ASIA MONTHLY

July 2026

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 July 2026 issue of the original Japanese version (published on June 26).

Asia: Asian economies face risks in both the short and long term

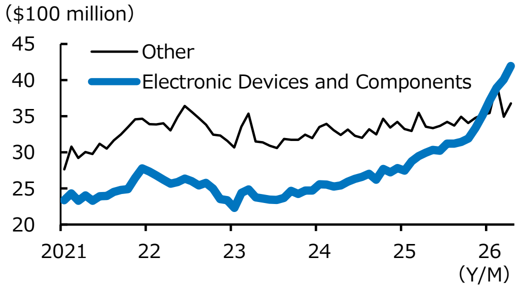
Looking ahead, Asian economies are expected to slow, mainly due to lower domestic demand, as inflation accelerates in response to the Middle East crisis. In addition, caution is required regarding risks such as worsening supply constraints in the short term and lower growth potential over the medium to long term.

1. Asian economies will enter a phase of slower growth

(1) Economies picked up in the first half of 2026, driven by foreign demand

Asian economies have picked up. Asia's real GDP growth rate (weighted average based on economy size) for the January-March quarter of 2026 was +5.9% year over year (YoY), surpassing the highest figure (+5.5% in 2025) recorded in the post-COVID period (2022-25). By country/territory, Taiwan registered growth of 14.5% YoY, the highest in 39 years, and India and Vietnam maintained close to 8% growth. South Korea, whose growth rate had been trending downward in recent years, posted 3.8%, far above its estimated potential growth rate in the 1% range. Overall, rising global demand for electronic devices and components driven by the worldwide AI boom lifted exports across Asia. A foreign-demand-led pick-up in Asian economies has been ongoing since April.

<Asia's Exports >
(Seasonally Adjusted Figures)



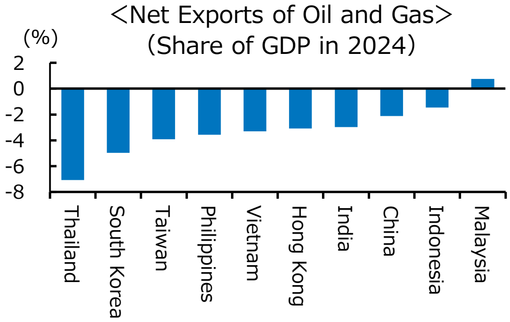
Source: Prepared by JRI based on data from CEIC
Note: Totals for 10 Asian countries/territories. Figures for electronic devices and components are totals of HS codes 84 and 85. Figures for some countries are based on their own definitions of electronic devices and components.

(2) In the second half of the year, accelerating inflation will weigh on domestic demand

Looking ahead, Asian economies are expected to see a slowdown. Most Asian economies are net importers of oil and gas, so rising energy prices will generate terms-of-trade losses and are expected to depress domestic demand through pressure on real incomes and corporate earnings. Producer prices throughout Asia are rising due to higher energy prices, and pass-through to consumer prices (CPI) is expected to progress going forward. In many countries/territories, current inflation rates already exceed central bank targets. Moreover, strong inflationary pressures will not dissipate anytime soon, and domestic demand is expected to be pushed lower over the near term. There are two reasons for this:

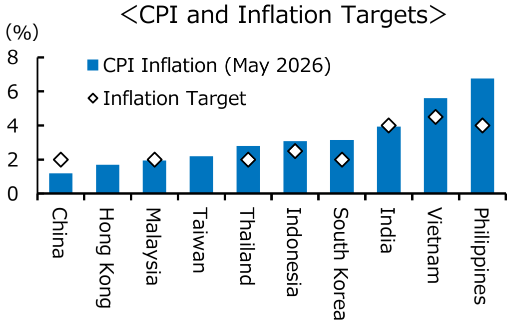
The first is that energy and food prices remain high. Under the main scenario of this paper, even after the end of hostilities between the U.S. and Iran, normalization of passage through the Strait of Hormuz will take time, so energy prices are projected to stay elevated through the end of 2026. In addition, a large-scale El Niño event is forecast to occur by this summer, raising concerns in Asia about stagnation in agricultural production due to drought or high temperatures, and surging food prices as a result.

<Net Exports of Oil and Gas>
(Share of GDP in 2024)



Source: Prepared by JRI based on data from UN Comtrade and IMF
Note: Oil and gas are SITC codes 33 and 34. Figures for Vietnam are for 2023.

<CPI and Inflation Targets>



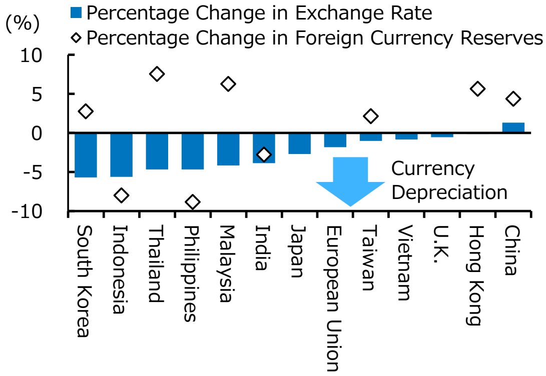
Source: Prepared by JRI based on data from CEIC
Note: For Hong Kong and Malaysia, CPI figures are for April. For Malaysia and Thailand, the inflation target refers to the midpoint of the target band.

The second is that Asian currencies are losing value against the dollar as the latter appreciates. Recently, Asian currencies have been depreciating, particularly those of India, the Philippines, and Indonesia, which have structural vulnerability in their balance of payments as they run current account deficits and are debtor nations, as well as those of Thailand and South Korea, which are heavily reliant on imported oil and gas. In these countries, import prices overall are being pushed up, keeping inflationary pressure elevated. Furthermore, in Indonesia and the Philippines, foreign exchange reserves have been significantly depleted by repeated foreign-exchange interventions aimed at halting currency depreciation. As a result, the central banks of Indonesia and the Philippines hiked interest rates by 1% and 0.5%, respectively, between April and June, leading to concerns that higher interest burdens will further depress consumption and investment.

To ease the pain for households, governments across Asia are implementing measures such as energy price controls and income support for low-income households. However, rising international energy prices are rippling into domestic prices through various channels, such as corporate price pass-through and currency depreciation, limiting the extent to which policy measures can mitigate the burden on consumers. Moreover, since the COVID pandemic, debt-to-GDP ratios have remained elevated in most countries, with Taiwan and Vietnam being exceptions, making it difficult to sustain such price-relief measures over the long term.

