Mizuho Economic Outlook & Analysis

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FY2016, FY2017 Economic Outlook
The global economy faces mounting uncertainties

The Japanese economy will be dependent upon public sector demand amid the weakness of private sector and external demand

◆ Even though the global economy should start to pick up toward 2017, it will be necessary to keep a close eye upon rising uncertainties stemming from mounting issues such as the future direction of "Brexit", political developments in Europe, outcome of the US presidential election and structural adjustments of the Chinese economy. The Japanese economy will likely remain dependent upon public sector demand. The core CPI should stay around 1%-level in FY2017.

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 remained tepid in the Apr-Jun quarter of 2016

The global economy overall lacked momentum in the Apr-Jun quarter of 2016. US economic growth remained weak, growing at a tepid pace around 1% for the third quarter in a row reflecting the fall of capital investment and inventory investment. As for the Eurozone economy, the pace of growth fell from the previous quarter due to factors stemming from the slowdown of domestic demand caused by the deterioration of purchasing power accompanying the rise of crude oil prices. Japan’s economic growth turned out to be more or less flat around 0%. Even when discounting the fact that this may stem from a backlash to growth in the Jan-Mar quarter which was boosted by the leap year factor, the results underscored that Japan has not yet emerged out of the soft patch from mid-2015. In China, even though the pace of economic growth levelled out and avoided a further slowdown, it should be noted that capital investment floundered at a single-digit pace, for the first time since such statistics were recorded. Turning to other Asian economies, despite the acceleration of growth in certain countries such as South Korea and Indonesia, note that the growth of the economy was due largely to one-off factors and that the overall economy remained weak.

Chart 1: Outlook on the global economy

(Y-o-y % change)

Calendar year	2014 (Actual)	2015 (Actual)	2016 (Forecast)	2017 (Forecast)
Total of forecast area	3.5	3.3	3.2	3.6
Japan, US, Eurozone	1.5	2.0	1.3	1.6
US	2.4	2.6	1.4	2.2
Eurozone	0.9	1.7	1.5	1.1
Japan	-0.0	0.5	0.5	0.7
Asia	6.4	6.1	6.0	6.0
China	7.3	6.9	6.6	6.5
NIEs	3.4	1.9	1.8	2.2
ASEAN5	4.6	4.8	4.7	4.6
India	7.0	7.2	7.7	7.6
Australia	2.7	2.5	2.7	2.5
Brazil	0.1	-3.8	-3.4	0.8
Russia	0.7	-3.7	-1.2	1.0
Crude oil price (WTI, USD/bbl)	93	49	42	45

Note: The total of the forecast area is calculated upon the 2014 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.

Turning to the corporate sector, business sentiment in developed market (DM) countries remain flat after falling sharply since the second half of last year. In contrast, emerging market (EM) business sentiment is picking up. Despite the sharp deterioration of post-Brexit UK business sentiment, the impact of Brexit upon other major countries and regions has been limited, at least for now.

2. While the global economy is expected to pick up toward 2017, keep a close eye upon downside risks.

In 2016, the pace of global economic growth (the total of MHRI's forecast area, on a weighted average basis) is forecast to stand at +3.2% y-o-y, falling for the second year in a row (2014: +3.5% y-o-y, 2015: +3.3% y-o-y) (**Chart 1**). In particular, these forecasts reflect the negative impact of the DM slowdown – mainly in the US – in the first half of 2016. However, a gradual recovery is expected from the second half of 2016, lifting the pace of growth to +3.6% y-o-y in 2017. Although we expect a gradual global recovery in 2017 as our main scenario, it will be necessary to keep a close eye upon downside risks, due to persistent uncertainties regarding the future course of the global economy.

The US economy should return to a mild expansion track in the Jul-Sep quarter despite the weakness in the first half of 2016. Personal consumption is forecast to keep growing at a moderate pace, underpinned by the rise of income. Despite its sharp fall in the Apr-Jun quarter, investment in inventories should also turn positive due mainly to the expansion of inventory build-up among retailers on the back of solid personal consumption. Even though corporate enterprises are expected to maintain a cautious stance in view of strong uncertainties regarding the future, a gradual upturn of capital investment is predicted toward 2017 because excess capacity in corporate sector is limited on the whole (with the exception of the shale oil/gas industry).

The Eurozone economy should continue to follow a gradual recovery path. However, the pace of growth is forecast to slow down in 2017. The odds are high that the pace of economic recovery will moderate mainly in investment from the second half of 2016 due to the rise of uncertainties stemming from the UK decision to exit the EU ("Brexit"). In the second half of 2017, the uncertainties should ease along with the progress of UK-EU negotiations and gradually lift the pace of growth. However, the Eurozone economy is subject to strong downside risks during the forecast horizon due to mounting concerns such as difficulties of Brexit negotiations and escalation of Europe's political turmoil.

