Mizuho Economic Outlook & Analysis

March 2017

FY2016, FY2017, FY2018 Economic Outlook

While the global economy is on growth track, US policy agenda and European political developments are risk factors

The Japanese economy is picking up mainly in the corporate sector

◆ The global economy is forecast to remain on an expansion track in 2018. In addition to the cyclical recovery of the global economy, the fiscal expansion stance of the new US administration will most likely serve as a driver of the global economy. On the other hand, it will be necessary to keep a close eye upon the Trump administration's protectionist stance and political turmoil in Europe. The Japanese economy should continue to follow a recovery track driven mainly by exports and capital investment, reflecting the improvement of the IT cycle, upturn of US corporate sentiment, and recovery of China's industrial sector.

.

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 economic recovery is gaining momentum

Looking at global economic trends up to now, the overall global economy slowed down in the first half of 2016 since the emerging market (EM) slowdown spread to the developed market (DM) economies. However, the global economy started to pick up from the second half of 2016 and appears to be gaining momentum particularly from the end of said period. The manufacturing PMI, which gauges corporate business confidence through surveys of purchasing managers around the world, has been rising on a global scale from the second half of 2016. It is the first time since the period from the second half of 2013 to the first half of 2014 that the index is improving both for EM and DM economies.

2. Three factors contributing to the global economic recovery

The current global economic recovery stems from (1) the improvement of the IT cycle, (2) the recovery of China's imports along with the pickup of its domestic demand, and (3) the rise of commodity prices.

It appears that the IT cycle has shifted into an "improvement" phase from the second half of 2016. Quarterly semiconductor sales is growing rapidly after bottoming out in the second quarter of 2016, indicating a global improvement of the IT market. While there is a strong correlation between the global IT cycle and the trends in Japan's IT-related demand, Japan's electronic parts & devices shipments index has also turned upward from the second half of 2016. In contrast, the inventory index has fallen sharply, resulting in a significant improvement of the inventory-shipments balance. In view of the improvement of the inventory-shipment balance, the current rise of production should continue for some time. Past inventory cycles of electronic parts & devices indicate that it takes around three to four years for the cycle to run its full course and that a shipments expansion phase usually lasts for approximately two to three years. Assuming that the shipments expansion phase started from the second half of 2016, past trends suggest that the improvement would continue throughout 2017.

Turning to the recovery of China's imports, trends in the volume of imports reveal that the year-on-year (y-o-y) change of imports (by volume) has remained in positive territory for five consecutive quarters up to the Oct-Dec quarter of 2016. The progress of adjustments in production and inventories in the commodities & materials sector may be cited as a factor in the background to the rise of imports. Furthermore, the expansion of housing investment and IT-related demand for mobile phones appears to have contributed to the recovery of imports. Looking forward, the recovery of imports should continue for some time, given movements to replenish inventories stemming from the improvement of the production-inventory balance and fiscal policy support through infrastructure investment. However, the recovery momentum should gradually moderate due to prospects that housing investment will gradually slow down due to measures to curb purchases of homes, and the continuation of adjustments in sectors saddled with excessive production capacity.

As for commodity prices which is the third factor, prices had been falling since 2014. In particular, the fall of crude oil prices had been sending downward pressures upon commodity-producing countries and also serving as a drag upon other EM and DM economies through financial market turmoil. However, crude oil prices are gradually rising since the second half of 2016 on the back of expectations toward the OPEC's output cut, contributing to the recovery of commodity-producing countries and positively affecting the global economy via the improvement of confidence due to the stabilization of the financial markets. Crude oil prices are forecast to follow an upward trend, given the improvement of the supply-demand balance reflecting the OPEC's output cut, and should serve to underpin the global economy through the stability of the financial markets.

3. The global economy will follow an expansion track in 2017 and 2018

The foregoing suggests that the global economy will continue to follow a cyclical recovery on the back of the improvement of the IT cycle and recovery of China's imports. This view is consistent with the OECD CLIs (Composite Leading Indicators) of major countries indicating economic trends six months forward which projects an improvement of economic conditions in the first half of 2017. Furthermore, the new US administration's tax cuts and fiscal expansion measures such as infrastructure investment are expected to serve as additional underpinnings for the global economy from the second half of 2017. In particular, the tax cut is expected to be on considerably large in view of its conformity with the policy agenda of the GOP which won a majority in both the House of Representatives and Senate. Considering that the impact of the US fiscal expansion will start to grow larger from 2018, MHRI's main scenario forecast is that the global economy will continue to follow an expansion track in 2018. The pace of global economic growth (the total of MHRI's forecast area, regional average) is forecast to be +3.8% y-o-y in 2017 recording an upturn for the first time in three years, and +3.9% y-o-y in 2018 (**Chart 1**).