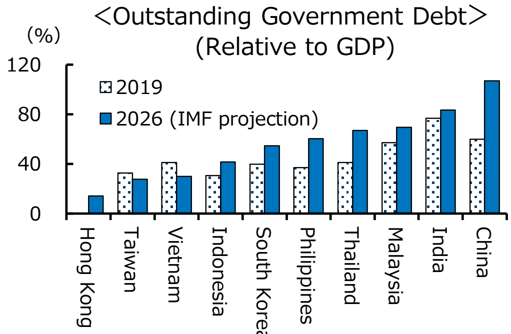
Foreign demand is expected to vary across Asia. The boom in AI-related investment, centered on the U.S., should continue for the time being. Therefore, in countries/territories that manufacture AI-related electronic devices and components, exports are projected to keep growing rapidly, partially offsetting the slowdown in domestic demand. Specifically, Taiwan, Vietnam, South Korea, and Malaysia, which have strengths in producing high-performance servers and telecommunications equipment for data centers, as well as the semiconductors required for them, are likely to benefit. By contrast, India, which has low export competitiveness in these goods and relies on the Middle East for about 20% of its goods exports, is expected to see weak foreign demand, as the turmoil in Middle Eastern economies will inevitably stall outward shipments of goods that are key exports for India, such as jewelry.

<Exchange Rates and Foreign Currency Reserves>



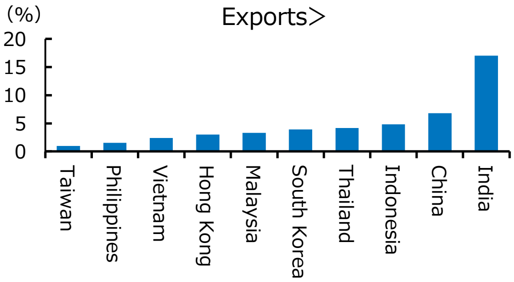
Source: Prepared by JRI based on data from Bloomberg L.P.
Note: Percentage changes in exchange rates compare rates on February 26 and June 15, 2026. Percentage changes in foreign currency reserves compare the average for April (or May) 2026 and the 2025 average.

<Outstanding Government Debt> (Relative to GDP)



Source: Prepared by JRI based on data from IMF

<Shares of The Middle East in Goods Exports>



Source: Prepared by JRI based on data from UN Comtrade and CEIC
Note: Figures are for 2023 for Vietnam, 2024 for Thailand, and 2025 for others.

(3) Supply constraints remain limited overall, though agricultural output is under pressure in some regions

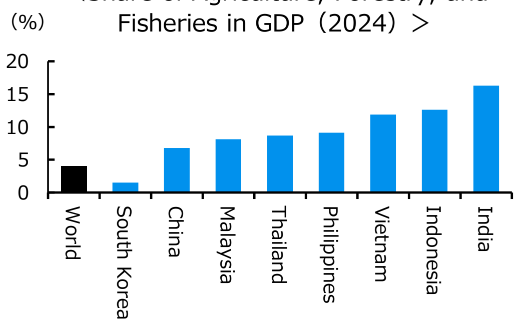
Although Asian countries have recently seen crude oil and natural gas imports from the Middle East stall due to the closure of the Strait of Hormuz, the likelihood of these economies facing expansive supply constraints is expected to be low. This is because 1) countries/territories are focusing on alternative procurement from the U.S., Russia, and elsewhere, while also beginning to import Middle Eastern energy shipped via routes that bypass the Strait of Hormuz, and 2) passage through the Strait is expected to gradually return to normal.

However, it needs to be borne in mind that in ASEAN and India, reduced fertilizer imports from the Middle East, combined with the effects of the El Niño phenomenon, are highly likely to harm agricultural production. In countries where agriculture, forestry, and fisheries account for a large share of GDP, such as India, this could hamper economic growth. It is also expected to slow income growth for agricultural workers, further dampening consumption.

Considering the above, the economic growth rate of Asia as a whole is expected to be +4.9% in 2026, lower than the rate of growth recorded in the previous year. However, at the national level, strengths and weaknesses are projected to emerge due to differences in the economic structures of countries/territories. India, where both supply and demand are exposed to numerous downside factors stemming from the Middle East crisis, and the Philippines and Thailand, where inflation is dealing a heavy blow to domestic demand, are expected to record their lowest growth rates since COVID. China, whose net imports of oil and gas are low and whose currency is stable, is less affected by the Middle East crisis, but long-standing structural weakness on the domestic demand front is projected to contribute to a flattening of growth. In contrast, Taiwan and Vietnam are likely to maintain high growth. Export gains from the AI boom are powering their economies, and sound government finances give them plenty of leeway to soften negative domestic-demand effects from the Middle East crisis.

In 2027, a disparity in economic performance between China and other Asian economies is forecast. China's structural domestic-demand stagnation will persist, and this, coupled with the effects of a declining birthrate and aging population, is expected to further depress its growth rate. Meanwhile, India and other Asian economies should see consumption recover as the pace of energy and food price rises slows, with investment that had been postponed also resuming.

<Share of Agriculture, Forestry, and Fisheries in GDP（2024）>



Source: Prepared by JRI based on data from World Bank

<Economic Growth Rate Forecasts>

(%)

	2024 (Actual)	2025 (Actual)	2026 (Forecast)	2027 (Forecast)
Asia total	**5.3**	**5.5**	**4.9**	**5.0**
Northeast Asia	4.8	4.8	4.6	4.1
China	5.0	5.0	4.5	4.3
South Korea	2.0	1.0	2.6	2.0
Taiwan	5.3	8.8	9.4	3.6
Hong Kong	2.6	3.6	3.5	2.5
ASEAN 5	5.1	5.1	4.6	5.0
Indonesia	5.0	5.1	4.8	5.0
Malaysia	5.1	5.2	4.7	4.9
Philippines	5.7	4.4	3.8	4.6
Thailand	2.9	2.4	1.8	2.1
Vietnam	7.0	8.0	7.5	7.8
India (Fiscal Year)	7.1	7.7	6.0	7.5

Source: Prepared by JRI based on data from IMF and national statistics and central bank of each country

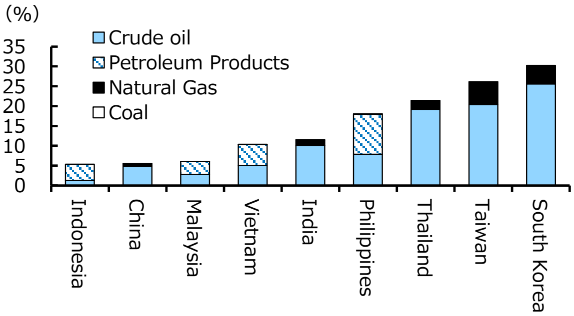
2. Vigilance is required as supply risks materialize

If, contrary to the main scenario, the Strait of Hormuz remains shut, Asian economies could fall into a severe recession, with countries/territories that depend heavily on overseas resources being the most at risk. South Korea, Taiwan, and Thailand are especially vulnerable, as oil and gas account for a large share of their primary energy supply, and most of the oil and gas is imported directly from countries around the Strait of Hormuz. Therefore, if imports from the Middle East were to be cut off for an extended period, the risk of serious economy-wide supply shortages would be substantial.