The Chinese economy should continue to follow a mild slowdown. In addition to downward pressures upon investment over the medium term due to progress of deleveraging, consumer spending is also expected to follow a mild slowdown against a background of soft employment and income growth. Even though the Chinese economy should be able to avoid a loss of momentum due to economic support measures comprised mainly of fiscal spending, future developments require ongoing attention since China's economic downturn would have a negative impact upon the overall global economy. The Asian economies excluding China will likely fall short of a self-sustained recovery. Even though exports should gradually pick up along with the recovery of the US economy, the pace of export recovery will be sluggish at best, in view of the slowdown of the European economy due to Brexit, as well as China's economic slowdown.

3. The global economy is subject to mounting uncertainties

The global economy is subject to mounting uncertainties such as the future course of Brexit, European political issues, the US presidential election, and China's structural adjustment. According to the Economic Policy Uncertainty (EPU) Index, an index of economic policy uncertainty based upon newspaper coverage, the index is rising to historical levels in the UK and Europe reflecting the uncertainties stemming from Brexit. The index is also rising sharply in the US ahead of the presidential election. Furthermore, the index is following an uptrend among certain EM countries such as China which is subject to structural problems and Brazil which is in a recession.

Turning to Brexit, the UK is starting to prepare for its exit from the EU under Prime Minister Theresa May. While the UK's notification of withdrawal from the EU is predicted to be triggered sometime in early 2017, there are strong uncertainties due to expectations of a rocky road ahead. From the perspective of European politics, the rise of anti-EU forces in not only the UK but in other EU countries is a source of concern. Given a number of political events in 2017 such as the French presidential election (April to May 2017) and the German federal election (around September 2017), it is necessary to keep a close eye upon the risk of Europe's political destabilization. Looking forward, a key political event is Italy's upcoming referendum on constitutional reform (around the end of October 2016). Since Italian Prime Minister Matteo Renzi has stated his intent to step down in the event of a vote "against reform", the referendum carries the risk of Italy's political destabilization.

In the US presidential election (November 2016), although Democratic Party nominee Hillary Clinton is said to have a lead according to public opinion polls, it is difficult to forecast the outcome of the election. In the event Donald Trump, a businessman known for radical comments, is elected president, market turmoil would be inevitable and would carry the risks of the contraction of US business confidence and decline of capital investment. Moreover, given that both nominees advocate protectionist policy measures such as opposition to the Trans-Pacific Partnership Agreement (TPP), trade policy under the new US administration would be a risk factor regardless of the election results.

In China, note the rise of corporate debt and nonperforming loans (NPLs). While the acquisition of NPLs by asset management companies and NPL securitizations are gradually under way since the government wishes to avoid hasty disposals to trigger financial sector turmoil, the odds are high that the disposal will turn out to be "a long battle". Corporate balance sheet adjustments in the course of the disposal process may serve to raise the uncertainties with respect to the Chinese economy.

4. Countries worldwide remain heavily skewed toward monetary policy

Despite persistent concerns regarding a global economic downturn stemming from rising uncertainties, countries worldwide remain heavily skewed toward monetary policy to address the economic malaise. In spite of the rise of expectations toward fiscal policy due to views regarding the limited power of monetary policy and criticism toward currency wars, the use of fiscal spending has been limited with the exception of Japan's new economic stimulus package.

Amid the intensification of prospects that interest rates will remain low for a prolonged period reflecting monetary easing measures around the world, financial markets remain in a "Goldilocks" state of firm stock and bond markets. Although Goldilocks appears to have staying power for the time being, note that the materialization of risk factors may trigger a market collapse.

5. Japan's economic growth is forecast to slow down to +0.6% in FY2016 and pick up in FY2017 (+0.9%) given the full-fledged implementation of economic stimulus measures

Japan's economic growth remained virtually flat at +0.0% q-o-q (+0.2% in annualized terms) in the Apr-Jun quarter of 2016 (the *First Preliminary Quarterly Estimates of GDP*, the "*1st QE*"), but remained in positive territory for the second quarter in a row. The upturn of housing investment and public investment served as the driver of growth. Having said so, the pace of growth turned out to be tepid due to the prolonged stagnation of exports and capital investment and lackluster personal consumption. Although the weakness stems partially from a backlash to growth in the Jan-Mar quarter which was boosted by the leap year effect, even when discounting this factor, the recent GDP results confirmed that the Japanese economy has not yet emerged out of the “soft patch” from the second half of 2015.

Looking forward from the Jul-Sep quarter of 2016, Japan’s economic recovery will likely depend upon public demand amid the weakness of external and private-sector demand.

