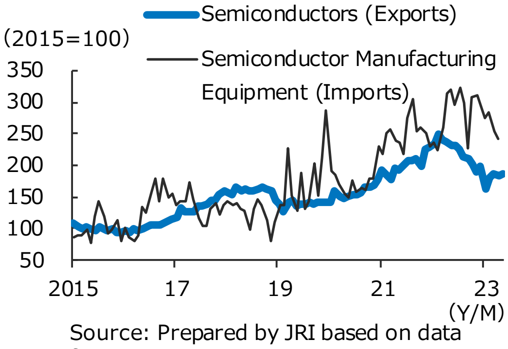
<NIEs Growth Rate Outlook>

(%)

	2019 (Actual)	2020 (Actual)	2021 (Actual)	2022 (Actual)	2023 (Forecast)	2024 (Forecast)
NIEs	2.0	0.0	5.3	1.9	1.8	2.4
South Korea	2.2	-0.7	4.3	2.6	1.5	2.3
Taiwan	3.1	3.4	6.5	2.4	1.8	2.5
Hong Kong	-1.7	-6.5	6.4	-3.5	3.5	2.9

Sources: Prepared by JRI based on data from national statistical bureaus, central banks, and the IMF

<South Korea and Taiwan Semiconductor Exports and Manufacturing Equipment Imports>



Source: Prepared by JRI based on data from CEIC

Downside economic risks include 1) downturns in the U.S. and Chinese economies and 2) tighter regulations due to the intensifying U.S.-China rivalry. Regarding the former, since the NIEs' exports are heavily dependent on the U.S. and Chinese markets, slumps in the U.S. and Chinese economies could prolong the offloading of inventories of advanced and memory semiconductors, the NIE's main exports, through reduced demand for items like PCs and smartphones. As for the latter, with the U.S.-China relationship becoming increasingly tense, the NIEs' exports would be adversely affected by tit-for-tat tightening of regulations. With the CHIPS-Plus Act coming into force last year, companies that have received subsidies in the U.S. are now barred from expanding production of advanced semiconductors in countries of concern, including China, for the next 10 years. In addition, controls on semiconductor exports to China were made more stringent last fall. Specifically, the export to Chinese companies of advanced semiconductors and related technologies that feature U.S. tech has been prohibited in principle. If such restrictions are made even tighter, South Korean and Taiwanese exports to China could be further stymied. China, for its part, has banned key infrastructure operators in China from procuring products from a major U.S. semiconductor company in an act of defiance against the U.S. If this mutual tightening of regulations by the U.S. and China escalates, it could aggravate turmoil in the semiconductor market and put significant downward pressure on the NIEs' economies.

ASEAN5 Recovery driven by domestic and inbound tourism demand

■ Although goods exports will be sluggish in 2023, economic normalization will provide a tailwind.

Real GDP growth in the ASEAN5 (Indonesia, Malaysia, the Philippines, Thailand, and Vietnam) for the January-March quarter of 2023 was a relatively high +4.7% YoY. Although the ASEAN5 economies are continuing to recover, the pace of the rebound varies from country to country, and differences in levels of dependence on goods exports have created clear divides.

<ASEAN5 Growth Rate Outlook>

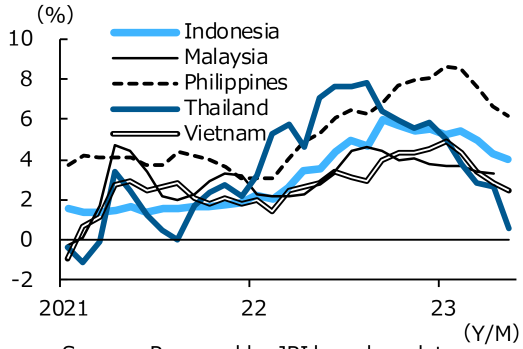
(%)