The Philippines and India would also be massively impacted. The Philippines, in addition to importing crude oil directly, also depends indirectly on the Middle East. For example, it imports many petroleum products from South Korea. India's level of reliance on the Middle East is moderate, but because its energy efficiency is low, any reduction in imports would have significant spillover effects on production.

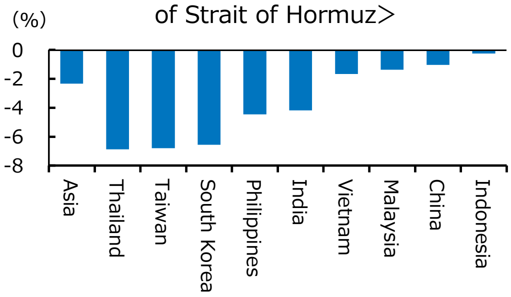
If the Strait of Hormuz were to remain closed for another year, Asia's real GDP could be pushed down by 2.3%, with the countries discussed above bearing the brunt. In countries/territories that experience deep recessions, there could be a rapid outflow of capital, which would also heighten the risk of currency and debt crises.

<Degree of Dependence on Countries Around The Strait of Hormuz as Measured by Their Share of Primary Energy Supply>



Sources: Prepared by JRI based on data from IEA and UN Comtrade
Note: Regarding the shares of each fossil fuel in primary energy supply, the percentage procured from abroad is multiplied by the share of imports (in value terms) coming from countries around the Strait of Hormuz (Iran, Iraq, UAE, Qatar, Kuwait, and Saudi Arabia). Figures are for 2023 or 2024.

<Impact on GDP of Prolonged Closure of Strait of Hormuz>



Source: Prepared by JRI based on data from IEA, UN Comtrade, UNCTAD, and Our World in Data
Note: Estimated the impact of the exhaustion of oil stockpiles and gas inventory after the continued closure of the Strait of Hormuz for one year, taking into account the regression coefficient for the rate of decline in GDP relative to the rate of decline in primary energy and the degree of dependence on countries around the Strait for primary energy supply. The proportion procured from alternative sources or via alternative routes is assumed to be a uniform 60%. Increases in domestic production or switches to other forms of energy are not taken into account.

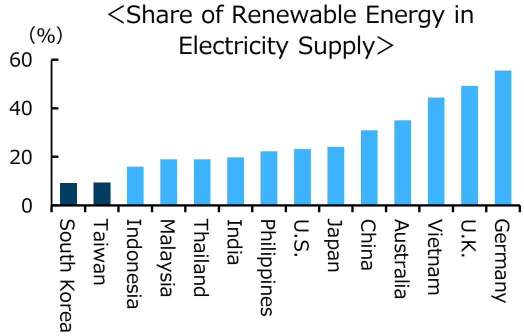
3. Concerns about medium- to long-term growth stagnation also exist

If confrontation and friction between regions become entrenched as the international order shifts, the negative economic effects will not be temporary. Unless countries/territories implement appropriate policy responses, structural constraints on economic activity will intensify, potentially leading to a decline in Asia's medium- to long-term growth potential.

(1) South Korea and Taiwan

Even after the current crisis subsides, instability in the Middle East is likely to persist. For South Korea and Taiwan in particular, reducing energy-supply risks will necessitate a diversification of sources of fossil-fuel procurement and a lowering of dependence on these fuels. Notably, both economies have lagged in the introduction of renewable energy as part of decarbonization efforts, making action from the policy side essential.

<Share of Renewable Energy in Electricity Supply>



Source: Prepared by JRI based on data from IEA
Note: Figures are for 2023 or 2024.

If the two countries do not take effective measures and supply risks continue to loom large, investment in electricity- and energy-intensive industries such as their mainstay semiconductor sectors may shrink or shift overseas, posing the danger of erosion of their export competitiveness. In Taiwan, semiconductor-related exports account for half of GDP, while South Korea hosts not only major semiconductor producers but also steel, chemical, and other energy-intensive industries. A decline in the export competitiveness of these sectors, combined with stagnant domestic demand due to falling birthrates and aging populations, could well lead to prolonged economic stagnation in both South Korea and Taiwan.

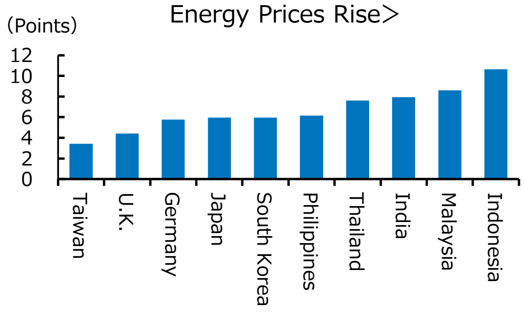
(2) ASEAN and India

As shifts in the global balance of power make international conflicts more likely, the prices of fossil fuels in international markets may remain elevated or become prone to sharp spikes. This dynamic heightens the medium- to long-term risk of growth stagnation in ASEAN and India for two reasons:

First, if inter-regional friction becomes the norm, it could erode the price competitiveness of ASEAN and India, and become an obstacle to exports and inward foreign direct investment. This is because for both ASEAN and India, fossil fuels account for a large proportion of their energy supply, and their economic structures make it easy for increases in international energy prices to ripple into prices overall.

Second, rising energy costs may strip companies of the capacity to invest in research and development (R&D), which would further slow the upgrading of their industrial sectors. In ASEAN countries and India, R&D investment as a proportion of GDP is generally below 1%, far lower than the global average of 2.6%. This could contribute to keeping ASEAN and India stuck in the "middle-income trap," a situation in which the manufacturing sector's role in global value chains remains confined to the assembly of final goods, resulting in stagnant income levels.

<Degree of Ripple Effect on Prices when Energy Prices Rise>



Sources: Prepared by JRI based on data from CEIC and IEA
Note: Multiplied the share of household electricity, gas charges, and automobile fuel costs (or similar categories in the case of Indonesia, India, and Thailand) by the share of fossil fuels in primary energy supply.

To avoid these medium- to long-term stagnation risks, ASEAN and India must pursue not only short-term, stopgap measures but also broader efforts to improve efficiency and strengthen resilience through energy conservation and decarbonization.

