Economic Prospects in China and ASEAN4

— China’s slowdown weighs on Asia while AEC will be a tailwind

Asian Economic Forecasting Team of JCER *

Points

➢ The Chinese economy is aiming to stage a soft landing through a shift to a “new normal,” but growth will slow, with the real GDP growth rate for 2016 through 2020 expected at 5.9% and 4.5% for 2021 through 2025. Amid the backdrop are a decline in the working-age population and the lack of progress in reforms for various structural issues, such as an increase in indebtedness among local governments.

➢ The economy in Thailand is buttressed by investment demand, such as in transportation infrastructure, but the low birth rate and the aging population will act as a drag, with the growth rate to slow to around 3%. One factor serving as a concern is a cutback in investments due to unstable politics.

➢ The growth rate for the Indonesian economy will strengthen in 2015 through 2016 on the back of the fiscal space created by scrapping fuel subsidies and a recent increase in infrastructure investments following the appointment of President Joko Widodo. The growth rate will be sluggish thereafter as structural reform will not make headway. The rupiah will weaken through 2019 due to interest rate hikes in the United States, but will strengthen moderately thereafter.

➢ The Malaysian economy will be that of a high-income nation around 2020, when GNI is expected to break above 15,000 per capita on the success of a liberal business environment and infrastructure development. A further tailwind will follow if the TPP comes to fruition. The challenge is whether domestic companies can push along with capturing added value in innovation.

➢ The economy in the Philippines will maintain its growth rate of about 5% on the continued bonus in the form of a population increase resulting from a high birthrate. The outflow of human resources to overseas countries will slow along with an increase in domestic income. A risk factor is a delay in establishing a favorable business environment, such as infrastructure.

* Kenji Yuasa, Yuki Masujima, Kengo Tahara, Takashi Onodera, Tamaki Sakura and Yuki Sotozono
1. China

Structural reform stalling, growth to slow down

The Xi Jinping administration aims for growth to stage a soft landing with a shift to a “new normal,” but the growth rate will slow for the projection period of 2015 through 2025 (Figure 1-1) due to a lack of progress in reforms for various structural problems that are bearing down on China. The real GDP growth rate (annualized) for 2016 through 2020 will be at 5.9%, with 4.5% for 2021 through 2025. A shift from capital expenditures to personal consumption in terms of their share of contribution to the growth rate will proceed at a modest pace. However, the growth rate in consumption will also slow moderately (Figure 1-2).

The background to the slowdown in the growth rate is rooted in the decline in the potential growth rate, which indicates the degree at which an economy could expand over the medium to long term while maintaining a steady inflation (Figure 1-3). While temporary growth will be maintained in 2015 through 2016 as a result of higher asset prices, such as in stocks, and a boost to financial sector growth on the back of a rapid succession of monetary easings, the impacts will weaken in 2017 and beyond and the economy will head toward an estimated potential growth rate of 5 - 5.5% on average for 2016 through 2020, with the real GDP growth rate expected to stage a turndown1. The potential growth rate was estimated by the Japan Center for Economic Research based on labor force population, capital stock and the pace of technological innovation.

1 For example, China’s Growth: Can Goldilocks Outgrow Bears? IMF Working Paper WP/15/113 by Maliszewski and Zhang (2015) states that the potential growth rate – excluding the amount pushed up by the surge in credit and rising housing prices because the rise in capital expenditures triggered by excessing monetary easing starting in 2008 is not sustainable – is lower than the estimate arrived at by using a standard production function approach.
Capital stock expanded rapidly due to the rapid developments that took place in local areas, but the rate of depreciation in capital will be higher due to an increase in the number of abandoned facilities that will not be used at all, as some development projects will be forced to be scrapped on the back of sluggish land prices. As a result, the contribution of capital stock to the potential growth rate will sink below 2% in 2021 through 2025 from around 4% from 2011 through 2015. The pace of improvement in the business environment will stagnate, with Total Factor Productivity (TFP) growth declining to around 2% in 2021 through 2025 from around 6% in 2006 through 2010 and around 4% for 2011 through 2015. This would conjure up an image of improvement of productivity, based on technological innovation, not advancing as planned. This TFP growth is virtually the same as the estimate given in the International Monetary Fund’s World Economic Outlook (WEO) for April 2015.