	2020 (Actual)	2021 (Actual)	2022 (Actual)	2023 (Forecast)	2024 (Forecast)
ASEAN5	-3.4	3.4	6.0	4.9	5.2
Indonesia	-2.1	3.7	5.3	4.9	5.2
Malaysia	-5.5	3.1	8.7	4.6	4.9
Philippines	-9.5	5.7	7.6	5.8	6.1
Thailand	-6.2	1.6	2.6	3.2	3.5
Vietnam	2.9	2.6	8.0	6.2	6.6

Sources: Prepared by JRI based on data from national statistical bureaus, central banks, and the IMF

With the easing of activity restrictions in each country, people are getting out and about more and more, and personal consumption in the ASEAN5 is brisk overall. In addition, increasing numbers of foreign tourists since the relaxation of entry restrictions have also contributed to the economic recovery. However, as a result of sluggish global demand for high-tech gear, goods exports have slowed, and in countries that are highly dependent on goods exports, such as Vietnam, Malaysia, and Thailand, the pace of economic recovery is weaker than in Indonesia and the Philippines.

<ASEAN5 Inflation Rates>



Source: Prepared by JRI based on data from CEIC

We expect the overall economic recovery for the region as a whole to continue in the second half of the year, with real GDP growth in the ASEAN5 expected to remain robust for the full year 2023. However, at +4.9%, growth will be slower than the +6.0% registered the previous year. Though exports will remain soft, we believe the recovery will continue, mainly thanks to domestic demand and inbound demand. On the domestic demand front, the ASEAN5 will benefit from further normalization of economic activity in many countries following the WHO's announcement in May this year that COVID-19 no longer constitutes a health emergency. In addition, against a backdrop of stable international commodity prices and national currencies, inflation has peaked, and the central banks of each country will be pressing pause on interest rate hikes. Accordingly, the downward pressure on consumption and investment from higher interest rates is expected to ease in the future. As for inbound demand, the Chinese government has been lifting its ban on group travel to one ASEAN country after another since February 2023, so inbound demand will be given a boost in the shape of more tourists from China. As of April of this year, the overall number of tourists to the ASEAN5, excluding Malaysia, had recovered to about 60% of the 2019 level, though the figure for tourists from China was only about 30%, leaving room for a large increase. Since the rise in inbound demand will increase employment, especially in the face-to-face services sector, it can also be expected to push up incomes, which will give a boost to domestic demand.

In our view, goods exports will remain stagnant for the time being but recover from 2024 onwards. However, it is important to note that there is growing concern about the outlook for the U.S. and Chinese economies, which have been strong until recently. For the ASEAN5, outbound shipments to the U.S. and China account for a sizable share of goods exports, at about 30% each. If economic deterioration in the two countries were to worsen, goods exports would drop, which would inevitably put downward pressure on the economies of the ASEAN5.

India Economic growth will remain firm

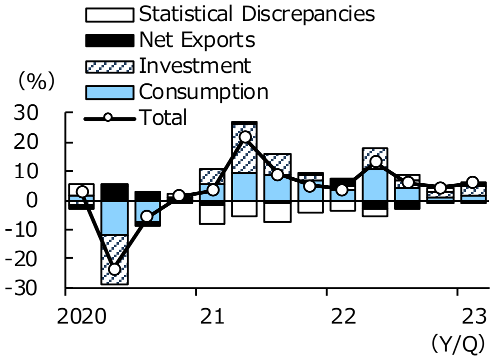
■ The economy has stayed resilient in the first half of 2023

Led by domestic demand, the Indian economy has been robust, as economic and social activities have normalized since the COVID pandemic and inflationary pressures have weakened. Real GDP growth in the January-March 2023 quarter accelerated to +6.1% YoY from +4.5% YoY in the preceding quarter. The manufacturing sector is also recovering as the release of pent-up demand (i.e., demand that was deferred during the pandemic) for face-to-face services is continuing, and increases in prices of raw material prices have slowed. And the economy has continued to expand steadily since April, with indicators such as the Purchasing Managers' Index (PMI), automobile sales, and stock price indices all improving. In late May, the Reserve Bank of India (RBI) stopped circulating 2,000 rupee bills, which triggered widespread concerns about the negative impact on the economy, but there has been no turmoil of the like seen in 2016, when nearly 90% of the cash in circulation suddenly became unusable. Among the reasons for this, the 2,000 rupee bills can be used as legal tender until the end of September, they account for only about 10% of cash in circulation, and they are used infrequently in daily life. On the other hand, the unemployment rate, according to figures compiled and released independently each month by a local think tank, has been rising recently, especially in urban areas. This reflects the fact that many people who had given up looking for work during the COVID pandemic have started seeking jobs again as the economy has recovered.