As for the impact of the Brexit decision, while corporate business confidence has deteriorated significantly among British firms, the ripple effect of Brexit upon the actual economic conditions of other countries appears limited, at least for now. However, note that downside factors regarding the overseas economies existing from before still linger, such as the structural adjustment of the Chinese economy and the weakness of capital investment among US corporations. Taken together with the headwinds of the sharp appreciation of the yen since the beginning of this year, the odds are high that Japan’s exports will continue to slump for some time. Turning to private-sector demand, we expect the weak growth of capital investment reflecting the erosion of corporate profits due to the appreciation of the yen. Personal consumption is also predicted to lack strength, given the erosion of disposable income accompanying the rise of social insurance burdens.

Japan’s economic stimulus package decided by Cabinet on August 2, 2016 totaled approximately JPY28 trillion, of which actual government spending is approximately JPY6 trillion. A large percentage of the actual spending includes JPY3 trillion in public works projects (estimated from the amount of construction bond issuance) possessing quick effect. According to estimations by Mizuho Research Institute Ltd. (MHRI), the new stimulus package is expected to lift Japan’s real GDP level by 1.1% (cumulative total of multiple years). However, the progress of the public works projects may take longer than expected due to the shortage of construction workers. The positive impact of the economic stimulus package upon the growth rates of each fiscal year is estimated to be approximately 0.1 to 0.3%.

One characteristic of the recent economic stimulus package is the inclusion of a 3% hike of the minimum wage. Even though its macroeconomic impact to lift wages would be small considering that there are not so many workers working near the minimum wage level, the inclusion of the hike is an appropriate measure from the perspective of eliminating Japan’s deep-rooted deflationary mindset and raising inflationary expectations. Furthermore, we propose so-called “nominal wage targeting” as one way to ensure the rise of inflation expectations. For example, the indication of a “2% inflation target + rate of labor productivity gain according to respective corporate enterprises” as a reference rate of pay-scale raise in spring wage negotiations would facilitate coordination among corporations toward the attainment of wage hikes which are consistent with the inflation target.

In view of the foregoing, the Japanese economy is forecast to slow slightly from FY2015 (+0.8%) to +0.6% in FY2016 (**Chart 2**). In contrast, Japan's economic growth should gradually recover in FY2017 (+0.9%), supported by the recovery of overseas economies and the full-fledged implementation of the economic stimulus measures. The contribution rate by public demand to GDP growth is expected to rise over 50% in both FY2016 and FY2017 (approximately 20% in FY2015), revealing a rising dependence of economic growth upon public demand.

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	0.6	0.9	0.8	0.1	0.9	0.6	0.8	1.1
Domestic demand	-1.5	0.7	0.6	1.0	1.3	-0.3	1.1	0.5	1.0	1.3
Private sector demand	-1.9	0.8	0.2	0.6	1.5	-0.6	0.7	0.1	0.7	1.0
Personal consumption	-2.9	-0.2	0.7	1.0	-0.8	-0.5	1.4	0.6	1.1	1.1
Housing investment	-11.7	2.4	5.1	-3.7	7.3	0.0	13.3	-5.1	-4.7	0.1
Capital investment	0.1	2.1	0.5	1.7	2.0	2.4	-0.9	1.5	1.7	1.9
Public sector demand	-0.3	0.7	1.9	1.9	0.7	0.7	2.4	1.6	2.0	2.2
Government consumption	0.1	1.6	1.6	1.7	1.2	2.7	1.5	0.7	1.9	2.1
Public investment	-2.6	-2.7	3.0	3.1	-1.1	-8.2	6.4	5.7	2.5	2.6
Net exports (contribution)	0.6	0.1	0.0	-0.1	-0.5	0.4	-0.2	0.1	0.0	0.0
Exports	7.9	0.4	0.3	2.1	-4.3	0.8	-1.3	3.4	1.7	1.7
Imports	3.4	-0.0	0.2	2.8	-1.3	-1.5	-0.2	2.8	2.9	2.8
GDP (nominal)	1.5	2.2	1.1	1.5	2.6	0.8	1.9	-0.4	2.7	1.1
GDP deflator	2.4	1.4	0.4	0.6	1.6	1.2	0.8	0.1	0.4	0.8
Industrial production	-0.5	-1.0	0.6	2.6	-1.2	-1.0	0.3	1.8	1.2	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	18.3	19.0	15.9	19.5	17.9	15.8	15.8	16.3
Domestic corporate goods prices	2.7	-3.2	-2.7	1.1	-2.9	-3.5	-4.0	-1.3	0.8	1.5
Consumer prices (ex fresh food)	2.8	-0.0	-0.0	0.9	-0.0	-0.1	-0.3	0.2	0.8	1.1
Consumer prices (ex fresh food, ex consumption tax hike)	0.7	-0.0	-0.0	0.9	-0.1	-0.1	-0.3	0.2	0.8	1.1
Consumer prices (ex food (ex alcohol) and energy, ex consumption tax hike)	0.5	0.5	0.3	0.6	0.5	0.6	0.5	0.3	0.6	0.7
Long-term interest rate (%)	0.48	0.30	-0.12	-0.09	0.40	0.18	-0.15	-0.13	-0.10	-0.08
Nikkei stock average (JPY)	16,273	18,841	16,100	16,800	19,730	17,951	16,400	15,800	16,350	17,200
Exchange rate (JPY/USD)	110	120	103	105	122	118	106	101	104	107
Crude oil price (WTI, USD/bbl)	81	45	44	45	53	38	44	45	45	46

