Mizuho Economic Outlook & Analysis

June 2016

FY2016, FY2017 Economic Outlook

Amid persisting concerns of a global economic downturn, fiscal stimulus will underpin the economy

The Japanese economy will remain subject to strong uncertainties due to the slowdown of the global economy and the impacts of the earthquake and the strong yen

◆ As the emerging market (EM) slowdown spreads to developed market (DM) economies, we continue to hold a cautious outlook on the global economy. Despite persisting concerns about a further slowdown of the global economy, an upturn is expected in 2017 due to support by fiscal stimulus measures. Turning to the Japanese economy which is still in a soft patch, fiscal stimulus will serve as underpinnings. Even so, the Japanese economy will remain subject to strong uncertainties due to the slowdown of the global economy and the impacts of the earthquake and the strong yen.

Mizuho Research Institute Ltd.
Koji Takeuchi, Senior Economist koji.takeuchi@mizuho-ri.co.jp
Hidenobu Tokuda, Senior Economist hidenobu.tokuda@mizuho-ri.co.jp

1. The global economy should follow a DM-led recovery toward 2017

The global economy continued to slow down in the Jan-Mar quarter of 2016 as it did in the previous quarter from October to December of 2015. As the EM slowdown spread to the DM economies, US economic growth dropped to around 0.5% q-o-q p.a. Even though the Eurozone and Japanese economies turned out to grow at a faster-than-expected pace, it should be noted that Eurozone growth was boosted temporarily by measures to address the influx of refugees. Turning to Japan, the economy would be assessed as an ongoing soft patch, considering factors such as the contraction of the economy in the preceding quarter (the Oct-Dec quarter of 2015) and the fact that personal consumption was lifted by the leap year-effect in the Jan-Mar quarter of 2016. While the Chinese economy continued to slow down, the pace of slowdown turned out to be mild because of the recovery of investment in infrastructure

Chart 1: Outlook on the global economy

(Y-o-y % change)

Calendar year	2013 (Actual)	2014 (Actual)	2015 (Actual)	2016 (Forecast)	2017 (Forecast)
Total of forecast area	3.3	3.5	3.2	3.2	3.7
Japan, US, Eurozone	0.8	1.5	1.9	1.4	1.7
US	1.5	2.4	2.4	1.6	2.3
Eurozone	-0.3	0.9	1.6	1.4	1.4
Japan	1.4	-0.0	0.6	0.5	0.6
Asia	6.4	6.3	6.1	6.0	6.0
China	7.7	7.3	6.9	6.6	6.5
NIES	2.9	3.4	2.0	1.8	2.2
ASEAN5	5.0	4.6	4.7	4.6	4.5
India	6.3	7.0	7.3	7.5	7.5
Australia	2.0	2.6	2.5	2.6	2.5
Brazil	3.0	0.1	-3.8	-3.5	0.6
Russia	1.3	0.7	-3.7	-1.2	1.0
Crude oil price (WTI, USD/bbl)	98	93	49	44	46

Note: The total of the forecast area is calculated upon the 2013 GDP share (PPP) by the IMF.
Sources: Made by MHRI based upon releases by the International Monetary Fund (IMF) and statistics of relevant countries and regions.

and real estate development due to economic stimulus measures. Even though economic stimulus measures were also taken in other Asian economies, many of the countries could not avoid a slowdown due to individual factors of the respective economies. On the other hand, the economic malaise among commodity-producing countries eased slightly, as exemplified by the improvement of Russia’s negative growth.

In 2016, the global economy growth (the total of MHRI’s forecast area, on a weighted average basis) will most likely remain at +3.2% (2014: +3.5%, 2015: +3.2%) around the same level as 2015 when the global economy slowed down from 2014 (**Chart 1**). The DM economies are forecast to slow sharply from 2015 due to the negative spillover of the EM slowdown to the decrease of exports and deterioration of sentiment. The rate of global economic growth should remain flat as the DM slowdown is offset by the improvement of negative growth among commodity-producing countries due to factors such as the rise of crude oil prices. Even so, we are inclined to believe that the actual state of the global economic momentum will weaken. In 2017, the rate of global economic growth is forecast to pick up and reach +3.7%, as the DM economies pick up and the economic deterioration among commodity-producing countries eases.

