

ASIA MONTHLY

September 2024

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This report is the revised English version of the September 2024 issue of the original Japanese version (published 28th Aug.).

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Topics *IT demand is driving the Asian economy, but also poses risks*

A strong recovery in global IT-related demand is driving the Asian economy through increased exports. However, the risk that the current AI boom will be transitory also warrants attention.

■ IT-related exports, mainly semiconductors, are strong

With the exception of China, the economies of Asian countries are holding firm on the whole, despite headwinds such as the slowdown in the Chinese economy and monetary policy being tightened in various countries. A background factor is a significant increase in IT-related demand around the world, and especially in the U.S.

Asian exports of goods, particularly IT-related goods, have been rising. Recently, capital investment related to AI (artificial intelligence) has been increasing worldwide, and this has had a substantial effect. Major U.S. cloud providers have enjoyed a growth spurt, and their services include not only data storage and computing processing, but also AI functions. The provision of such cloud services has expanded rapidly, which has led to the rise in capital investment. Advanced semiconductors are indispensable for the manufacture of products with AI functions, so the AI boom is providing a tailwind for companies in Taiwan and South Korea, which produce a large proportion of such chips. Furthermore, firms in Malaysia, Vietnam, Thailand, and other countries that manufacture advanced semiconductor packages and high-tech manufactured products containing the chips are also reaping rewards.

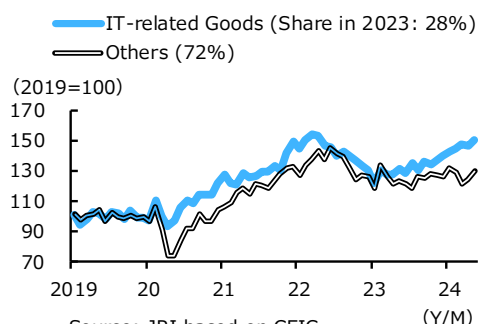
This expansionary phase of the silicon cycle is expected to continue for a while. According to WSTS (World Semiconductor Trade Statistics), semiconductor sales fell by 8.2% year over year (YoY) in 2023, but are projected to keep rising rapidly through 2025.

■ Exports of IT-related services are also driving the Asian economy

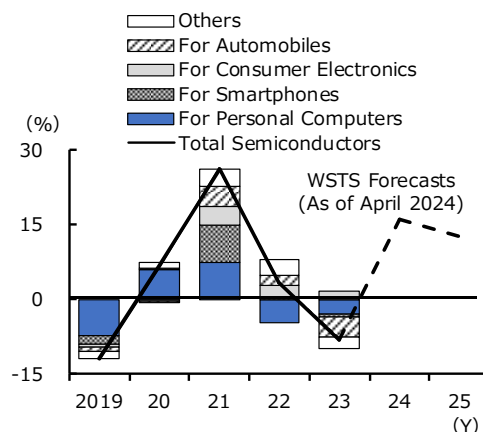
The increase in IT-related demand is not limited to goods, but has also spread to encompass services. The IT-BPO (business process outsourcing) sector is seeing especially fast export growth. According to a study by Everest Group (conducted in 2020), the sector has been developing in India and the Philippines, and these two countries now have substantial shares of the global market: about 40% for India and around 20% for the Philippines.

Exports in the IT-BPO sector are included in "other service exports," which are total service exports excluding travel and transportation, and in 2023 these exports accounted for 7.7% of GDP in India and 8.3% in the Philippines. The real GDP growth rates of the two countries (India: +7.8% YoY in January-March; Philippines: +6.3% YoY in April-June) are some of the

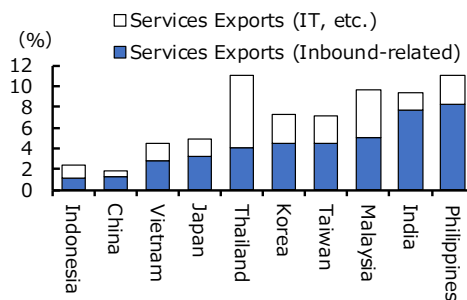
<Goods Exports in Asia (USD, SA)>



<Semiconductor Sales (YoY) >



<Services Exports in Asia>
(% of GDP, 2023)



highest among Asian countries, and service exports are the driving force behind this economic growth.

Looking at the IT-BPO sector in more detail, IT support services account for a large share of the total in India, while contact center and back-office operations account for a major share in the Philippines. There are concerns that a side effect of the use of AI may be reduced employment, but India and the Philippines are handling support operations that require human workers, such as the build-out and management of systems related to AI. The two countries have common strengths such as 1) an abundance of English-speaking workers, 2) low wages, and 3) excellent IT-related infrastructure, and both have been successful in winning orders from companies in the developed countries of the West, which are suffering from labor shortages.