Chart 1: Outlook on the global economy

(Y-o-y % change)

Calendar year	2014 (Actual)	2015 (Actual)	2016 (Estimate)	2017 (Forecast)	2018 (Forecast)
Total of forecast area	3.6	3.4	3.3	3.8	3.9
Japan, US, Eurozone	1.6	2.2	1.6	1.9	1.9
US	2.4	2.6	1.6	2.3	2.3
Eurozone	1.2	2.0	1.7	1.5	1.6
Japan	0.3	1.2	1.0	1.3	1.4
Asia	6.4	6.1	6.0	6.0	6.1
China	7.3	6.9	6.7	6.5	6.4
NIEs	3.5	2.0	2.1	2.2	2.5
ASEAN5	4.6	4.8	4.9	4.9	5.0
India	7.0	7.2	7.0	7.5	7.5
Australia	2.8	2.4	2.4	2.2	2.7
Brazil	0.1	-3.8	-3.4	1.0	2.0
Russia	0.7	-2.8	-0.2	1.0	1.5
Crude oil price (WTI, USD/bbl)	93	49	43	57	65

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.

4. Risk factors intensifying future uncertainties

Despite our main scenario outlook of an expansion going forward, there are numerous factors which intensify future uncertainties such as the Trump administration's protectionist policy stance and Europe's political turmoil.

Turning first to the Trump administration's protectionist policy agenda, the new US president has stated upon assumption of office that the US would withdraw from the Trans-Pacific Partnership agreement (TPP) and renegotiate the North American Free Trade Agreement (NAFTA). He is also directing frequent criticisms toward individual companies using social networking services (SNS). A further intensification of protectionist policies, including border adjustments and foreign exchange policy, could serve as downside risks upon the global economy through the contraction of global trade. According to MHRI's calculations, a 10% fall of US imports would depress the global economy by approximately 1% via global trade. Furthermore, in addition to the economic slowdown of trade partners included in the foregoing calculation, there is the possibility that the US economy would also be subject to significant negative impacts of protectionism such as the rise of corporate costs due to the rise of imports in real terms stemming from border adjustments and decline of the labor force population due to anti-immigration policies which are not included in the foregoing calculation.

As for political developments in Europe, a spate of elections are scheduled in 2017 including the lower house election in the Netherlands (March), the French presidential election (April, May), and the legislative election in Germany (September). Depending upon the outcome of the elections, political turmoil may have a negative impact upon the economy. Given the victory of the "Leavers" in the 2016 UK Brexit referendum which sent tremors throughout the world, it is necessary to take note that political parties possessing skeptical views toward the EU are gaining a greater presence in the countries holding elections. In particular, polls show that Marine Le Pen of the far-right National Front is the frontrunner in France. Despite current views that she would not win in a runoff election, forecasts on election results require caution as shown by the UK referendum and US presidential election. In the event of a Le Pen presidency, the rise of the possibility of France's exit from the EU and concerns regarding an ensuing collapse of the EU would lead to downward pressures upon European economic conditions through the deterioration of business confidence, and a possible crisis among fragile European financial institutions amid a lack of a unified crisis response mechanism under the EU.

5. Japan's economic growth will likely moderate to +1.2% in FY2016 from the previous fiscal year (+1.3%)

The Japanese economy grew +0.2% q-o-q (+1.0% in annualized terms) in the Oct-Dec quarter of 2016 (the *First Preliminary Quarterly Estimates of GDP*, the "*1st QE*"), recording growth in positive territory for the fourth quarter in a row. The recovery of exports (+2.6% q-o-q) reflecting the improvement of the overseas economies continued to push up Japan's real GDP growth rate. In addition, capital investment also picked up (+0.9% q-o-q). In contrast, personal consumption (-0.0% q-o-q) remained lackluster due in part to downward pressures stemming from weather factors. Oct-Dec quarter GDP data confirm that the Japanese economy is following a gradual recovery path driven mainly by the corporate sector.

As regards the Jan-Mar quarter of 2017 also, the recovery driven mainly by exports and capital investment should continue due to factors such as the improvement of the global IT cycle and improvement of US corporate business confidence, and the recovery of China's mining & manufacturing sector. However, since the stagnation in the first half of the fiscal year will serve as a drag, FY2016 full-year growth is forecast to slow slightly to +1.2% from FY2015 (+1.3%) (**Chart 2**).

Chart 2: Outlook on the Japanese economy

(%)