Meanwhile, a slowdown in trade and investment is becoming apparent against the backdrop of weak global demand for goods. With economic slowdowns occurring in Europe and the U.S., the destinations for about 40% of India’s exports, growth in goods exports has faltered substantially, and inward direct investment in India in FY2022 (April 2022 to March 2023) also declined year-on-year for the first time in a decade. Although India is less reliant on exports and foreign investment than East and Southeast Asia and has thus far experienced only limited downward pressure on its economy, the Indian government and industry are becoming increasingly anxious about the global economic outlook.

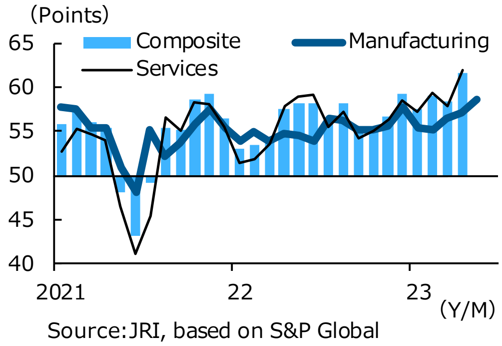
Given this environment, there are signs of a change in the monetary authorities’ policy stance. Starting in May 2022, the RBI raised interest rates at six consecutive monetary policy meetings in order to stabilize rupee exchange rates and prices, but in April 2023, contrary to market expectations, it left its policy rate unchanged. After the meeting that month, the RBI stressed that the pause in interest rate hikes was temporary and did not imply a shift away from its monetary tightening stance. However, at its June monetary policy meeting, the RBI again left its policy rate remained unchanged, due to increasing uncertainty in the world economy and a fallback in inflation

<Real GDP (YoY) >



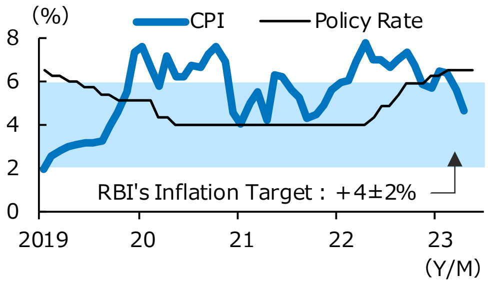
Source:JRI, based on Ministry of Statistics and Programme Implementation

<PMI (Purchasing Manager's Index) >



Source:JRI, based on S&P Global

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



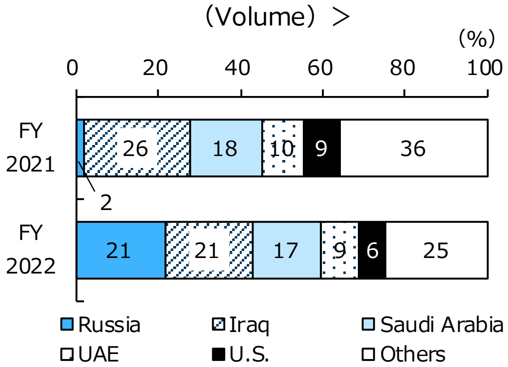
Source:JRI, based onReserve Bank of India to within the target range. The collapse of midsized U.S. banks and widening concerns about the vulnerability of a major Swiss bank may have influenced this change in the RBI's monetary policy stance, as these events triggered worries about the risk that rapid monetary tightening could destabilize India's domestic financial system.