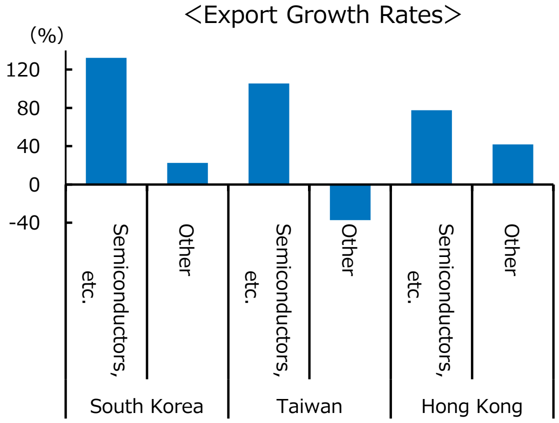
(Tomohiro Hosoi)
(Wu Zijing)
(Thoma Imagawa)

NIEs *The AI boom is driving economies*

■ A virtuous cycle for foreign and domestic demand is being established thanks to global AI-related demand

In general, the economies of the NIEs (South Korea, Taiwan, and Hong Kong) are expanding. In South Korea and Taiwan in particular, rising exports of electronic components and devices, centered on semiconductors, are serving as powerful economic drivers. As generative AI proliferates worldwide, demand for AI servers, the semiconductors required to produce them, and related components has been expanding rapidly. Taiwan is strong in logic chip fabrication, while South Korea is strong in memory chips, and both economies are benefiting significantly from global investment in AI infrastructure. Their exports of these semiconductors have risen sharply as a result.

<Export Growth Rates>



Source: Prepared by JRI based on data from CEIC
Note: Growth rates from April 2024 to April 2026. "Semiconductors, etc." refers to electronic devices and components (based on each country's definition). "Other" excludes the export value of semiconductors, etc.

In South Korea and Taiwan, against the backdrop of export expansion, corporate earnings have improved, which in turn is having a positive impact on domestic demand. Semiconductor-related firms are leading increases in machinery investment and factory construction, and are also actively hiring personnel and raising wages. Personal consumption is also recovering, supported by this improved employment/income environment.

In Hong Kong, too, trade in goods, particularly electronic components, has increased. Service exports are also firm, thanks to a recovery in international financial transactions and rising inbound demand from mainland China. In addition, domestic demand is recovering. Real-estate development investment has picked up, and consumption is being buoyed by the wealth effect of rising housing prices.

■ High prices will depress economies

Looking ahead, the NIEs will continue expanding, but the pace of growth is expected to slow. For the full year of 2026, the NIEs are projected to grow by 5.0%, accelerating from 3.9% in 2025, but the rapid growth seen in early 2026 is projected to gradually settle into a more moderate pace.

For the time being, exports and investment driven by expanding AI-related demand should continue to drive economic activity. In South Korea and Taiwan in particular, high growth in exports of semiconductors and other electronic components is expected to continue, and capital investment related to that growth is likely to remain at elevated levels.

<Projected Growth Rates for NIEs (South Korea, Taiwan, and Hong Kong)>

(%)

	2023 (Actual)	2024 (Actual)	2025 (Actual)	2026 (Forecast)	2027 (Forecast)
NIEs	1.6	3.1	3.9	5.0	2.6
South Korea	1.6	2.0	1.0	2.6	2.0
Taiwan	1.1	5.3	8.8	9.4	3.6
Hong Kong	3.2	2.6	3.6	3.5	2.5

Sources: Prepared by JRI based on data from IMF and national statistics and central bank data from each country

However, higher inflation stemming from the Middle East crisis is expected to dampen consumption, slowing the pace of economic expansion. The governments of the NIEs are implementing measures to curb fuel and electricity prices in order to ease the burden on households, but the rising raw-material and energy costs faced by companies will gradually spill over into higher prices for a wide range of goods and services.

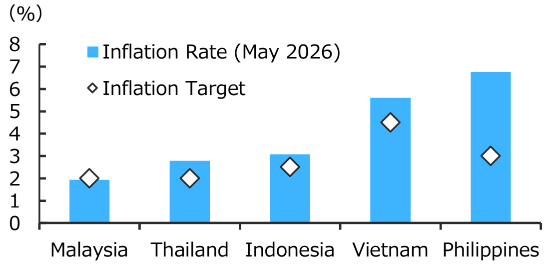
At the same time, the NIEs' heavy dependence on AI-related demand could also become a risk factor. If global AI-related investment were to enter a correction phase due, for example, to worries about the profitability of AI businesses, exports and capital investment could fall well short of expectations. In such a scenario, deteriorating corporate earnings could adversely impact the employment/income environment for consumers, creating a ripple effect on personal consumption. South Korea and Taiwan warrant particular caution regarding such significant downturn risks, as they are heavily reliant on AI-related demand.

(Thoma Imagawa)

ASEAN5 Economies will slow through the second half of the year

■ Inflation is reigniting in the ASEAN5

<Inflation Rates and Inflation Targets>



Source: Prepared by JRI based on data from CEIC
Note: For Malaysia, the inflation rate is for April. For Malaysia and Thailand, the inflation target refers to the midpoint of the target band.

The real GDP growth rate of the ASEAN5 in the January-March quarter of 2026 was +5.2% YoY, unchanged from the +5.2% figure registered in the previous quarter. Backed by the worldwide AI boom, demand for electronic devices and related components expanded, and exports stayed on the recovery track. However, domestic demand lacked momentum, and in the Philippines in particular, consumption and investment felt the weight of currency depreciation and stagnant remittances from citizens working overseas.

Signs of economic slowdown have emerged recently, especially in countries with domestic-demand-led economies. On the foreign demand side, exports of IT-related goods, particularly from Malaysia, Vietnam, and Thailand, remain at high levels, and are driving overall exports. In Thailand, however, clouds have formed over inbound demand, the country's main economic driver. The number of long-haul tourists from Europe (who account for roughly 25% of total visitors) has fallen, reflecting the turmoil in Middle Eastern airspace and soaring airfares resulting from higher aviation fuel costs.

On the domestic demand side, inflationary pressure has strengthened due to higher crude oil prices and currency depreciation, and this is weighing on consumption and investment. In all ASEAN countries except Malaysia, inflation rates have already risen above the target ranges set by their central banks. Although governments are attempting to ease the burden on households through such measures as expanded fuel subsidies, these moves have led to concerns about fiscal deterioration, resulting in currency slides in foreign-exchange markets. In fact, the Indonesian rupiah and Philippine peso have fallen by 11.1% and 6.4%, respectively, since the beginning of the year. This depreciation is pushing up import prices, which is further amplifying inflationary pressure. Against this backdrop, the central banks of both countries hiked interest rates between April and June, and higher interest burdens are increasingly weighing on domestic demand.

■ Economic growth will trend lower through the second half of 2026

<Projected Growth Rates for ASEAN5>

(%)

	2023 (Actual)	2024 (Actual)	2025 (Actual)	2026 (Forecast)	2027 (Forecast)
ASEAN5	4.4	5.1	5.1	4.6	5.0
Indonesia	5.0	5.0	5.1	4.8	5.0
Malaysia	3.5	5.1	5.2	4.7	4.9
Philippines	5.5	5.7	4.4	3.8	4.6
Thailand	2.2	2.9	2.4	1.8	2.1
Vietnam	5.1	7.0	8.0	7.5	7.8

Source: Prepared by JRI based on national statistics from each country

Looking ahead, ASEAN economies are expected to slow overall, though the degree of weakness will vary across countries. In all countries except Malaysia, rising energy prices are likely to generate terms-of-trade losses and depress domestic demand through pressure on real incomes and corporate earnings. Accelerated inflation due to El Niño is also expected to weigh on consumption and investment. By contrast, continued growth in demand for electronic devices and components resulting from the AI boom will continue to lift exports in Malaysia and Vietnam, and solid expansion of foreign demand is expected to offset domestic-demand weakness in both countries. In the ASEAN5 as a whole, full-year real GDP growth for 2026 is projected to decelerate to +4.6% from +5.1% in the previous year.