Figure 1-3: Contributions to potential growth

Figure 1-4: Government income from land transfers (sales)

Aging, local government debt, disparities amid urbanization

Problems abound, such as a decline in the ratio of the working-age population, sluggish real estate prices and the expanding indebtedness among local governments facing a dramatic drop (Figure 1-4) in income from land transfers (sales) and a widening disparity between cities and rural areas stemming from reasons including restrictions imposed on farmers from transferring their family register. Stable growth can be sustained if these problems are resolved as a result of reform (the reform scenario), but on the other hand, if it ends in failure, the growth rate will plunge (China slowdown scenario). Specifically, if resolving the debt problems of local governments ends in failure, not only will development projects come to a halt, but advances in urbanization also will be impeded, which would widen the gap in regional disparities and in turn destabilize society.

Urbanization will progress at a good clip until 2025, while the working-age population will be on the decline after peaking at 1.06 billion people in 2013, according to a forecast by the United
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Nations (Figure 1-5).

Looking at trends in wages and cash income per capita in urban as well as rural areas, income per capita in rural areas grew by around 8% from 2001 through 2005, while wages in urban areas (non-private corporations) rose more rapidly at around 14%. Amid such trends, a pickup in the pace of those who move from rural to urban areas contributes to the increase of employees income per capita nationwide (Figure 1-6). However, rural wage growth has been greater than that in urban areas in recent years as it supposedly reached the so-called Lewis Turning Point, as wages rose in rural areas (agricultural sector) following a bottoming of surplus labor in these areas amid industrialization in part due to a decline in the working-age population. Wage growth in rural areas is expected to stagnate compared with that for urban areas, with the regional debt problem acting as a drag for the next 10 years.

Figure 1-5: Working-age population and the ratio of urbanization

<table>
<thead>
<tr>
<th>Year</th>
<th>Working age population (hundred million people)</th>
<th>Ratio of urbanization (RHS)</th>
</tr>
</thead>
<tbody>
<tr>
<td>05</td>
<td>8</td>
<td>58%</td>
</tr>
<tr>
<td>10</td>
<td>10</td>
<td>70%</td>
</tr>
<tr>
<td>15</td>
<td>12</td>
<td>80%</td>
</tr>
<tr>
<td>20</td>
<td>14</td>
<td>90%</td>
</tr>
<tr>
<td>25</td>
<td>16</td>
<td>100%</td>
</tr>
</tbody>
</table>

Note: Working-age population is defined as those aged 15-64. The ratio of urbanization is the ratio of population in urban area to the overall population. Sources: United Nations; Haver Analytics.

Figure 1-6: Changes in wages in urban and rural areas

<table>
<thead>
<tr>
<th>Year</th>
<th>Urban wage rate (y/y % chg.)</th>
<th>Rural cash income per person (y/y % chg.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>05</td>
<td>0.5%</td>
<td>8%</td>
</tr>
<tr>
<td>10</td>
<td>1.5%</td>
<td>12%</td>
</tr>
<tr>
<td>15</td>
<td>2.5%</td>
<td>16%</td>
</tr>
<tr>
<td>20</td>
<td>3.5%</td>
<td>20%</td>
</tr>
<tr>
<td>25</td>
<td>4.5%</td>
<td>24%</td>
</tr>
</tbody>
</table>

Note: The data of whole country is estimated by JCER. Sources: Haver Analytics; JCER.

The Chinese government is pushing along with rapid urbanization by utilizing the state-run China Development Bank, and is set to proactively advance infrastructure investment both at home and overseas by utilizing the Silk Road Fund (established in December 2014), the Asian Infrastructure Investment Bank (AIIB, for which a signing ceremony was held in June 2015), the insurance investment fund that was finalized in June 2015 and the New Development Bank (a BRICS bank). For example, if progress is made in infrastructure investments for the route that runs through the South China Sea using the Silk Road Fund, China will have a closer economic relationship with countries like Thailand and Malaysia. On the other hand, disorderly lending that...
does not consider a project’s profitability or efficiency would lead to a decline in China’s growth rate itself. In other words, looking at medium-term growth, the key will be whether China would be able to steadily resolve the distortions that exist, such as seen in institutions, the business conditions and environmental problems.

