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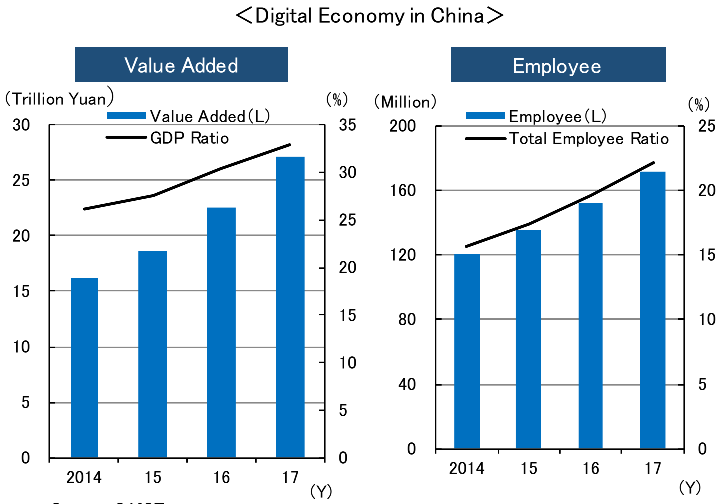
Topics Growth of China's digital economy is expected to slow down

China's digital economy has achieved rapid growth and worked as a growth driver in the past. However, the environment surrounding the digital economy is changing, and the pace of growth is anticipated to slow in the future.

■ Expansion of the digital economy continued

The growth of China's digital economy has been remarkable, and has been a driving force behind economic growth. According to the White Paper on China's Digital Economic Growth and Employment 2018 issued by the China Academy of Information and Communications Technology (CAICT), a thinktank under the Ministry of Industry and Information Technology (MIIT), China's digital economy was valued at 27.1 trillion yuan as of 2017, accounting for 32.9% of its GDP. Since the digital economy was only valued at 1.2 trillion yuan or 10.3% of China's GDP in 2002, China's digital economy has become 22 times larger in size over the past 15 years.



Source: CAICT

The digital economy has also played a key role in employment. The number of workers in the digital economy sector amounted to 170 million in 2017, which accounted for 22.1% of the total number of workers. Looking at the breakdown by industry, the number of workers engaged in the agriculture, forestry and fishery sector was 790,000, with 50.54 million in the mining and manufacturing sector and 120.16 million in the service sector, which indicates 70% of workers are employed in the service sector. Since the number of workers was merely 44.11 million in 2007, the digital economy actually created jobs for 130 million over 10 years.

In the July to September quarter of 2018, China's real GDP grew 6.5%, compared to the same period in the previous year, which was the second lowest level since the January to March period of 2009, when growth was recorded at 6.4% from the corresponding period of the previous year. As the decline in China's potential growth rate is inevitable from a medium- to long-term perspective due to a decrease in working population, anticipation for the rapidly growing digital economy has been increasing. In September, the Chinese government announced guiding opinions on the development of the digital economy and expansion of employment. The guiding opinions were issued by 19 departments including the National Development and Reform Commission (NDRC), which clearly demonstrated the Chinese government's attitude toward supporting the growth of the digital economy across ministries.

■ China's digital economy has been overvalued from the international perspective

An attempt to grasp the digital economy has already started among developed countries and international organizations. The Bureau of Economic Analysis (BEA) under the U.S. Department of Commerce estimated the size of the digital economy in the United States as 1.2 trillion dollars, and the number of workers in the sector as 5.9 million in 2016. Their ratio to GDP and to total workers was 6.5% and 3.9%, respectively, which was much lower compared to China. The International Monetary Fund (IMF) also estimated the size of the digital economy in the United States as 8.3% to GDP in 2015.