Downside risks going forward include 1) a rekindling of the Middle East crisis, 2) further currency depreciation, and 3) political instability in some member countries. In particular, if the reopening of the Strait of Hormuz is delayed and supply constraints become prolonged, the ASEAN5 as a whole could fall into a severe recession.

(Wu Zijing)

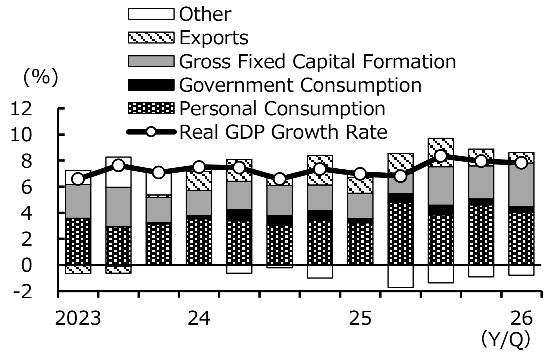
India *A shift in the growth model is required*

■ High growth of around 8% was maintained for a third consecutive quarter

The Indian economy continues to expand. The real GDP growth rate in the January-March quarter of 2026 was +7.8% YoY, keeping up the rapid expansion recorded in the previous quarter (+8.0% YoY). By demand component, personal consumption climbed 7.1% YoY, maintaining the strong growth recorded in the previous quarter (+8.2% YoY). In September 2025, the Indian government slashed the Goods and Services Tax (GST), and partly because of this, sales of durable goods such as automobiles increased. In addition, gross fixed capital formation accelerated to +10.8% YoY from the previous quarter's +8.2% YoY. Investment overall was driven by massive infrastructure development expenditures of around 11 trillion rupees (about 19 trillion yen) in FY2025, which amounted to more than 20% of central government spending that year.

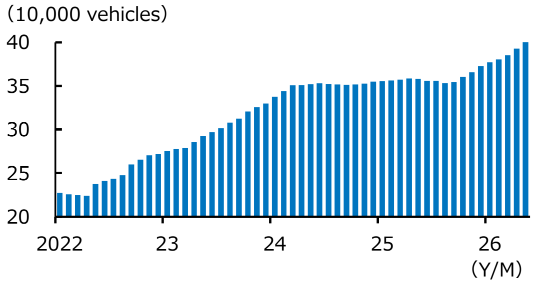
However, the pick-up in foreign demand showed signs of a temporary stall, with export growth slowing to +2.7% YoY from +4.4% YoY in the previous quarter. Service exports increased 8.9% YoY, maintaining the rapid growth registered in the previous quarter (+7.5% YoY), but exports of goods declined 2.8% YoY, having seen positive growth in the previous quarter (+1.4% YoY). A big reason for this was that exports to the Middle East, which account for 20% of goods exports, fell sharply (-14.2% YoY) due to the outbreak of armed conflict there.

<Real GDP Growth Rate (YoY change)>



Source: Prepared by JRI based on data from CEIC

<Automobile Sales>



Source: Prepared by JRI based on data from CEIC
Note: Passenger vehicle sales volume. 12-month trailing moving averages.

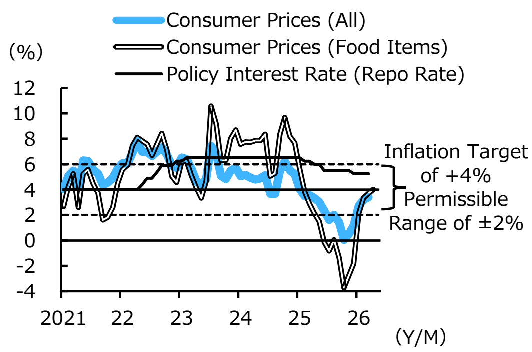
■ Downside economic pressures from both the demand and supply sides are becoming evident

Looking ahead, the Indian economy is expected to face a slowdown. Real GDP growth is projected to be +6.0% in FY2026 (April 2026 - March 2027), considerably down from the figure of +7.7% recorded the previous year. The Middle East crisis and El Niño are expected to lead to downward economic pressures from both the demand and supply sides.

On the demand side, higher inflation stemming from the Middle East crisis will depress domestic demand, and foreign demand is also expected to be lackluster.

A significant slowdown in consumption, which has been driving the economy until now, is regarded as unavoidable, as household purchasing power is being eroded by rising inflation. Consumer price inflation accelerated to 3.9% YoY in May, up from 3.5% YoY in April, reflecting the spillover of surging international energy prices into domestic prices. Specifically, two factors were at work: 1) In May, state-run oil companies raised gasoline and household LPG prices in response to widening losses that were the result of them having refrained from putting up prices until then, and 2)

<Inflation Rate and Policy Interest Rate>



Source: Prepared by JRI based on data from CEIC
Note: Food items included differed until December 2025.

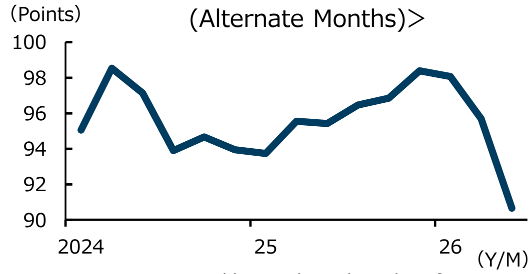
depreciation of the rupee has been pushing up import prices across the board. Inflationary pressure is also expected to intensify further in the near term, and consumer price inflation is likely to move higher than the upper limit of the central bank's inflation target (6.0%) in the near future. Contributing factors include expectations that energy prices will remain elevated even after hostilities between the U.S. and Iran end, and concerns that El Niño will lead to poor harvests and soaring food prices. Consumer confidence has already deteriorated markedly, and alongside the fading impact of the GST reduction, consumption, particularly of durable goods such as automobiles and home appliances, is expected to be sapped of growth momentum in the near term.

Investment is also expected to decelerate. Wholesale price inflation, which includes procurement prices of raw materials and capital goods, rose sharply from 4.0% YoY in March to 9.7% YoY in May, eroding firms' capacity to invest. Infrastructure investment by the government is also expected to stagnate. Although the FY2026 central government budget allocates 12 trillion rupees for infrastructure development, up 10% from the previous year, the surge in energy and raw-material prices is likely to weaken its stimulative effect on the economy.