Financial structural reform is somewhat more advanced than that in other sectors. The deregulation of bank interest rates is forging ahead, and the policy to abolish bank lending restrictions, which is capped at 75% of bank deposits, was finalized in June 2015. Progress is being made in the internationalization of the Chinese yuan and its inclusion in the IMF’s Special Drawing Rights (SDR) with the end of 2015 as the target. However, adopting such steps in financial structural reform as a means of monetary easing could possibly create a breeding ground for a structural bubble, which would not lead to sustainable growth. China would need to liberalize the transfer of capital, which still has a lot of room for reform, in a steady and cautious manner from a medium- to long-term standpoint.

2. Thailand

Low birthrate and aging population weigh on growth

The economy in Thailand grew at a high rate of around 5% in the middle of the 2000s, but growth is rapidly decelerating after slumping in 2008 due to the global financial crisis, along with the impact from flooding and political turmoil later on. The economy is not expected to return to a high growth rate of 5% in the future, with a gradual decline expected toward a growth rate of around 3% (Figure 2-1, 2-2).

![Figure 2-1: Contributions to Real GDP Growth](image)

![Figure 2-2: Contributions to the Potential Growth](image)
Demographic changes are among the reasons behind the deceleration. A declining birth rate and an aging population is most pronounced in Thailand out of all Southeast Asian countries. The total fertility rate, which estimates the total number of children one woman is to bear in a lifetime, stood at above five in 1970, but broke below two in 1990 and was at 1.4 in 2013, which shows a rapid decline to a level equal to that in Japan. The population is expected to start declining in the 2020s according to a forecast by the United Nations, and the labor force population is expected to start decreasing around 2020 (Figure 2-3).

The unemployment rate in Thailand was low at 0.8% in 2014, with the labor participation rate of women at 62% (Figure 2-4), which is higher than that in Japan (49%). Trends to move bases for labor-intensive industries, such as the sewing industry, outside the country, such as to Bangladesh and Cambodia, and incoming labor from surrounding nations to farms in Thailand can be seen as tightening labor supply and demand as well as putting upward pressure on wages.

However, the backdrop to low unemployment rate and the high labor participation rate of women shows that surplus labor has the tendency to be absorbed by agricultural, independent and
similar businesses. The number of workers in the agricultural sector takes up over 30% of all industries, and looking at data by employment status, those who own their business make up over 30% (of this total, around half is in the agricultural, forestry and fisheries industries). Also, around a quarter of employed women work for free for their family businesses (of this total, around two-thirds are in the agricultural, forestry and fisheries industries; Figure 2-5).

A major gap exists in income per person between the agricultural and the manufacturing/services sectors, with a shift in employment from the agricultural industry to continue going forward. It will become necessary to provide education and vocational training to respond to changes in the industrial structure. Like Japan, it will become important to set up a framework that would allow the elderly, who have a desire to work, to participate in the labor force in response to the aging of society.

The ratio of the population aged 65 years and above (old-age dependency ratio) in relation to the working generation (15 to 64 years old) is expected to rise from 12.4% in 2010 to around 23% in 2025 (Figure 2-6). The burden on the social security system is expected to become greater.

The hike in the existing 7% value-added tax to 10% has been mothballed as a special measure, but a hike would be needed after economic recovery is verified. If the tax system, among other areas, do no change from the status quo, the fiscal balance of the overall government is expected to remain in the red.

Vigorous demand for infrastructure for transportation network in the Mekong region

The Thai government has announced an infrastructure investment plan to develop railroads, roads, airports and others from 2015 through 2022. The plan is for the government, state-run businesses, public and private partnerships (PPP) and other entities to invest a total of 2.4 trillion baht (around 18% of GDP).