The US economy should return to a mild expansion track as the temporary downward pressures in the Jan-Mar quarter gradually fade. Personal consumption is forecast to keep growing, underpinned by the expansion of employment and income, and the stabilization of consumer confidence. In addition to a cessation of the surge of the US dollar and fall of crude oil prices, the negative pressures upon exports and capital investment should gradually start to ease. Regarding the Eurozone economy, even though personal consumption will continue to pick up, the pace of economic recovery should turn out to be tepid, considering that the corporate sector will maintain a cautious stance toward investment. The Japanese economy will remain subject to strong uncertainties in FY2016 due to the slowdown of overseas economies and the impacts of the earthquake and the strong yen. In FY2017, the rate of Japan’s economic growth will vary greatly depending upon whether or not the consumption tax hike is implemented as scheduled. Turning to the EM economies, we expect the persistence of strong concerns regarding downside risks. Looking beyond until the year 2017, the Asian economies are forecast to see an improvement of their export environment. However, China’s economic slowdown will most likely serve as a drag and keep Asia’s overall growth rate flat. China should continue to follow a mild slowdown dragged down primarily by investment amid lingering adjustment pressures stemming from excess production capacity and debt. Turning to the Asian economies excluding China, exports should gradually pick up on the tailwinds of US economic recovery. However, the pace of Asia’s (ex China) economic recovery will likely remain tepid as the impact of policy measures gradually decline due to the limited options for economic stimulus measures in view of fiscal conditions and inflation trends.

2. Even though the financial market turmoil from the New Year has subsided for now, concerns regarding global economic slowdown continue to linger

While the rise of concerns regarding the EM economies led to a worldwide stock market plunge, the financial markets are now stabilizing following an upturn since mid-February. Market sentiment is also improving due to a cessation of the renminbi depreciation and a rally of the crude oil market. However, amid the ongoing EM slowdown centering around China, note the persistence of risks of a further destabilization of the financial markets triggered by trends in the crude oil market and foreign exchange rates and political events. It would be necessary to keep a close eye upon developments since the destabilization of financial markets serves as downside risks upon the global economy through the deterioration of corporate and household sentiment.

Turning to the price of crude oil, even though the idea of an oil production freeze among the OPEC members and non-OPEC countries including Russia triggered a crude oil market rally since February – the freeze was subsequently shelved due to confrontation between Saudi Arabia ad Iran. Even so, crude oil prices are still recovering on the back of the fall of supply by Canada and Nigeria. Canadian oil sands production is said to have been suspended by 1.2 million bbl/day which is equivalent to approximately 30% of crude oil production, as a result of wildfires in the province of Alberta. In Nigeria, reports of attacks upon oil-related facilities by antigovernment rebels are giving rise to concerns of a sharp supply shortage. That said, since the impact of these temporary factors will fade, there are lingering risks that crude oil prices will start to fall again unless talks of a production freeze materialize at the OPEC meeting in June.

As for foreign exchange rates, the strong dollar is still subject to correction on the back of factors including the ebb of expectations of a US interest rate hike in comparison to the year-end of 2015 and US unease with a strong dollar as indicated in the US Treasury Department's report to Congress *(Foreign Exchange of Major Trading Partners of the United States*, April 29, 2016). While the pause in the appreciation of the US dollar is serving to ease the depreciation of the renminbi, the minutes of the FOMC meeting in April indicate the possibility of an interest rate hike in June. If the US starts to move toward interest rate hikes again, the dollar may start to strengthen again. In such event, the renminbi and EM currencies may weaken again and serve as market destabilization risks.

The most serious risk among political events is the UK referendum on whether it will stay in or leave the Eurozone ("Brexit") on June 23rd. Various polls reveal that those in favor of "staying" and those in favor of "leaving" are more or less balanced. In the event of a choice to leave the Eurozone, financial market turmoil will most likely be unavoidable. In the US presidential elections, it looks certain that Donald Trump – known for his radical comments – will secure the delegates needed to become the Republican Party's presidential nominee. If Mr. Trump wins in the general election, the escalation of risk aversion is highly likely in the financial markets at least over the short term, even if he shifts to a more realistic stance.

3. Worldwide fiscal expansion policy will underpin the global economy

Countries worldwide are poised to take concerted action to avoid a global economic downturn stemming from factors such as financial market turmoil. While the G20 Summit in April confirmed that members would be ready to take all possible measures, the summit meeting also revealed the limitations of monetary policy. Amid these developments, attention is focusing upon fiscal policy.