■ Careful not to overreach on AI boom

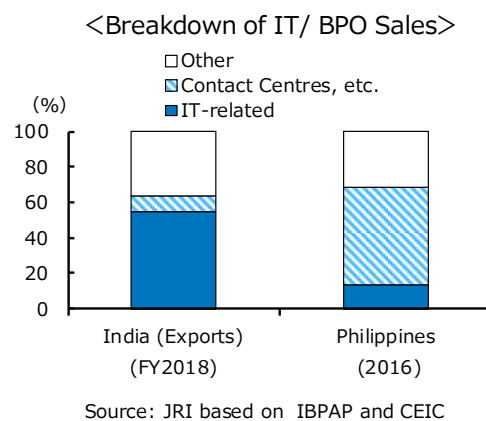
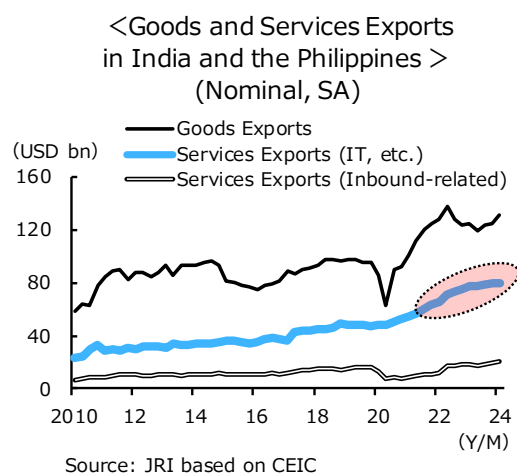
The increase in IT-related demand has thus benefited a wide range of goods and services sectors in Asian countries. This trend is expected to continue into the future, with further expansion in output of semiconductors and other products as well as increases in the provision of services linked to them.

However, attention also needs to be paid to the risk of a sharp drop in IT-related demand. It is worth noting that this recovery phase of the silicon cycle is largely dependent on expectations for the AI boom. Specifically, IT-related demand in the current phase has been skewed toward AI-related investment for companies, and demand for smartphones and PCs, which mainly comes from households, has lacked strength. The time has come for smartphones and PCs purchased during the pandemic to be replaced, so that sort of demand is expected to increase for the time being, but if IT-related demand remains skewed toward corporate AI investment, prospects for a powerful economic boost will fade as time goes on.

Another worrying factor is the increasing uncertainty surrounding the outlook for the U.S. economy. Although the U.S. economy has remained resilient on the whole, there have been some signs of deterioration, with business sentiment in the manufacturing sector being one example. Since current IT demand is being driven mainly by the U.S., a key question is whether U.S. economic stability will be maintained. Notably, with the U.S.-China confrontation intensifying, the U.S. government is tightening China-related restrictions on semiconductors, making a resurgence in IT demand in China unlikely. The U.S. government has significantly curbed China's access to semiconductor technology used in AI, and is currently mulling controls on the export of HBM (high bandwidth memory) chips to China.

In the near term, the expansion of IT-related demand is expected to drive the Asian economy, but downside risks cannot be overlooked. Looking ahead, despite the prevailing optimism, attention needs to be paid to the risk of the boom drying up.

(Minoru Nogimori)



Topics *China's economic structural reform plan lacks teeth*

The economic restructuring plan presented at China's Third Plenum proved a disappointment, as while it included a declaration that dependence on real estate would be reduced, it failed to articulate a clear stance on strengthening China's growth potential.

■ Third Plenum held

In mid-July, the Third Plenum took place. The Third Plenum refers to the third plenary session of a newly elected Central Committee of the Communist Party of China, and is positioned as a meeting for formulating medium- to long-term economic structural reform plans. It has traditionally been an important conference for shaping the direction of China's economic management, and is an event that attracts a lot of attention. This time saw the adoption of an economic structural reform plan entitled "Resolution of the Central Committee of the Communist Party of China on Further Deepening Reform Comprehensively to Advance Chinese Modernization."

■ Three challenges for the Chinese economy

There are numerous issues that the Chinese government ought to address, but to double the size of the economy by 2035, a goal that was declared when the draft of the current five-year plan was announced, it will be important to overcome the following three challenges.

The first is to break away from dependence on real estate. Real-estate-related businesses account for about 30% of China's economy, and have long been the driver of economic growth. However, for China, economic growth dependent on real estate is probably unsustainable. In addition to the short-term issue of the ongoing housing market slump, China is also faced with two medium- to long-term structural problems: a declining population and a deterioration in local-government finances.