Foreign demand is expected to remain sluggish overall, with contrasting trends between goods and services. Service exports have continued to grow rapidly since April, driven by increasing global demand for IT and business process outsourcing (BPO), and the near-term outlook is for continued, stable growth. Goods exports, however, will remain weighed down by lower shipments of jewelry, a key export item, due to turmoil in Middle Eastern economies, and are projected to remain flat or drop slightly going forward.

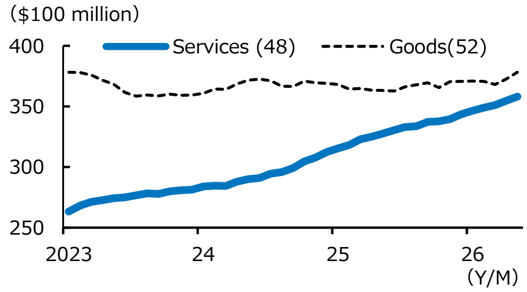
On the supply side, stagnation in agricultural production, which accounts for 20% of GDP, is expected to depress the economy. The India Meteorological Department is forecasting that rainfall during the monsoon season (June-September) will reach only 90% of the long-term average due to El Niño, making a slowdown in agricultural output likely. Historically, India's GDP growth rate for agriculture, forestry, and fisheries tends to decline in the presence of El Niño. This year, the impact on agricultural production may be even greater than when El Niño has occurred in the past, as the phenomenon will be compounded by surging energy prices and disruptions in fertilizer imports from the Middle East. In addition, stagnation in agricultural output will worsen the employment/income environment for workers in agriculture, forestry, and fisheries, who make up 40% of the total labor force, so is likely to further weaken consumption.

<Consumer Confidence Index (Alternate Months)>



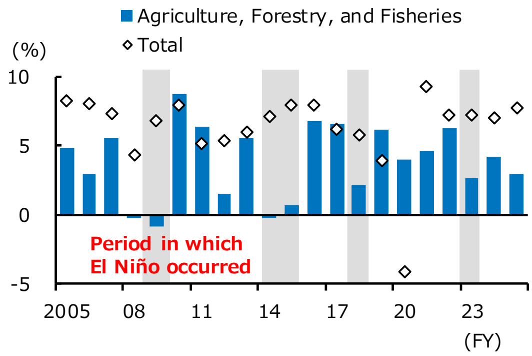
Source: Prepared by JRI based on data from CEIC
Note: Indicates households' view of the economy over the next 12 months. 100 is the borderline between optimism and pessimism.

<Exports of Goods and Services>



Source: Prepared by JRI based on data from CEIC
Note: 12-month trailing moving averages. Figures in parentheses are export shares in 2025.

<Past Real GDP Growth Rates>



Sources: Prepared by JRI based on data from CEIC and Japan Meteorological Agency
Note: Until FY2022, the basis for GDP statistics differed. Regarding the period in which El Niño occurred, the period in which the phenomenon was announced as occurring by the Japan Meteorological Agency has been roughly matched with Indian fiscal years.

■ Enhancing value-add in the manufacturing sector is key

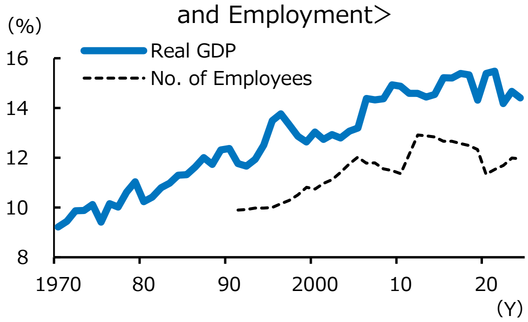
As the above discussion has shown, India faces downward pressures on both demand and supply during this current period of crisis, and the margin of decline in the growth rate is expected to be particularly large even among Asian economies, which are predominantly net importers of energy. Underlying this vulnerability is the long-standing structural weakness of India's manufacturing sector. In 2014, the Modi government announced the "Make in India" initiative, and has been working to accelerate economic growth and create employment opportunities by strengthening manufacturing. However, the share of manufacturing in GDP and employment has actually been declining in recent years, and there are signs that industrialization has hit a wall. With domestic manufacturing failing to expand, the sector's international competitiveness has also stalled. Although the Modi government is aiming to foster advanced manufacturing, India's comparative advantage over other countries remains limited to certain segments such as smartphone assembly. Therefore, unlike Taiwan, South Korea, or China, the Indian economy cannot be expected to benefit from the AI boom and be supported by increased exports of semiconductors or advanced devices. And in general, because manufacturing has high capacity to absorb workers, labor typically shifts from agriculture to manufacturing in developing countries as their economies grow. In India, however, the labor absorption capacity of manufacturing has not increased, and the number of farm workers and agriculture's share of GDP remain high. This is also amplifying the economic impacts of the Middle East crisis and El Niño.

With the proliferation of AI and robotics, assembly and finishing processes, where India currently has a comparative advantage, may become automated, further undermining the country's industrialization. To avoid such an outcome, India needs to pursue higher value-added manufacturing by deploying and diffusing technology. Specifically, it must proactively accept inward foreign direct investment, develop domestic STEM talent, and encourage investment in R&D.

■ Services also need a shift in growth model

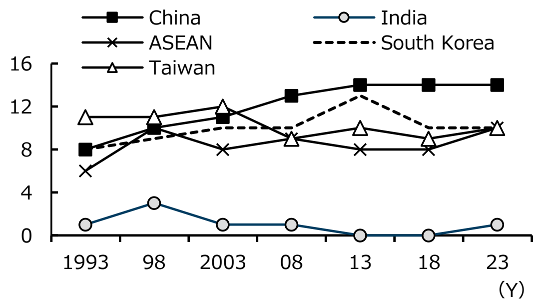
The service sector, which has driven India's economy until now, and particularly the IT and BPO industries, which account for 60% of service exports, is also at risk of stagnation. The market capitalization of the Nifty IT index, which comprises major Indian IT firms such as TCS and Infosys, has been sluggish despite its constituent companies booking solid profits recently. This reflects growing concerns that rapid AI adoption will reduce future demand for software development, maintenance, and back-office services such as call centers, all areas where India has traditionally excelled. A 2026 survey by Z47 and OpenAI of 100 Indian firms found that 40% of companies with high levels of AI utilization have cut IT and BPO spending by

<Share of Manufacturing in Real GDP and Employment>



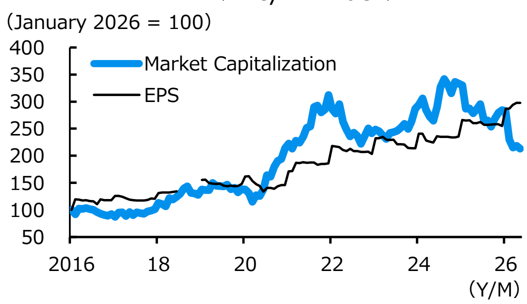
Sources: Prepared by JRI based on data from UNCTAD and ILO
Note: The base year for real GDP is 2020.