China has been reinforcing its fiscal policy measures in a bid to avoid downside risks to its economy. The same stance is prevalent also among the DM economies. The US is expected to shift to a fiscal expansion mode toward 2017, in a turnaround from its fiscal austerity stance after the financial crisis. With the exception of Germany, the Eurozone is planning to take an expansionary fiscal policy stance in 2016. Japan is planning to take economic stimulus measures and postpone the consumption tax hike. These expansionary fiscal policy measures are expected to underpin the fragile global economy.

4. The Japanese economy is forecast to grow +0.9% in FY2016, driven by a last-minute rush of demand and slow down to +0.2% in FY2017 due to a backlash to the previous year

The Japanese economy grew +0.4% q-o-q (+1.7% in annualized terms) in the Jan-Mar quarter of 2016 (the *First Preliminary Quarterly Estimates of GDP*, the "*1st QE*"), recording positive growth for the first time in two quarters. Even so, the results indicate that the pace of growth was still flat in the Jan-Mar quarter when averaged out with the decline in the Oct-Dec quarter of 2015 (-0.4% q-o-q). In particular, despite the strength of personal consumption (+0.5% q-o-q), it was still insufficient to compensate for the drop in the Oct-Dec quarter (-0.8% q-o-q). The recovery of consumer spending would still be considered weak in view of the fact that growth was boosted by the leap year.

In FY2016, the Japanese economy is still expected to be weighed down by the overseas economic slowdown and lingering inventory adjustment pressures. In addition to the foregoing, note the impact of the following new factors in the latest *Economic Outlook*: (1) the Kumamoto earthquake, (2) the appreciation of the yen, and (3) fiscal policy. Firstly, as for the “the Kumamoto earthquake”, it is necessary to take note of the impact of the suspension of production due to supply chain disruptions. According to media reports, it appears that motor vehicle production fell by approximately 90 thousand units due to the suspension of major motor vehicle manufacturers’ plants throughout Japan as a result of earthquake damages to motor vehicle parts factories. Estimations indicate that industrial production in April would fall by approximately 2% due to the foregoing decline of output.

Secondly, turning to “the appreciation of the yen”, it would be necessary to take note of its “asymmetrical” impact upon exports. When the yen weakened subsequent to the launch of Abenomics, exports did not rise as much as expected. In contrast, in an asymmetrical relation to the depreciation of the yen, exports may be suppressed under the current appreciation of the yen. This stems from the need for companies - particularly in times of a sharp appreciation of the yen - to raise overseas sales prices even at the expense of export volumes in order to avoid the deterioration of the profitability of exports. In fact, quantitative analysis verify that a sharp appreciation of the yen has a larger impact upon exports than normal exchange rate fluctuations or a sharp depreciation of the yen.

Thirdly, as for “fiscal policy”, additional expenditures of approximately JPY1.2 trillion have been earmarked already for recovery and reconstruction in response to the Kumamoto earthquake in the initial budget (contingency reserves) and supplementary budget for FY2016. The budget will be used for emergency costs such as the construction of temporary housing for a while. Subsequently, the rest of the budget should be used to establish a reserve fund for full-fledged recovery and reconstruction. On the basis of the damages which have become evident thus far, MHRI’s latest *Economic Outlook* assumes that total budget expenditures of JPY1.5 trillion will be spent over the entire recovery process. For economic stimulus measures, it should be possible to generate fiscal revenues around JPY4 trillion to JPY5 trillion without issuing additional government bonds. Budget augmentations would be decided from a political perspective in view of factors such as the strength of Japan’s economic recovery, financial market trends, and public opinion and fiscal consolidation around the world. Accordingly, MHRI’s latest *Economic Outlook* assumes an economic stimulus package around JPY5 trillion (of which JPY1.5 trillion will be comprised of public investment).

As for the consumption tax hike, MHRI's latest *Economic Outlook* is based upon the assumption that the consumption tax hike will be implemented as scheduled. In this case, the last-minute rush of demand arising in the second half of the fiscal year should serve to lift personal consumption. According to estimations by MHRI, the last-minute rush of demand would push up FY2016 real GDP growth by 0.2% to 0.3%. In addition to Prime Minister Shinzo Abe's comments that the postponement of the consumption tax hike would be decided by "political judgment at the time based upon expert analysis",

Chart 2: Outlook on the Japanese economy

(%)