In terms of developing the great Mekong subregion, which includes the southern section of China, Thailand is positioned so that the North-South Economic Corridor, the East-West Economic Corridor and the Southern Economic Corridor pass through it and thus transport development would help invigorate trade within China and the ASEAN region. While it is still unclear whether the infrastructure investment is to proceed at the scheduled rate, it would serve as a factor buttressing growth over the medium and long term. Growth in domestic capital expenditures was sluggish from the second half of the 2000s to the first half of the 2010s due to the impact of events...
including the global financial crisis and the domestic political turmoil, and is expected to grow at the 3% level for the next 10 years.

In terms of imports and exports, trade in the ASEAN region is expected to increase further, but exports from Thailand are expected to moderately slow along with decelerating growth rates in China and advanced economies (Figure 2-7).

Thailand follows Malaysia among the ASEAN4 to already have a business environment in place. However, one risk is the possibility of destabilizing politics. Corruption among politicians has been criticized for many years, with a frequent occurrence of coup d’état and little trust in politicians among the citizens. A general election is to be held in 2016 with a new constitution to be promulgated following a national referendum, but there is a need to closely monitor risks of another instance of political disorder.

3. Indonesia

Recent high growth to slow as structural reform suffers

President Joko Widodo assumed office in October 2014. Flagging his concept of a maritime nexus, and aiming at infrastructure development on Java and promoting shipbuilding and tourism industries, Joko has made his intentions clear, among other items, that he would scrap fuel subsidies in order to secure a budget to move forward with infrastructure development; terminate the construction plan for the Sunda Strait Bridge, which entailed an enormous budget; and shift the foundation of growth to processing and manufacturing industries from the main industries to date, including drilling and exporting crude oil and natural gas (The Nikkei Business Daily dated March 25). The forecast for growth is on the high side through 2017 compared with market projections, reflecting the progress made in recent large-scale infrastructure investments (Figure 3-1). However,
structural reform will stall thereafter in part due to the impact of a divided parliament with the opposition gaining a majority. The growth rate will fall off over the medium term, with improvements in the business environment not making headway (Figure 3-2).

![Figure 3-1: Contributions to the Real GDP Growth Rate](image)

Indonesia’s strength lies in the continued year-on-year growth of around 1.5% in the labor force population through 2025. Seen by age group, many of the working population are at the age of 50 or younger, generating a bonus in the form of population growth during the projection period, as there are not as many in their 50s or older. The labor participation rate of women is at 47.2% (2010; Figure 3-3), which is around the same level as in Japan (46.2% in 2012). If this improves, it would bolster the labor force population and could possibly push the growth rate higher. Indonesia’s growth rate will be buoyed by the working-age population during the projection period.
Also, there is room for the labor force population to rise if the labor participation rate for women is given a boost. That said, a virtuous cycle in which urbanization leads to improved education levels for women, and in turn, higher wages (employment rate) for women cannot be expected.\(^2\)

**Figure 3-3: Labor Participation Rate (2010)**

![Labor Participation Rate](image)

Source: United Nations, "World Population Prospects: The 2012 Revision"

Current account will not move into positive territory

Looking at destinations of Indonesia’s exports, a shift to Asia from the United States and Europe is clear. Meanwhile, Japan’s share is on the decline. Japan used to account for about half of the total in the early 1980s, but this has been limited to around 15% most recently in 2013. Exports to the United States have also dropped to below 10% from around 20% during the same period and those to Europe stood at around 15% in the second half of the 1990s, but have since dropped to recent levels of less than 10%. Exports to China (including Hong Kong) were less than 1% in the early 1980s, but have continued to rise since the mid-1980s and surpassed those to the United States in 2008. Exports to Malaysia, Thailand and the Philippines were below 1% in 1990, but have most recently risen to an aggregate total of above 10%. Exports to India were also below 1% through 1995, but have grown to around 7% most recently. Since the 1990s, exports to South Korea have been at 6% to 7%, 3% to 5% to Taiwan and around 10% to Singapore, all of which have been comparatively steady (Figure 3-4).