■ The pace of economic expansion will slow in the second half of 2023 and beyond

Looking ahead, the pace of economic expansion is expected to slow gradually due to such factors as 1) the ending of the release of pent-up demand, 2) the termination of various financial assistance measures that were introduced in response to the COVID pandemic, and 3) the global economic slowdown. Nevertheless, growth should remain solid thanks to the dissipation of inflationary pressures, the resulting suspension of monetary tightening, and an increase in the amount of personal income not subject to taxation.

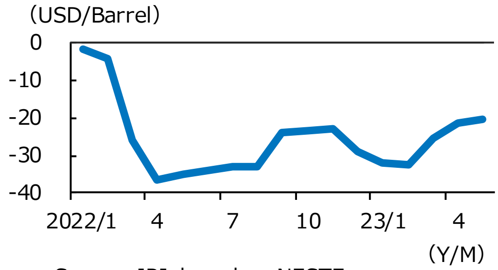
Upside risks to the economy include a fiscal spending splurge ahead of the general election for the Lok Sabha (lower house), which is scheduled for the first half of 2024. Although the government has conveyed that it intends to cut the fiscal deficit as a percentage of nominal GDP in FY2023 from the previous year in order to restore fiscal soundness, if the strong economy results in tax revenues increasing at a faster pace than predicted in the draft budget, the government may put together a package of measures to further stimulate the economy, and this could include financial assistance for low-income earners.

<Origin of India's Crude Oil Imports (Volume) >



Source:JRI, based on Ministry of Commerce and Industry

<Oil Price Spreads (Urals−Brent Crude Oil) >



Source:JRI, based on NESTE
Note:Spread on the 15 day of each month (or closest day to that)

Meanwhile, downside risks to the economy include renewed inflationary pressures, particularly for energy and food. Regarding energy prices, upward pressure in the near term will come from higher demand in conjunction with China's economic recovery, from geopolitical risks, and other factors. Since the start of Russia's military invasion of Ukraine, India has significantly increased its imports of cheap crude oil from Russia in an effort to curb inflation, and Russia is now its biggest oil supplier. However, the relative cheapness of Russian crude oil is gradually fading, and the inflation-curtailing effect of expanding oil imports from Russia is limited. In addition, the Indian government is expected to tread carefully in increasing imports of Russian crude, as excessive dependence on imports from Russia could reduce the stability of crude oil procurement and sour relations with the G7 (major developed countries), which are more important partners than Russia in terms of trade, investment, and policy toward China.

As for food, for this year's monsoon season (around June to September), which has a big short-term impact on the agricultural sector, the India Meteorological Department is forecasting rainfall on par with typical years, but it also views the probability of a lengthy El Niño event occurring from late 2023 onward as high. If this prediction proves correct, reduced rainfall and higher temperatures from early fall could adversely affect farm output. Since around 40% of India's workers are employed in agriculture and food accounts for about 40% of consumer prices, a decline in agricultural production could have serious repercussions for the economy and society. If the RBI were to embark on further sharp hikes in interest rates in response to a re-acceleration in inflation, the economy could falter due to lower durable goods consumption and capital investment.

China The economy will slow in the second half of the year

■ The service sector recovered sharply in the first half of 2023

China's economy has been bouncing back since the government abandoned its zero-COVID policy at the end of last year. Real GDP growth in the January-March quarter of this year stood at an annualized +4.5%, an increase from the figure of +2.9% recorded for the previous quarter. By industry, the service sector, which had been in a slump due to the zero-COVID policy and the confusion that accompanied its discontinuation, saw recoveries in the categories of lodging (from -5.8% YoY in October-December to +13.6% YoY in January-March), transportation (-3.9% YoY to +4.8% YoY), and wholesale/retail trade (+0.3% YoY to +5.5% YoY). In addition, growth in the real-estate sector turned positive, coming in at +1.3% YoY compared with -7.2% YoY in the previous quarter. Lending restrictions implemented in 2022 resulted in cash-flow difficulties for real-estate firms, which caused disruptions in the supply of housing, but the subsequent easing of the restrictions has reinvigorated real-estate activity and the supply issues have been resolved.