	FY2014	FY2015	FY2016	FY2017	FY2015		FY2016		FY2017	
					1H	2H	1H	2H	1H	2H
	(Actual)	(Actual)	(Forecast)	(Forecast)	(Actual)	(Actual)	(Forecast)	(Forecast)	(Forecast)	(Forecast)
Real GDP	-0.9	0.8	0.9	0.2	0.9	-0.1	0.9	1.7	-1.0	0.8
Domestic demand	-1.5	0.7	1.0	0.0	1.3	-0.5	1.0	2.4	-1.4	0.7
Private sector demand	-1.9	0.7	0.7	-0.3	1.3	-0.8	0.5	2.6	-2.2	0.6
Personal consumption	-2.9	-0.3	1.2	-0.6	-0.9	-0.7	1.2	3.1	-3.3	1.4
Housing investment	-11.7	2.4	3.2	-6.6	8.4	-1.2	5.6	2.7	-10.3	-7.8
Capital investment	0.1	1.6	1.0	0.6	1.2	1.6	-0.7	3.2	-0.7	0.9
Public sector demand	-0.3	0.8	1.8	1.1	1.3	0.2	2.3	1.9	1.1	0.8
Government consumption	0.1	1.6	1.5	1.4	1.5	2.3	1.4	1.2	1.3	1.7
Public investment	-2.6	-2.2	3.0	0.2	0.9	-8.6	6.8	5.1	0.5	-3.3
Net exports (contribution)	0.6	0.1	-0.1	0.1	-0.5	0.5	-0.1	-0.7	0.0	0.0
Exports	7.9	0.4	1.0	2.7	-5.0	1.6	0.4	1.7	2.7	3.8
Imports	3.4	-0.1	1.5	2.1	-2.0	-1.0	0.8	5.6	0.1	2.7
GDP (nominal)	1.5	2.2	1.3	1.8	2.4	0.9	0.7	2.8	0.7	3.0
GDP deflator	2.4	1.4	0.4	1.7	1.6	1.2	0.4	0.5	1.4	1.9
Industrial production	-0.5	-1.0	1.1	1.4	-1.2	-1.0	-0.0	3.1	-0.6	1.1
Unemployment rate	3.5	3.3	3.2	3.1	3.4	3.3	3.2	3.2	3.1	3.0
Current account balance (JPY trillion)	8.7	18.0	17.5	18.1	15.9	19.5	18.7	15.4	17.1	17.5
Domestic corporate goods prices	2.7	-3.2	-2.0	3.2	-2.9	-3.5	-3.3	-0.5	2.8	3.5
Consumer prices (ex fresh food)	2.8	-0.0	0.1	2.0	0.0	-0.0	-0.4	0.5	2.1	1.9
Consumer prices (ex fresh food, ex consumption tax)	0.8	-0.0	0.1	1.1	-0.0	-0.0	-0.4	0.5	1.2	0.9
Consumer prices (ex food (ex alcohol))	0.6	0.7	0.2	0.8	0.6	0.8	0.2	0.2	0.8	0.7
Long-term interest rate (%)	0.48	0.30	-0.08	-0.09	0.40	0.18	-0.10	-0.10	-0.10	-0.08
Nikkei stock average (JPY)	16,273	18,841	16,100	16,800	19,730	18,000	16,100	16,200	16,600	17,050
Exchange rate (JPY/USD)	110	120	107	111	122	118	106	107	110	113
Crude oil price (WTI, USD/bbl)	81	45	47	47	53	38	47	47	46	49

Notes: 1. Data on fiscal years (FY) are set forth as the % change over the previous year (y-o-y). Half year GDP data are set forth as the change over the previous term p.a. (the GDP deflator is set forth as the % change y-o-y).
2. Half year data on industrial production are set forth as the change over the previous term. Half year data on the unemployment rate are seasonally-adjusted. Half year data on the current account balance are adjusted for seasonal factors and converted into annualized rates (p.a.).
3. Half year data on domestic corporate goods prices and consumer prices are set forth as the % change y-o-y.
4. The price of crude oil refers to the nearest term contract for WTI. The long-term interest rate refers to the yield on newly-issued 10-yr JGBs.

Sources: Made by MHRI based upon Cabinet Office, *National Accounts of Japan*, Ministry of Economy, Trade and Industry, *Indices of Industrial Production*, Ministry of Internal Affairs and Communications, *Labour Force Survey, Consumer Price Index*, Bank of Japan, *Balance of Payments*, *Corporate Goods Price Index*, and others.

note that there are media reports that he is close to establishing his policy stance to postpone the tax hike. Considering the timing of the Upper House election, the possibility of a postponement may not be disregarded altogether.