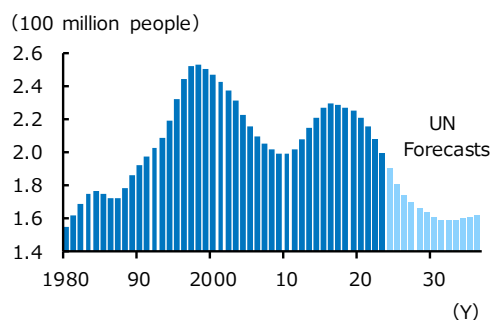
On the population side, the number of people aged around 30, the core age group for first-time home buying, has already peaked and is expected to continue to fall. In tandem with this decline in population, housing demand has also entered a long-term downward trend. And on the local-government finance side, proceeds from the transfer of land use rights (land sale revenue) is a key source of income for local governments, which creates the problem of trends in the real-estate market having a significant impact on

<Key Agenda Items at 20th Third Plenum>

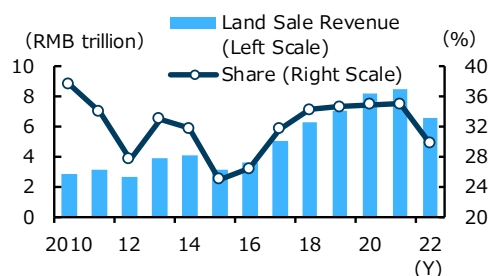
Matters Discussed	Key Decisions Made
Economic Restructuring	• Adoption of "Resolution of the Central Committee of the Communist Party of China on Further Deepening Reform Comprehensively to Advance Chinese Modernization"
Economic Analysis	• Achievement of annual economic targets • Focus on expanding domestic demand
Personnel	• Confirmation of previous decision to expel former defense minister Li Shangfu and two others from the CCP • Confirmation of previous decision to expel former defense minister Li Shangfu and two others from the CCP

Source: Prepared by JRI based on the Third Plenum Communiqué (July 18, 2024)

<Chinese Population Aged 25-34>

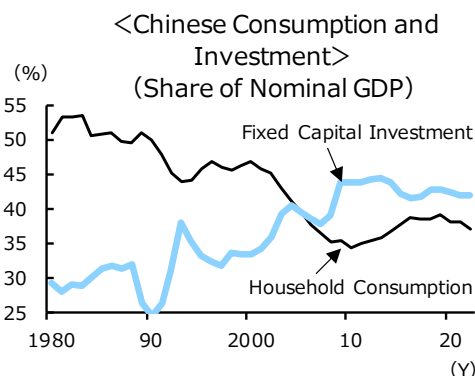


<Land Sale Revenue>



local-government finances. While fiscal management problems stay beneath the surface as long as real-estate prices continue to rise, given the current situation, with property prices having begun to decline, local-government finances will become less sustainable, and the economy will be adversely affected by consequences such as tax hikes and the suspension of infrastructure development.

The second challenge is to shift to consumption-driven growth. China's rapid economic development in the 2000s was driven by investment and exports. Although this growth pattern worked well for China in helping it move out of the low-income country category, it is unlikely to be effective for making the transition to a high-income country. A characteristic of China is that consumption accounts for a smaller share and investment accounts for a larger share of its economy than in other countries. This means that investment is inefficient, so the status quo is unsustainable. For China to become one of the world's top countries in terms of income per capita and enjoy the affluence that comes with being a high-income country, it would be advised to pivot to consumption-driven economic growth. But to accomplish this transition, it will need to implement policies that increase households' willingness to consume.



Source: Prepared by JRI based on data from the United Nations

The third challenge is to solve the problem of youth unemployment. China's youth unemployment rate is extremely high compared to other countries. Background factors that have been pointed out include a lack of job opportunities that appeal to new university graduates, excessive government intervention in growing companies, and outdated employment and salary conventions. The increase in the number of unemployed young people will create two structural problems over the medium to long term. The first is that human capital accumulation will be hindered if people fail to develop a career while they are young. The second is that the number of marriages will fall due to financial struggles, accelerating the decline in the birthrate. As a result, China's potential growth rate will be pushed down by both qualitative and quantitative labor factors.

■ The reform plan lacks teeth

Given the challenges facing the Chinese economy, the economic structural reform plan presented at the Third Plenum was disappointing overall, as it contained only a few measures deserving of praise.

One of the positives concerned action to deal with the real-estate problem. Since eliminating the real-estate woes in a stroke would be difficult, taking the time to sort out problematic firms and financial institutions while averting a serious crisis that would affect the entire financial system is probably a sensible course of action. It was also announced that the consumption tax, all the revenue from which used to go to the central government, will be restructured in phases so that it provides local-government tax revenue. This measure should be effective in shoring up local-government finances.

On the other hand, with regard to stimulating consumption, although the plan included a statement about "refining long-term mechanisms for expanding consumption," the wording was fairly vague, and no specific measures were mentioned. Therefore, it is difficult to see this statement easing public anxiety about the future and leading to a sustainable increase in consumption. Furthermore, as to the problem of youth unemployment, the plan provides little indication that the government intends to use policy to confront the issue head-on and boost employment.

As the above has shown, it is undeniable that the economic structural reform plan presented at the recent Third Plenum contains few policies that will contribute to medium- to long-term sustainable growth, and is instead biased toward supply-side measures that are easy for the government to implement, such as the acceleration of state-led innovation and the promotion of high-tech industries. There are therefore concerns that the two problems of sluggish consumption and youth unemployment will become a drag on the economy over the medium to long term, causing the growth rate to decline.

(Junya Sano)