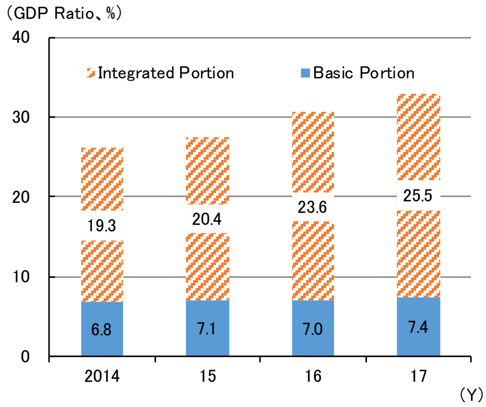
China exceeds the United States in terms of the size of its digital economy expressed as a percentage of GDP because of a difference in the method of estimation. In the methods used, the "basic portion" refers to a group of industries generally described as the ICT sector, comprising manufacturing of ICT equipment and services related to communication, Internet and computers. Meanwhile, the "integrated portion" refers to added value and jobs created in sectors other than the ICT sector as a result of digitalization. While China regards the combination of the basic portion and the integrated portion as the digital economy, the BEA and the IMF regard only the basic portion as the digital economy. Since this includes medium- and small-sized manufacturers and retailers which engaged in electronic commerce (EC) transactions as well as food services outlets and delivery persons who joined food delivery platforms, the size of the digital economy estimated using the Chinese method inevitably becomes larger.

From the perspective of the BEA and the IMF, China's digital economy has been overvalued. When China's digital economy is divided into its basic portion and integrated portion, the ratio of the former becomes approximately 7% of GDP. With the ratio of China's digital economy significantly reduced from 30%, it is at a similar level as the United States and its size can be regarded as the second largest following the United States. Since the penetration of the Internet in China is 55.8% as of 2017, which is still significantly lower compared with that of developed countries, there is considerable room for further expansion of the digital economy in China. For this reason, it is natural for the Chinese government to pursue the expansion of the digital economy.

■ Three factors may slow down growth

The digital economy is a savior for the Chinese government, as the country suffers from slowing growth. This is because the digital economy is considered to have the following three benefits: 1) The digital economy has a significant effect in creating jobs and contributes to improvements in productivity, 2) the majority of companies that support the digital economy are spontaneously developed private companies and they do not require economic stimulus measures and monetary easing measures through public funds that may accompany side effects, and 3) the digital economy has the effect of promoting the shift in industrial structure from the secondary industry to the tertiary industry.

＜Breakdown of China's Digital Economy＞



Source: CAICT

However, the environment surrounding the digital economy has been changing, and the pace of growth is expected to slow down in the future. The first factor behind this is an expansion of the "gig economy" in line with the development of the digital economy. Gig economy refers to a way of working by undertaking one-off jobs on the Internet. In developed countries, while it enables a wide range of workstyles, it is also regarded as a hotbed of relative poverty. In China, jobs like delivery persons for EC services and drivers of ridesharing services fall under this category. While its whole picture is unclear, the number of ridesharing drivers was estimated at 21.15 million in 2017 according to the Development Report of China's Sharing Economy 2018 released by the State Information Center (SIC), a thinktank of the Chinese government. One of the problems behind this is that many workers in the gig economy have not participated in the social security system, so the number of citizens the fall through the social safety net may increase as a result of the development of the digital economy. While there are voices within China calling for a solution to this problem which may impair social instability, the expansion of the safety net will result in increased costs and may reduce the momentum of growth.

The second factor is a slowdown in consumer spending. In the January to October period of 2018, retail sales grew 8.6% from the corresponding period of the previous year, remaining at a lower level. Growth has been consistently slowing down since 2009, and it is expected to remain at the lower level going forward. Since the main battlefield of IT companies underpinning China's digital economy is the lifestyle services market that is close to consumers, the effect cannot be prevented. Another concern for the gloomy outlook of the digital economy is the sluggish shipments of smartphones in China. The shipments of smartphones in 2017 declined by 12.3% from the year earlier, recording a negative annual growth for the first time. In the January to October period of 2018, shipments dropped by 15.3% from the same period of the previous year, continuing to struggle.

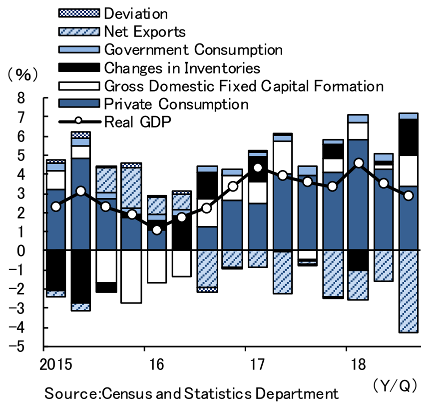
The third factor is a move toward the tightened regulation of the digital economy. As for P2P, a platform of short-term financial intermediation used among individuals and self-employed workers, a series of defaults and frauds took place and therefore the government strengthened oversight. As a result, the number of business operators and the volume of transactions as of October 2018 decreased to 30% and 40% of the peak period, respectively. In addition, bicycle sharing, which had become extremely popular, entered the shakeout stage as problems prevailed with the market reaching the saturation point. Such problems included the fact that deposits which were to be refunded at the time of membership cancellation were not actually refunded. Will the tightened regulation result in the shrinkage of market or a trigger for revitalization? The sharing economy which has driven the digital economy now faces a turning point.