In view of the foregoing, the Japanese economy is forecast to grow at a mild pace of +0.9% in FY2016 (**Chart 2**). In FY2017, the pace of real GDP growth should come under downward pressures (around 0.7% pt to 0.8% pt) due to a backlash to the last-minute rush of demand in a run-up to the consumption tax hike and the rise of burdens upon households. However, the economy should avoid losing momentum as the negative impact stemming from the consumption tax hike wears off in the second half of the fiscal year. MHRI forecasts that real GDP during the full year in FY2017 will grow +0.2%. An estimation of Japan's growth rate excluding the impact of the consumption tax hike would be +0.6% in FY2016, slightly lower than FY2015 (+0.8%). In contrast, Japan's economic growth would gradually recover in FY2017 (+1.0%), supported by the recovery of DM economies.

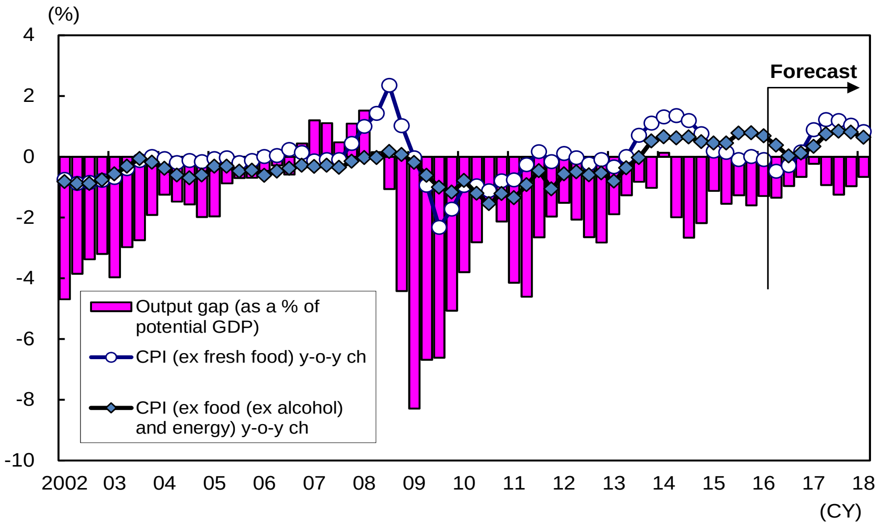
5. Slumping crude oil prices and the appreciation of the yen will keep the y-o-y change of the core CPI around zero percent in FY2016

According to estimations by MHRI, the output gap (the difference between actual and potential GDP) stood at -1.3% of potential GDP as of the Jan-Mar quarter of 2016 (which means an excess of supply by approximately JPY7 trillion) (**Chart 3**). Based upon MHRI's latest *Economic Outlook*, the excess supply in the output gap is projected to improve and move closer to zero as the level of economic activity rises due to the last minute rush of demand in the second half of FY2016. Even though the output gap should widen to slightly larger than 1% of potential GDP from FY2017, it should gradually improve in the second half of the fiscal year as the economy avoids a loss of momentum.

The y-o-y change of the core CPI (general, excluding fresh food) has been trending around 0% since the summer of 2015, reflecting the fall of crude oil prices, and stood at -0.3% as of April 2016. Even in FY2016, the core CPI should remain around 0% due to the low level of crude oil prices, and the decline of import costs due to the appreciation of the yen reflecting the US stance to contain the strong dollar. Even though the impact of these factors should fade toward the end of the fiscal year, the CPI is forecast to remain close to zero (-0.1%) for the full year FY2016.

In the year FY2017, despite negative pressures upon the deterioration of the output gap after the consumption tax hike, (1) the gradual upturn of crude oil prices, and (2) expectations of another depreciation of the yen, should lead to the rise of gradual upward pressures upon the core CPI. The y-o-y % change of the core CPI in FY2017 is forecast to reach +1.1% when excluding the impact of the consumption tax hike (approximately +2.0% when including the impact of the consumption tax hike). Even so, it should fall short of the BOJ's target to reach around 2% "during FY2017".

Chart 3: The output gap and inflation rate



Notes: 1. The CPI excludes the impact of the consumption tax hike.
2. The output gap is estimated by MHRI.

Sources: Made by MHRI based upon Cabinet Office, *National Accounts of Japan,* Ministry of Internal Affairs and Communications, *Consumer Price Index,* and others.