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.

The resurgence of concerns regarding the hollowing-out of Japan's domestic economy due to a further appreciation of the yen may be cited as a risk factor for the future course of the Japanese economy. The yen started to strengthen from the turn of the year in 2016, reaching close to JPY100/USD as of the end of August. In view of the tendency for currency exchange rates to overshoot, the risk of a further yen appreciation may not be ruled out. Since econometric analysis indicates that a further appreciation of the yen above JPY90/USD would accelerate the trend among Japanese companies to move their production sites overseas, it would be necessary to keep a closer eye upon foreign exchange rate developments.

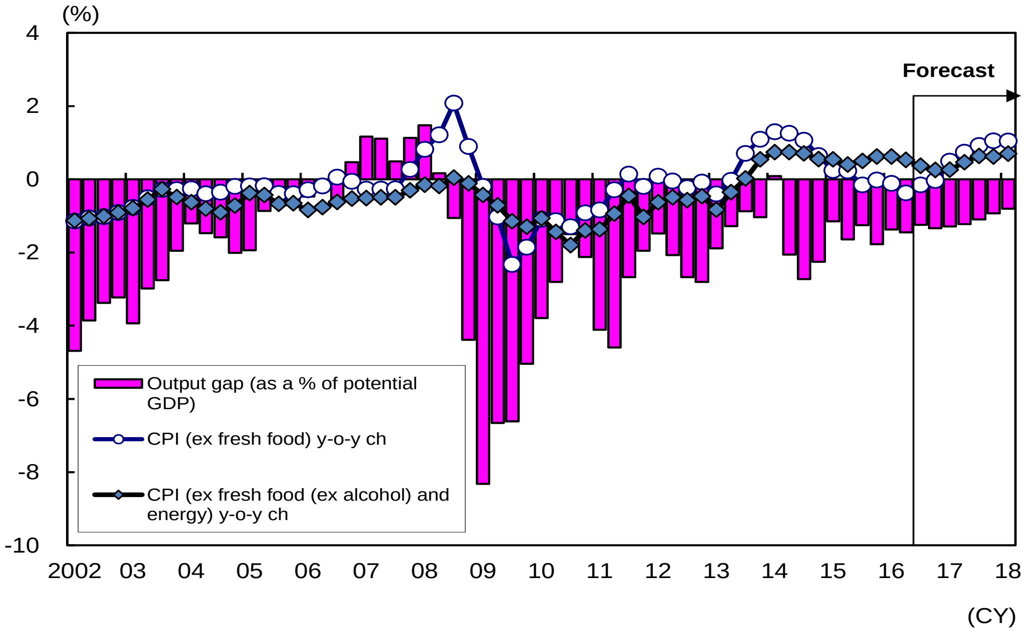
6. Core inflation rate will be around 1% in FY2017, falling short of the BOJ's inflation target

According to calculations by MHRI, the output gap (the difference between actual and potential GDP) stood at -1.4% of potential GDP (which means an excess of supply by approximately JPY8 trillion) as of the Apr-Jun quarter of 2016 (**Chart 3**). Based upon MHRI's latest *Economic Outlook*, the excess supply in the output gap is projected to improve as the level of economic activity rises due to a gradual upturn of the economy. Having said so, it is unlikely that the excess supply will be eliminated during the forecast horizon up to the Jan-Mar quarter of 2018.

The y-o-y change of the core CPI (general, excluding fresh food) has been trending below 0% since the summer of 2015, reflecting the fall of crude oil prices, and stood at -0.5% as of July 2016. Looking forward, 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 at 0.0% for the full year FY2016.

In the year FY2017, we expect to see the gradual rise of upward pressures upon the core CPI due to (1) a mild upturn of crude oil prices, and (2) expectations that the yen will weaken again. The y-o-y % change of the core CPI in FY2017 is forecast to reach +0.9%. Even so, it should fall short of the BOJ's baseline scenario 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.