(Yuji Miura)

Hong Kong *Economic slowdown became apparent*

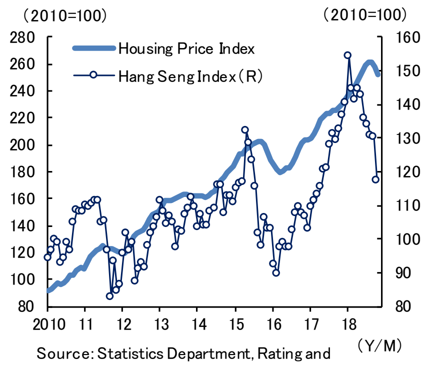
■ Growth rate declined in the July to September quarter of 2018

<GDP Growth Rate and Contributions by Expenditures(YoY)>



Source:Census and Statistics Department

<Housing Price Index and Hang Seng Index>



Source: Statistics Department, Rating and Valuation Department

The Hong Kong economy has been in the process of slowing down. In the July to September quarter of 2018, Hong Kong's real GDP grew 2.9% compared to the corresponding period in the previous year, falling below 3% for the first time in eight quarters. The main reason behind this slowdown is a decline in private consumption. It seems downward pressure was placed on consumer spending by a negative wealth effect due to the drop in stock prices and housing prices as well as deterioration of the consumer mindset reflecting increasing uncertainty surrounding the future outlook resulting from the trade frictions between the United States and China. Growth of exports also slightly declined, compared to the same period of the previous year, from 4.8% in the April–June period to 4.7% in the July–September period. This is attributable mainly to the slowdown of consumption expenditures by Chinese tourists owning to the cheaper yuan. Meanwhile, exports of goods have remained brisk, indicating that the effect of the trade dispute between the United States and China has been limited so far. While an increase in inventories was prominent during the quarter, this was due to frontloaded imports. It seems that there is no need to worry about downward pressure on domestic production as a result of the inventory increase.

In the future outlook, the slowdown trend will likely continue. Exports of goods have currently increased as companies rushed shipments in anticipation of further intensification of the trade war between the United States and China. The negative impact of tariffs on Chinese goods which have already been imposed by the United States will likely become tangible in the future. Moreover, interest rate hikes in connection with the rising interest rates in the United States are expected to continue to curb consumer spending in the form of a decline in asset prices. However, the employment and income conditions have remained robust as seen in the employment rate remaining at the lowest level during the past 20 years, and the connection between Hong Kong and mainland China will likely strengthen following the completion of infrastructure projects such as Hong Kong-Zhuhai-Macao Bridge and Guangzhou-Shenzhen-Hong Kong Express Rail Link. Given such positive effects, an economic stall will likely be avoided and Hong Kong is anticipated to secure a 2% rate of growth, in line with the potential growth rate.

■ China's influence has been on the rise

There have been a series of events which indicated the increasing influence of China. In September 2018, the activities of the pro-independence Hong Kong National Party were prohibited. In addition, a by-election was held in November after a pro-democracy legislative councilor was disqualified from the Legislative Council of Hong Kong over the oath-taking controversy. As a result, the Pro-Beijing camp (pro-China camp) won the by-election and expanded its dominance. Furthermore, as for Guangzhou-Shenzhen-Hong Kong Express Rail Link which has been recently completed, a method called the "Co-location of Customs, Immigration and Quarantine (CIQ) Facilities" has been adopted, wherein Hong Kong and China's customs, immigration and quarantine procedures are implemented at the Hong Kong terminal only in order to streamline procedures. Consequently, there has been criticism that China's judicial power will be exercised over station and train lines within Hong Kong. The increasing influence of China basically works positively on the economy through the flows of people and capital between Hong Kong and mainland China. However, if there will be setbacks in Hong Kong's rule of law and sophisticated autonomy based on customary law of "one country, two systems," the position of Hong Kong as the international financial and trading center on the basis of such system may be shaken. In order for Hong Kong to maintain its original position, a stance that keeps with the principle of "one country, two systems" will be required.