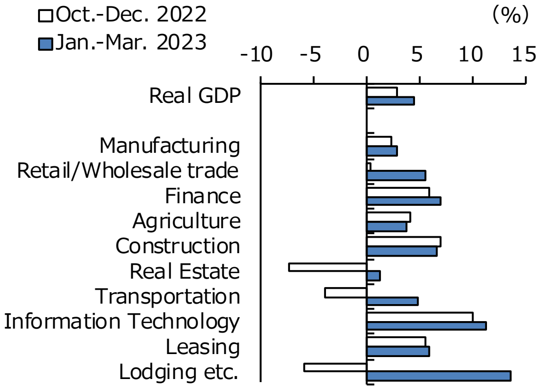
This momentum has continued in the April-June quarter. Retail sales remained high, with increases seen in sales of food/beverages, jewelry, and cosmetics. The Labor Day holiday period (April 29 - May 3) witnessed a sharp resurgence in domestic tourism to the pre-COVID 2019 level, with a 20% increase in the number of travelers and a 0.7% rise in tourism revenue. In addition, sales of automobiles also climbed, albeit moderately, as automakers competed with each other in making hefty price cuts to boost sales.

■ The government will need to take steps to shore up the economy

Thanks to the boom in the first half of the year, full-year growth for 2023 is expected to be +5.6% YoY, accelerating from +3.0% YoY in the previous year and surpassing the government's target (around +5.0%). However, we anticipate that the pace of growth will slow to around +3% in the second half of the year. Economic performance will be hampered for three reasons: 1) softness in goods consumption, 2) sluggish external demand, and 3) real-estate market adjustments. Let us examine each of these reasons in detail:

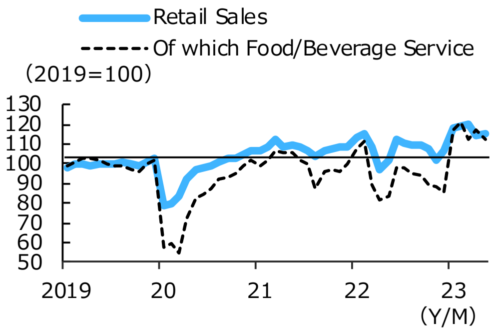
First, in contrast to the service sector, which has rebounded strongly since the ending of the zero-COVID policy, consumption in the goods sector remains stalled. According to U.S. market intelligence firm IDC, smartphone sales in China fell by a record 13% YoY in 2022, and have continued to

<Real GDP Growth (by Industry, YoY)>



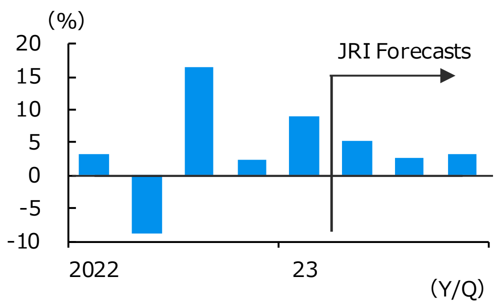
Source: Prepared by JRI based on data from CEIC
Note: Figures in parentheses are shares of 2022 GDP.

<Retail Sales (Seasonally-adjusted)>



Source: Prepared by JRI based on data from CEIC
Note: Food/beverage service's share of retail sales (2020)

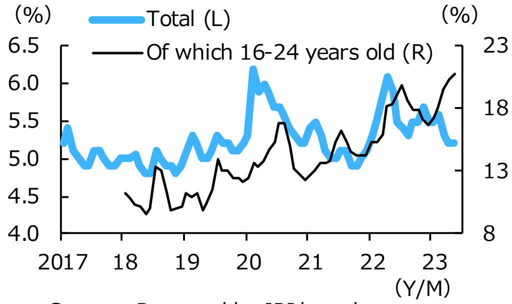
<Real GDP Growth (YoY)>



Source: Prepared by JRI based on data from CEIC decline, sliding 11.8% YoY in the January-March quarter of 2023. Although auto sales have picked up recently, this reflects efforts to clear inventory ahead of the introduction on July 1 of stricter emission regulations that will ban the production, import, and sale of vehicles that do not meet standards. Sales are therefore expected to decline sharply from July onward. Households have been reluctant to purchase new cars since the withdrawal of tax breaks at the end of last year. In addition, the May unemployment rate was 5.2%, higher than before the COVID pandemic (2017-19 average: 5.0%). Youth unemployment is especially high, having exceeded 20%, so there is scant impetus for consumption from the employment side. Against this backdrop of weak goods consumption, both the CPI and core CPI (which excludes food and energy) remained low in May, rising by 0.2% and 0.6%, respectively YoY. With the economy slowing, lower resource and food prices could lead to deflation.