<Comparative Advantage of Advanced Manufacturing>



Source: Prepared by JRI based on data from RIETI-TID
Note: Number of traded goods for which revealed comparative advantage (export share of each country / world export share) is greater than 1 in five phases of production in machinery field (general, electrical, household devices, transportation, precision).

<Nifty IT Index>



Source: Prepared by JRI based on data from Bloomberg L.P.
Note: EPS data for the second half of 2018, when a discontinuity was observed, is excluded.

more than 25%. The U.S., India's main export destination, is ahead of India in AI utilization, which poses the danger of U.S. firms rapidly internalizing operations, leading to a significant contraction in demand for IT and BPO services in the future. India's service-sector growth model thus requires an overhaul to adapt to the changing environment. Essential steps include 1) upgrading IT and BPO export businesses by, for example, offering AI-driven support for client problem-solving, and 2) actively deploying AI in the domestic service industries that employ most service-sector workers, such as logistics, finance, healthcare, education, and public administration, to raise productivity.

(Tomohiro Hosoi)

China Structural problems are a drag on China's economic growth

■ Domestic demand has slowed recently

The Chinese economy has again entered a phase of more moderate growth. Lackluster domestic demand has led to economy-wide sluggishness.

Looking at each demand component, investment has slowed substantially. In May, fixed asset investment sank deeper into negative territory, sliding 10.7% YoY. By sector, infrastructure investment, which had been supporting overall investment since the beginning of the year, fell 9.5% YoY, registering a YoY decline for the second consecutive month. Causes included a drop in major project starts. Manufacturing investment also stayed in the doldrums, slumping 4.2% YoY. Behind this were the waning effects of government subsidies for upgrading equipment, as well as rising producer-goods prices and heightened uncertainty, which made firms less willing to invest in capital goods. Furthermore, the margin of decline in real-estate development investment widened, partly due to lackluster sales of homes.

<Key Economic Measures in Initial Budget>

	2025	2026
Fiscal Deficit (As Percentage of GDP)	Around 4%	Around 4%
Ultra-long-term Special Government Bond Issuance	1.3 trillion yuan	1.3 trillion yuan
Subsidies for Replacement of Durable Consumer Goods	0.3 trillion yuan	0.25 trillion yuan
Subsidies for Upgrade of Equipment	0.2 trillion yuan	0.2 trillion yuan
Key Strategy and Focus Area Projects	0.8 trillion yuan	0.8 trillion yuan
Local Government Special Bond Issuance	4.4 trillion yuan	4.4 trillion yuan
Policy Financing Support	0.5 trillion yuan	0.8 trillion yuan
Special Funds for Domestic Demand Promotion (Interest Subsidies, etc.)	---	0.1 trillion yuan
Capital Injections into State-owned Banks (Special Government Bonds)	0.5 trillion yuan	0.3 trillion yuan

Source: Prepared by JRI based on the Government Work Report and various media reports

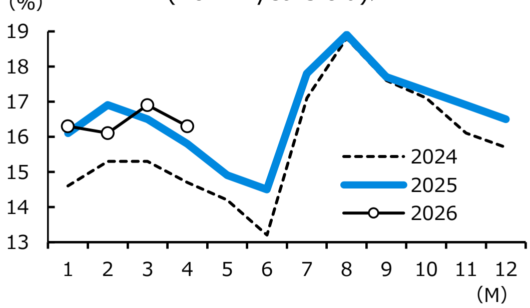
Consumption is also showing signs of weakness. In May, retail sales dipped 0.6% YoY, marking the first decline in three years and five months. Services consumption growth has weakened, and goods consumption was down YoY for the second straight month. Looking at categories, the effect of government subsidies for the replacement of durable consumer goods faded, with sales of home appliances and automobiles dropping at a faster rate. Telecommunications equipment, consumption of which had been holding firm, also saw slower sales due to such factors as price increases for smartphones caused by surging semiconductor prices. Furthermore, rising interest rates around the world have pushed down gold prices, resulting in jewelry sales posting a large year-on-year decline as consumers decided to delay new purchases.

However, exports remain strong. Exports in May rose 19.4% YoY, accelerating from the 14.7% recorded in the January–March quarter. By country/territory, exports to ASEAN and the EU, which are key export destinations, continued to rise rapidly, and exports to the U.S. are showing signs of bottoming out. Categories such as automobiles, particularly EVs, and intermediate goods such as electronic components drove the expansion.

■ Negative effects from the Middle East crisis will emerge, and the economic growth rate will be lower than the previous year's

Looking ahead, the adverse impact of the Middle East crisis will become evident through the second half of the year, and the slowdown in the economy is expected to become even more pronounced. The effects of the Middle East crisis on China's economy will appear mainly on the demand side rather than the supply side. Compared with other Asian economies, the share of oil and gas in China's energy supply is small, and it has ample stockpiles, so oil and gas supply constraints are unlikely to

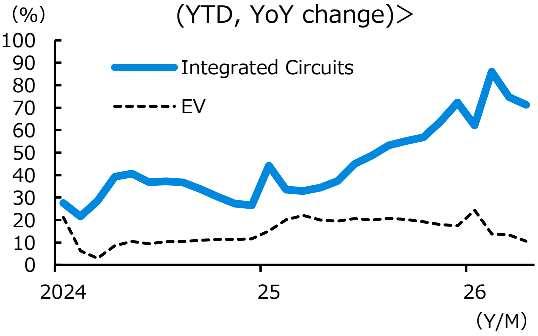
<Youth Unemployment Rate (16-24 years old)>



Source: Prepared by JRI based on data from CEIC become a drag on economic growth. On the other hand, domestic demand already has structural weaknesses, and elevated energy prices due to the Middle East crisis will further depress consumption and investment through the following two channels:

The first is lower consumer purchasing power. Consumption is structurally fragile due to factors such as the negative wealth effect of the real-estate slump and the high level of youth unemployment. Given that, persistently high prices of gasoline and other forms of energy can be expected to further reduce household purchasing power and damage consumer confidence.

<Real Exports by Category (YTD, YoY change)>



Source: Prepared by JRI based on data from CEIC

The second is worsening corporate earnings. Rising producer-goods prices due largely to higher energy costs stemming from the Middle East crisis are increasing the burden on companies, and investment is expected to slow significantly. In addition, the employment environment may significantly worsen, placing additional downward pressure on consumption.