(Michinori Naruse)

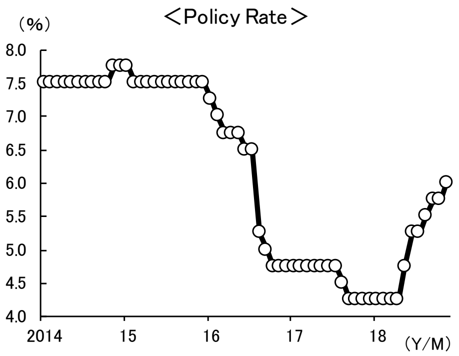
Indonesia *Sense of populism heightened prior to the election*

■ Trend of interest rate hikes will likely continue in the first half of 2019

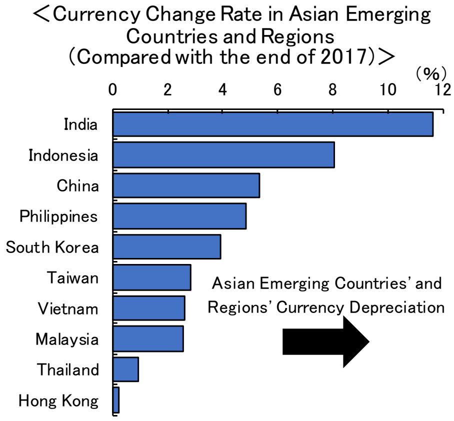
On November 15, 2018, Indonesia's central bank raised its policy rate for the sixth time this year. As a result, Bank Indonesia's policy rate, or the BI 7-Day Reverse Repo Rate, surged to 6.00%, reflecting rate hikes totaling 1.75% during 2018.

Behind continued rate hikes by Bank Indonesia are the acceleration of the cheaper rupiah and heightened concerns over inflation. In fact, looking at the exchange rate for the Indonesia rupiah to the U.S. dollar as of the end of November, the rupiah depreciated by 8.0% against the dollar compared to the exchange rate as of the end of 2017. Amid a series of rate hikes by the United States, there have been fund outflows from many emerging countries to the United States. Indonesia, which has been suffering from current account deficits and fiscal balance deficits, has a higher risk of losing the value of its currency compared to other major emerging countries in Asia. In addition, as Indonesia is highly dependent on imported goods, there have been heightened concerns over inflation of imported goods in line with the acceleration of currency depreciation.

As for the future outlook, given that the United States is expected to continue hiking rates until mid-2019, Bank Indonesia will likely continue raising its policy rates for the purposes of protecting its currency and preventing inflation of imported goods. However, in light of the government's active investments in infrastructure development as well as a surge of government consumption and private consumption in line with the legislative election and presidential election scheduled in April 2019, the rapid downturn of the Indonesian economy due to the rate hikes will likely be avoided.



Source : Bank Indonesia
Note1 : On Aug. 2016 Bank Indonesia changed its policy rate from BI Rate to 7-Day Reverse Repo Rate.
Note2 : Bank Indonesia rise its policy rate by 25 bps on 17th and 31st May 2018.



Source : Bloomberg L.P.

■ While the 16th economic policy package was announced, the implementation of some of the initiatives will be postponed

Meanwhile, the future of the policy for attracting foreign capital, one of the Joko administration's signature policies, will be surrounded by dark clouds. On November 19, 2018, the Indonesian government announced its 16th economic policy package aimed at promoting foreign direct investment and controlling the outflow of funds. The package mainly comprises three pillars including 1) relaxation of requirements for the tax holiday system, a preferential tax treatment for companies that invest in Indonesia, 2) relaxation of the negative list for foreign investment, and 3) obligation to deposit proceeds from the export of resources into a financial bank account in Indonesia and preferential tax treatment for companies that meet this obligation. However, as small- and medium-sized company owners in Indonesia expressed many concerns over the deterioration of earnings as a result of market entry by foreign companies, the Indonesian government announced the postponement of the relaxation of the negative list on November 23. This seems to reflect that the Indonesian government had already considered giving priority to domestic companies, looking ahead of the upcoming legislative and presidential elections.