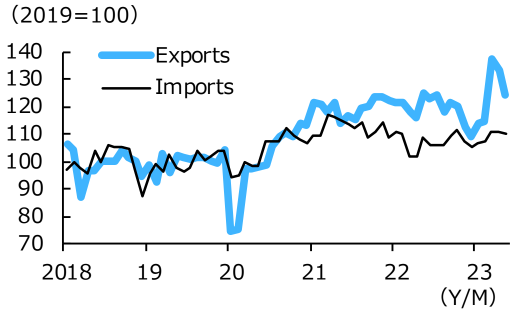
Second, exports of goods have surged since the end of 2022 as exporters shipped goods that they had received orders for during the zero-COVID policy period but had been unable to deliver. However, their order backlogs had been more or less eliminated by April. Compounding the worldwide slump in demand for smartphones, PCs, and other high-tech products following the fading out of stay-home-related demand, any slowdown in the U.S. economy is likely to cause further declines in exports of goods. In May, the new export orders component of China's manufacturing PMI was below the key 50 level for the second month in a row.

<Unemployment Rate>



Source: Prepared by JRI based on data from CEIC

<Real Imports (Seasonally-adjusted)>

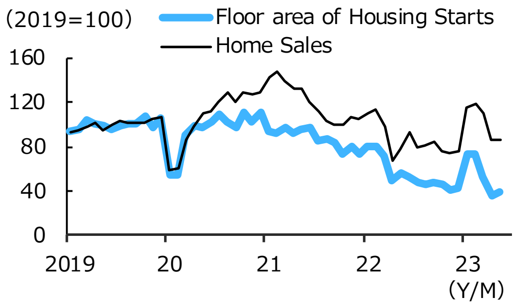


Source: Prepared by JRI based on data from the Netherlands Bureau for Economic Policy Analysis
Note: Figures for April and May are estimates.

In addition, tighter U.S. regulation of the Chinese semiconductor industry could also have negative implications. The U.S. has used the guardrails provision of the CHIPS-Plus Act and its export control framework to make it harder to produce and procure semiconductors, especially advanced ones, within China. As a result, it has become difficult to manufacture certain high-tech products in China. Although global demand for electronics in general is expected to gradually recover through 2024 after an adjustment phase, companies in China could face restricted supply of high-tech products and may not be able to increase their exports even as demand rebounds.

Third, the real-estate market is floundering. As noted above, a relaxation of regulations has eased supply issues, and home sales briefly turned upwards at the beginning of the year. Since March, however, they have resumed their downward slide, and the floor area of housing starts, a leading indicator, has dropped to the level of the mid-2000s. The current slump in the real-estate market reflects the "common prosperity" policy concept that the Chinese government articulated 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

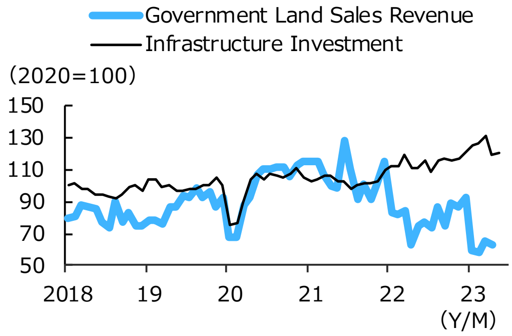
<Housing Sales and Starts (Seasonally-adjusted)>



Source: Prepared by JRI based on data from CEIC 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 possibility.