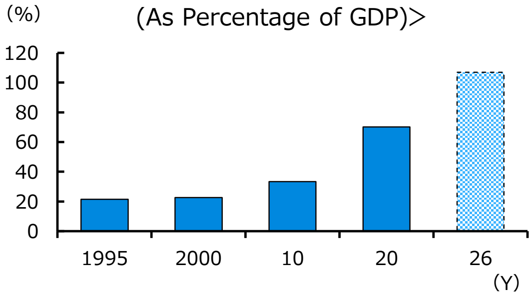
Domestic demand is thus expected to cool further, and the spending-boosting effects of policy measures are also likely to be limited. The government will probably take additional economic measures in response to the slowdown, but they are unlikely to prove effective because of two factors:

The first concerns the policy orientation of the Xi Jinping administration. Although the government is increasingly aware that consumption needs to be stimulated to achieve stable growth, given its sense of crisis about "strong supply, weak demand" (i.e., excessive supply and insufficient demand), actual policy measures do not directly increase household purchasing power. Instead, they are designed to revive demand by strengthening supply capacity. As evidence for this, the government's special action plan to boost consumption (2025) states that "effective demand will be generated through high-quality supply," presenting this as its basic policy for stimulating consumption. This approach has echoes of Say's law, which contends that supply creates demand, but with it, the supply of goods and services could increase while households remain reluctant to make purchases, so the structural issue of excess supply coexisting alongside inadequate demand is unlikely to be resolved.

The second is that leeway to boost consumption and investment is narrowing. The effects of subsidies for the replacement of durable goods have already run their course, and because most key durable goods are already eligible for the subsidies, there is little room for further expansion of the subsidy program. On the producer side, subsidies for the upgrade of equipment have been available since 2024, and they have eaten into future demand to a considerable extent. For this reason, the amount of money earmarked for these subsidies in the initial budget for 2026, which was announced in March, remained roughly unchanged from the previous year. At the Communist Party Politburo meeting held at the end of April, economic management for the near term was a key item on the agenda, but the statement released after the meeting did not include any language indicating additional measures would be taken.

One remaining option for stimulating consumption is direct cash handouts to households, of the kind doled out in developed countries during the COVID pandemic. These would increase the purchasing power of consumers directly, but given China's fiscal situation, such government largesse is probably unfeasible. According to the April 2026 edition of the World Economic Outlook published by the IMF, China's general government debt as a percentage of GDP, which tended to be in the 20% range from the mid-1990s to the 2000s, had risen to the 70% range in 2020 and is projected to exceed 100% in 2026. Economic measures taken during the 2008 global financial crisis and the 2020 pandemic, as well as such factors as ballooning debt at local-government

<China's General Government Debt (As Percentage of GDP)>



Source: Prepared by JRI based on data from IMF
Note: Figure for 2026 is the IMF projection.

financing vehicles (LGFVs), have caused the country's overall debt level to surge, and reduced capacity to expand fiscal expenditure.

In light of the above, domestic demand is expected to slow, though foreign demand should remain brisk due to the following three factors: The first is a bottoming out of exports to the U.S. At the U.S.–China summit in May, the two countries' leaders agreed to establish boards of trade and investment, expand imports and exports of agricultural products, remove non-tariff barriers, and have China purchase U.S. civilian aircraft. This agreement is expected to ease U.S.–China trade friction for the time being, and support a gradual recovery in exports from China to the U.S. The second is an expansion of EV sales. Concerns about crude oil supply due to the Middle East crisis will likely accelerate the shift from internal combustion engine vehicles to EVs, particularly in Asia, so Chinese EV exports can be expected to expand. The third is an increase in exports of intermediate goods to ASEAN and the NIEs. Although such exports may slow somewhat in reaction to last year's export rush ahead of the imposition of Trump's tariffs, they are expected to remain resilient thanks to the global AI boom.

Overall, while foreign demand will remain firm, it will not be sufficient to offset the slowdown in domestic demand, and China's real GDP growth in 2026 is projected to be +4.5% YoY, below the +5.0% growth recorded in 2025. And with the country's potential growth rate continuing to decline due to the aging population and declining birthrate, growth in 2027 is expected to slow further, to around +4.3%.

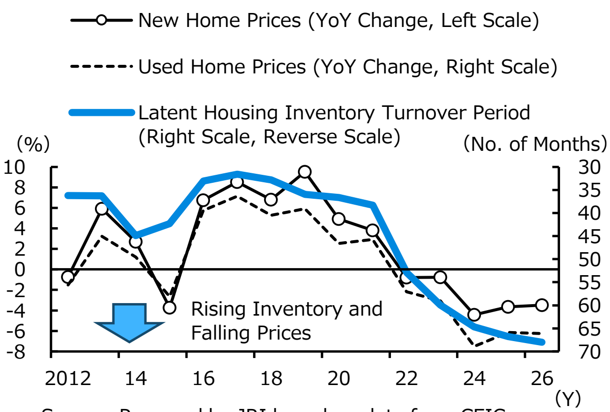
■ The issue of excess supply capacity remains unresolved, and there is a risk of a sharp decline in the growth rate

As discussed above, structural problems such as excess production capacity in the manufacturing and real-estate sectors are causing economic stagnation in China. If cautious stances on stimulating demand continue and the policy approach of emphasizing expansion of supply capacity is maintained, structural adjustment will inevitably be delayed. Specifically, the workforce will remain locked inside unprofitable sectors and firms, and inefficient allocation of capital will persist. So-called "involution," i.e., excessive competition, and overprotection of industry by local governments have saddled the manufacturing sector with too many facilities and too much equipment, which is putting pressure on corporate earnings and finances. Excess supply in real estate is also severe. While housing sales have been sluggish for a prolonged period, scant progress has been made with adjusting supply, resulting in a buildup of inventory. In response to the above issues, the government has been gradually taking some steps, such as tackling involution in manufacturing, easing housing purchase restrictions, and allowing troubled real-estate developers to collapse. However, it has not undertaken painful, fundamental structural reforms, and the impact of current measures has been limited. As a result, excess production capacity is in danger of becoming entrenched, hindering efficient resource allocation to growth sectors and further lowering the potential growth rate.

In addition, delays in fiscal and social security reform are also a concern. Although the Xi Jinping administration has been moving to expand pension and medical insurance benefits and increase contributions to child allowances in order to support sustained consumption growth, these measures remain small in scale due to insufficient financial resources, and thus cannot be expected to dispel consumers' anxiety about the future.

If the Chinese government fails to implement appropriate policy responses to address insufficient demand and excess supply, deflationary pressure may intensify and external imbalances may widen, posing the danger of increased international friction. Saddled with excess production capacity and confronted by tepid domestic consumption, many Chinese companies are stepping up export drives in search of opportunities abroad. In response to such moves, the EU announced in May that it would be tightening curbs on imports from China as a means of

<Housing Prices and Housing Inventory Turnover Periods>



Source: Prepared by JRI based on data from CEIC
Note: Housing inventory turnover period = unsold floor area / sold floor area.Figures for 2026 are JRI estimates based on actual data for January-May 2025.

protecting its own firms. And though tensions with the U.S. have eased since the summit with President Trump, they could re-ignite, and lead to the U.S. getting tougher on China, such as by raising tariffs, once again. If such a situation plays out, there is a danger of the current strong growth of foreign demand also being undermined.

(Junya Sano)
(Hiromu Komiya)