Attracting foreign capital and protecting domestic companies are delicate issues faced by emerging nations. They tend to incline towards the stance of pandering to public opinions, especially prior to elections. However, there are numerous examples of withdrawals of foreign companies and rapid depreciation of currencies after governments inclined towards populism, as in the recent cases of Southern American countries. It is vital for the Indonesian government to clearly indicate the medium- to long-term benefits of foreign capital participation in the domestic market for Indonesia's economy and to execute various economic reforms while developing consensus with the business industry within the country. The real ability of the Joko administration is now being tested not only by the electorate but also by foreign companies and investors.

(Yuta Tsukada)

China *90-day U.S.-China negotiations commenced*

■ Raising of retaliatory tariffs on Chinese goods has been temporarily frozen

The focal point of the U.S.-China summit meeting held on December 1, 2018, was whether the intensification of the trade war between the two countries will be halted or not. As a result of the summit meeting, the two countries reached a consensus on the implementation of measures to prevent the intensification of the trade dispute to a certain extent.

Firstly, the U.S. side announced the temporary freezing of an additional increase in retaliatory tariffs (from 10% to 25%) on Chinese goods amounting to 200.0 billion dollars, which had been scheduled to be initiated on January 1, 2019. However, it was also indicated that the hike in tariffs to 25% will be implemented if the two countries could not reach a consensus within 90 days as a result of the negotiations in five fields including 1) coercion of technology transfer, 2) protection of intellectual property rights, 3) non-tariff trade barriers, 4) cyberattacks, and 5) services and agriculture.

Immediately following the summit, the China side expressed that China will mitigate the conflicts on economy and trade between China and the United States through the opening of its market and the expansion of imports. While details were not disclosed at that time, it seems that coordination has been made toward expanding the purchases of agricultural products, energy and industrial products (including automobiles) made in the United States, according to the materials published by the While House and the regular press conference by the Ministry of Commerce held on December 6. Increasing the purchases of U.S. products has been a tactic frequently adopted by the Chinese government as a measure to mitigate trade frictions with the United States. In light of the situation where the Chinese government has been further reinforcing measures to expand imports in order to stimulate domestic demand and meet consumer needs, imports from the United States will likely be expanded on a considerable scale. The tactic, therefore, is considered to be effective to a certain extent as a basis for negotiation.

＜Measures to Prevent Intensification of Trade Frictions＞

Announced By	Measures
United States	・Temporarily freeze the raising of retaliatory tariffs on Chinese goods scheduled to be initiated on January 1, 2019
	・If agreement is not reached in the negotiations on five fields, including technology transfers, within 90 days following the U.S.-China Summit Meeting, the raising of tariffs, which had been frozen, will be implemented
China	・By promoting market opening and import expansion in line with the needs of the Chinese market and consumers, mitigate economic conflicts between the U.S. and China
	・Promote negotiations between two countries with a focus on the elimination of retaliatory tariffs

Source: News of the Communist Party of China, Ministry of Commerce, Ministry of Foreign Affairs, White House, Media Reports

■ The trump card for the conclusion of negotiations is the review of industrial policies

There are two key points in U.S.-China negotiations from China’s perspective.

The first point is whether the results of negotiations concerning national security such as cyberattacks may affect the economy. National security related issues are a field in which the Xi Jinping administration cannot afford to compromise, and it is impossible to reach a consensus of some kind within a short period of 90 days. China will likely respond to negotiations on security related matters, but will request that the U.S. side separate them from the negotiations on economic and trade matters.

The second point is the review of industrial policies. In order to wipe away concerns over the outlook of the Chinese economy, it is indispensable to mitigate the trade disputes with the United States. Indeed, the necessity for that has been increasing due to the current economic downturn. The manufacturing PMI (Purchasing Managers' Index) in November was at its lowest level since August 2016. While exports to the United States have been increasing owning partly to the depreciation of yuan and the rush in demand looking ahead of the raising of tariffs, such effects will unlikely continue for a long time. In addition, since China cannot afford to compromise on the national security front as explained earlier, the review of industrial policies will be the trump card for China to conclude the negotiations with the U.S. As the first step of China’s domestic policies towards the conclusion of the negotiations, attention has been paid to whether the review of subsidies and non-tariff trade barriers and the greater protection of intellectual property rights will be incorporated as initiatives that contribute to the sustainable, high-quality development of the Chinese economy under the economic management policies for 2019 and the medium-term economic reform plan whose announcement has been delayed.

(Junya Sano)