Faced with mounting pressure on their economy, the Chinese authorities are becoming more aggressive in their economic support measures. In June, the People's Bank of China cut interest rates for the first time since August 2022, and additional rate cuts as well as measures to stimulate consumption, including a tax cut for automobiles, are on the horizon. However, to get the economy fully afloat, the central government will need to embark on large-scale fiscal spending program. After 2022, the zero-COVID policy led to a sluggish economy, and infrastructure investment was substantially increased, but this spending was financed by local governments taking on debt. With the real-estate market currently sagging, revenue from land sales, a key source of cash for local governments, has plummeted, which for the time being will make it difficult to increase the debt burden shouldered by local governments. In April 2020, amid the COVID pandemic, the central government issued RMB 1 trillion in special treasury bonds to invigorate the economy, but this time around, it will need to take on an even greater debt burden to prevent the economy from losing steam later this year.

<Infrastructure Investment and Land Sales Revenue (Seasonally-adjusted) >



Source: Prepared by JRI based on data from CEIC

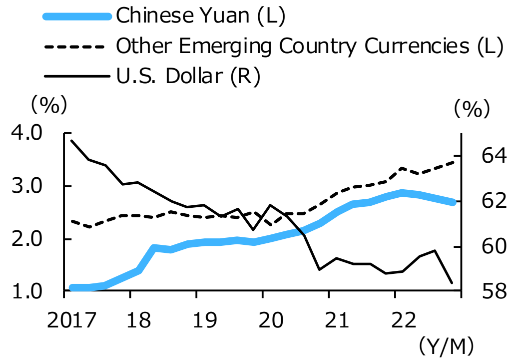
■ An economic slowdown will also impede yuan internationalization

Recently, the media has been filled with stories about the growing use of the yuan in emerging countries. However, the Chinese government has been averse to opening up its financial and capital markets, wary of possible side-effects such as yuan exchange rate instability, so actually, the internationalization of the yuan has not progressed very much.

As an example of the increased use of yuan, Russian companies have switched from dollars to yuan or rubles for settling trade transactions since Russian banks were shut out of SWIFT as part of the sanctions imposed in response to the invasion of Ukraine. Moreover, China is making conspicuous efforts in diplomatic circles to expand "petroyuan" (i.e., use of the yuan in crude oil trade), and Saudi Arabia is considering invoicing some of its oil sales to China in yuan. However, this expanded use of the yuan has been limited to trade transactions, where China has global influence. In the case of capital transactions, which are larger in scale than current transactions such as trade, little headway has been made with the use of the yuan. In particular, the deepening rift between the West and China/Russia has led Western investors to reduce their investments in mainland Chinese securities, creating a headwind against more widespread use of the yuan. Another factor hamstringing yuan utilization is the fact that U.S. interest rates are higher than Chinese interest rates, which is piling downward pressure on the yuan. As the economic slowdown intensifies, it is expected that it will become more difficult for the Chinese government to get more proactive about opening up its financial and capital markets.

That being said, the rapid series of interest rate hikes by the U.S. Fed has sharply increased the cost of raising dollar funds around the world, resulting in gradual "dedollarization" in emerging economies. A look at the asset composition of foreign exchange reserves held by central banks and governments in various countries reveals that the share of

<Currency Shares of Global Foreign Exchange Reserves>



Source: Prepared by JRI based on data from the IMF dollar-denominated assets continues to decline. Recently, however, it is not the yuan that is eating into the dollar’s share, but rather currencies of emerging countries other than China. Although it has been reported that Argentina, Iran, and other countries are switching to the yuan for trade settlements, such switches tend to be limited to payments for imports. Trade transactions are often settled in the currency of one of the parties to the trade (the supplying country’s currency in the case of imports and one’s own country’s currency in the case of exports), and settlements where the yuan has replaced the dollar are not widespread. Even within the ASEAN zone, QR codes are increasingly being used to link payments in each other's currencies, and there is little enthusiasm for using the yuan.

All in all, it remains difficult to see the yuan gaining enough ground to usurp the dollar, given that the headwinds, such as the confrontation between the West and China/Russia and China's economic slowdown, are more powerful than the tailwinds.