While the value of exports has been on the rise, the growth rate during the projection period will be limited to between 4% and 5%, compared with 8.4% growth in 2006 through 2010. Like the other ASEAN nations, sustainable growth can be expected, given the rise in the trade ratio in the Asian region, if it can make the most of the establishment of the ASEAN Economic Community

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(AEC), but this would be dependent on easing regulations on foreign capital.

An urgent challenge is to do away with the twin deficits: a current account deficit associated with net imports of oil and a fiscal deficit (the constitution calls for mandatory reduction when the deficit is 3% or more of GDP). The trade balance will trend in positive territory in the first half of the 2020s, but the current account balance will not shift into the black during the projection period, although the amount of deficit is to decline in relation to nominal GDP. Easing restrictions on foreign capital, including foreign direct investments, as a way to increase investments in domestic refinery facilities of raw materials, including oil, is necessary for sustainable growth.

Monetary policy will remain on the tighter side until 2018 as a way to prevent upward pressure on prices and excessive weakness in the country’s currency, amid a continued weakening in the rupiah through 2020 on the back of steady interest rate hikes in the United States. As monetary policy eases thereafter, the rupiah will strengthen to 11,000 against the US dollar into 2025. Growth in gross fixed capital formation is to remain at 1.5% in terms of its contribution to GDP, while wages will rise by 10% or more in 2021 through 2025, along with moderate deceleration in consumption.

4. Malaysia

Poised to become a high-income country around 2020

Prime Minister Najib Razak announced a new five-year plan, the 11th Malaysia Plan, for 2016 through 2020 in May. The plan consists of six strategic measures: (1) enhancing inclusiveness towards an equitable society; (2) improving wellbeing for all; (3) accelerating human capital development for an advanced nation; (4) pursuing green growth for sustainability and resilience; (5) strengthening infrastructure to support economic expansion; and (6) re-engineering economic growth for greater prosperity. The five years to 2020 marks the final years of Vision 2020, adopted in 1991 by the Mahathir administration, which aimed to become a high-income country by 2020.

The government is planning to spend 260 billion ringgit for the 11th Malaysia Plan (around 20% of GDP). Meanwhile, the federal government will also work to restore fiscal health and aims for fiscal equilibrium in 2020, given that the federal government debt was at 54.5% of GDP in 2014, which is close to the legally-binding ceiling of 55%. The goods and services tax that was adopted in 2015 is positive for fiscal conditions, but additional tax hikes or a cut in outlays is necessary to achieve a fiscal surplus.

Malaysia surpasses other ASEAN nations in its level of income per capita at over 10,000 dollars as of 2014. The growth rate will gradually slow to 4-5% in 2015 through 2020 (Figures 4-1, 4-2), but GNI per capita will exceed $15,000 around 2020, which means that it will become a high-income nation then (Figure 4-3). Achieving the highest productivity among the ASEAN4 was a result of the government pushing along with improving a liberal business environment, such as
infrastructure development and trade liberalization, and working on the popularization of high-school education. In addition, preferential policies for Malay residents, who earn comparatively less income, kept disparities in check, enabling a major reduction in poverty.

Moderate rise expected for labor participation by women

The labor force population through 2020 is expected to grow at an annualized rate of just below 2%, but will decelerate to around 1.5% into 2025. The labor participation rate of women in Malaysia stood at 54% in 2014, which was substantially lower than that of men, which is around 80%. The participation rate is around 70% for women in the latter half of their 20s, but many end up leaving work for childcare, among other reasons, and the participation rate falls as they get older (Figure 4-4). Creating a working environment conducive for women is critical for sustaining
a high rate of growth amid expectations of slower population growth. The government aims to raise the participation rate of women to 59% by 2020, but the rate of increase is expected to be moderate, with an estimate of just below 60% in 2025 (Figure 4-5).

The Malaysian government has unveiled policies to lower its dependency on foreign laborers with limited skills because it aims to shift to knowledge-intensive industries and boost the earnings of low-income groups. Wages per person will slow down, but will rise by an annualized rate of 5% or above and the modest rise in labor share is expected to continue for a while.

Current account surplus to be sustained, currency to strengthen moderately

Exports will be limited to modest growth given a slowdown in overseas economies, even though industrial products, such as electric and electronic products as well as natural resources, have helped drive growth in exports. That said, growth in imports will also slow, resulting in narrower but sustained trade and current account surplus levels during the projection period. In terms of the foreign exchange rate against the US dollar the next several years, the ringgit is expected to weaken on the back of interest rate hikes in the United States, but the currency should strengthen moderately thereafter with a modest recovery in crude oil prices.

If the currently negotiated TPP comes to fruition, it will serve as a tailwind for the Malaysian economy as Malaysia is already involved in negotiations. According to a calculation by Petri & Plummer\(^3\), adoption of the TPP will shore up income in Malaysia by at least 5% as of 2025.

Malaysia, which is expected to become one of the high-income countries, enjoys substantial

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technological contributions from multinational corporations. On the other hand, technological transfers have not gained ground compared with South Korea and Taiwan, with a relative delay seen in technological development among domestic corporations. Other factors of concern include the possibility of state-run companies prompting inefficiency and the possibility of them obstructing negotiations on trade liberalization.

5. The Philippines

High population growth to continue, with the birth rate at 3

The Philippine economy is expected to sustain high growth among the ASEAN4, based on solid domestic demand benefiting from the bonus of population growth stemming from a high birth rate. The total fertility rate in the Philippines was a high 3.3 as of 2014 (Figure 5-1), with the population reaching 100 million in 2014. The population is expected to rise by between 1.5% and just below 2% for the next ten years.

The economic growth rate will decelerate but remain at around 5% in 2025, with domestic demand growing at a healthy clip centered on consumption (Figure 5-2, 5-3). GDP per capita will reach the $7,000 level in 2025, compared with around $3,000 at the moment.

Figure 5-1: Total fertility rates and population growth of Asian countries (2005-10)

Slowdown in the rush of workers moving to other countries

Filipinos who work overseas account for around 10% of the population, but the draining of human resources due to their move overseas should gradually come to a halt with the rise in income at home. The amount of funds remitted by those who work overseas stood at 10% of GDP in 2005, falling to around 7% by 2014. The rate at which workers move overseas has declined as

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the economy in the Philippines has strengthened compared with overseas economies in recent years. The surplus in the balance of secondary income, which includes remittance from overseas workers, will gradually narrow going forward. Still, the current account surplus is expected to be maintained until 2025 (Figure 5-4).

**Infrastructure development to continue at a moderate pace**

Infrastructure development, which has been relatively slow, and the improved business environment, including an easing of restrictions on foreign capital, will be crucial in raising domestic productivity. The quality of infrastructure, such as ports, is low in the Philippines compared with surrounding countries (Figure 5-5), and logistics costs are relatively high. Infrastructure development is necessary if the country is to benefit from the AEC or free trade
agreements. The Philippine Development Plan 2011-16 aims to increase the infrastructure-related budget to at least 5% of GDP in 2016 from 2.2% in 2012. Infrastructure development is expected to advance at a moderate pace for the next 10 years, although uncertainties exist surrounding progress, given that many projects have been delayed in the past due to investments not advancing as planned.

Figure 5-5: Quality of infrastructure in Asian countries

![Graph showing quality of infrastructure in Asian countries]

Note: The scores ranging from 1 to 7, calculated by WEF.

The background to the delay in infrastructure development to date is due to the Philippines continuing to lag behind other countries in developing a business environment conducive to investment. According to the World Bank's Doing Business 2015, the Philippines ranked 154th out of 189 countries in terms of investor protection, and stood at 124th place in the enforcement of contracts, making it the lowest among China and the ASEAN4.

Under the Aquino administration, which took office in 2010, the government has gradually moved forward with improving the business environment, but many uncertainties exist surrounding improvement going forward. President Benigno Aquino cannot run in the presidential elections in 2016. The risk of stagnant growth will rise if the next president favors populist policies.