	FY2015	FY2016	FY2017	FY2018	FY2016		FY2017		FY2018	
					1H	2H	1H	2H	1H	2H
	(Actual)	(Forecast)	(Forecast)	(Forecast)	(Actual)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)
Real GDP	1.3	1.2	1.4	1.3	1.8	1.1	1.5	1.5	1.3	1.1
Domestic demand	1.1	0.6	1.0	1.2	1.1	0.2	1.4	1.0	1.2	1.5
Private sector demand	1.1	0.7	0.8	1.2	1.7	0.0	1.1	0.8	1.1	1.7
Personal consumption	0.5	0.6	0.7	0.8	1.1	0.5	0.8	0.7	0.8	0.8
Housing investment	2.7	5.9	-4.7	-1.3	10.8	1.2	-8.6	-2.4	-2.1	1.5
Capital investment	0.6	1.8	2.5	2.1	1.9	2.1	2.7	2.3	1.9	2.2
Public sector demand	1.2	0.3	1.8	1.5	-0.4	0.6	2.4	1.7	1.5	1.2
Government consumption	2.0	0.8	1.4	1.7	-0.5	1.3	1.4	1.5	1.7	1.7
Public investment	-2.0	-1.5	3.4	0.7	0.3	-2.3	6.5	2.5	1.0	-1.0
Net exports (contribution)	0.2	0.6	0.3	0.1	0.7	0.9	0.0	0.0	0.0	0.0
Exports	0.8	2.8	4.2	2.0	0.6	8.7	2.4	3.7	1.9	0.7
Imports	-0.2	-0.9	2.3	1.7	-3.3	3.4	2.4	1.1	1.4	2.9
GDP (nominal)	2.8	1.2	1.7	1.8	1.5	0.8	2.2	1.4	2.3	1.0
GDP deflator	1.4	-0.1	0.3	0.5	0.2	-0.3	0.2	0.4	0.5	0.5
Industrial production	-1.0	1.4	3.6	1.8	0.4	3.1	1.2	1.5	0.8	0.4
Unemployment rate	3.3	3.1	3.0	2.9	3.1	3.0	3.0	3.0	2.9	2.9
Current account balance (JPY trillion)	18.0	21.5	22.4	20.8	19.2	22.2	21.3	21.4	19.8	19.1
Domestic corporate goods prices	-3.3	-2.4	2.2	2.0	-4.1	-0.7	2.0	2.5	2.2	1.9
Consumer prices (ex fresh food)	-0.0	-0.2	1.1	1.0	-0.4	0.1	1.0	1.3	1.2	1.1
Consumer prices (ex fresh food, ex consumption tax hike)	-0.0	-0.2	1.1	1.0	-0.4	0.1	1.0	1.3	1.2	1.1
Consumer prices (ex food (ex alcohol) and energy, ex consumption tax hike)	0.5	0.2	0.3	0.6	0.4	0.1	0.2	0.5	0.5	0.7
Long-term interest rate (%)	0.29	-0.05	0.05	0.05	-0.12	0.02	0.05	0.05	0.05	0.05
Nikkei stock average (JPY)	18,841	17,600	20,000	21,100	16,500	18,700	19,600	20,400	21,000	21,300
Exchange rate (JPY/USD)	120	109	116	119	105	112	115	117	119	119
Crude oil price (WTI, USD/bbl)	45	48	59	65	46	51	57	62	66	66

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.

6. The Japanese economy will recover in FY2017, with the growth rate rising to +1.4%

In FY2017, the Japanese economy should continue to follow a recovery track, driven by the upturn of the overseas economies, the improvement of the inventory cycle, and the implementation of public investment accompanying the economic stimulus measures.

Looking closer at the components of demand, a number of external factors mentioned above (improvement of the IT cycle, recovery of US corporate business confidence, recovery of China's mining & manufacturing sector) should continue to push up Japan's exports. Reflecting the export recovery, the cautious stance among manufacturers toward capital investment should ease amid the aggravation of the labor shortage, and investment toward the improvement of productivity such as factory automation is also expected. In the nonmanufacturing sector, construction investment should continue to rise mainly in connection with the 2020 Tokyo Olympic games, inbound travel and the expansion of logistic facilities.

Meanwhile, despite the upturn of durable goods consumption and the improvement of consumer confidence reflecting the rise of the stock market, the recovery of personal consumption is forecast to remain tepid because of the erosion of real wages due to the rise of energy prices. Furthermore, over the long term, the rise of labor compensation stemming from the expansion of women's labor force participation will not lead readily to the rise of personal consumption because of deep-rooted concerns about post-retirement livelihood in old age. The progress of women's labor force participation from around 2013 following the launch of Abenomics has led to a sharp rise of spousal income particularly among those in the 40s. Even so, consumption expenditures are continuing to slump in this age bracket. According to an opinion survey by the Bank of Japan (*Public Opinion Survey on Household Financial Assets and Liabilities*), the 40s are a generation with strong concerns about their livelihoods in old age. Thus, the extra spousal income is most likely being channeled to savings rather than spending.

As shown above, FY2017 real GDP growth is forecast to rise to +1.4% from FY2016 (forecast: +1.2%) due to expectations toward economic recovery driven mainly by the corporate sector.

Turning to FY2018, despite a peak-out of the upturn of the IT cycle and domestic inventory cycle, the economy should continue to grow above its potential growth rate (estimated to be +0.9% by MHRI) as the engine of growth shifts from external to domestic demand. Past cyclical movements of the economy show that expansion cycles usually run their course in approximately two years. Judging from the fact that the Japanese economy lifted off from a soft patch around the middle of FY2016, the economic recovery should start to peak out in FY2018. That said, given the ongoing strength of construction investment in connection with the 2020 Tokyo Olympic Games, as well as personal consumption which is gaining strength along with the spread of wage hikes. In view of these factors, FY2018 growth is forecast to stand at +1.3%, in a mild downturn from FY2017.

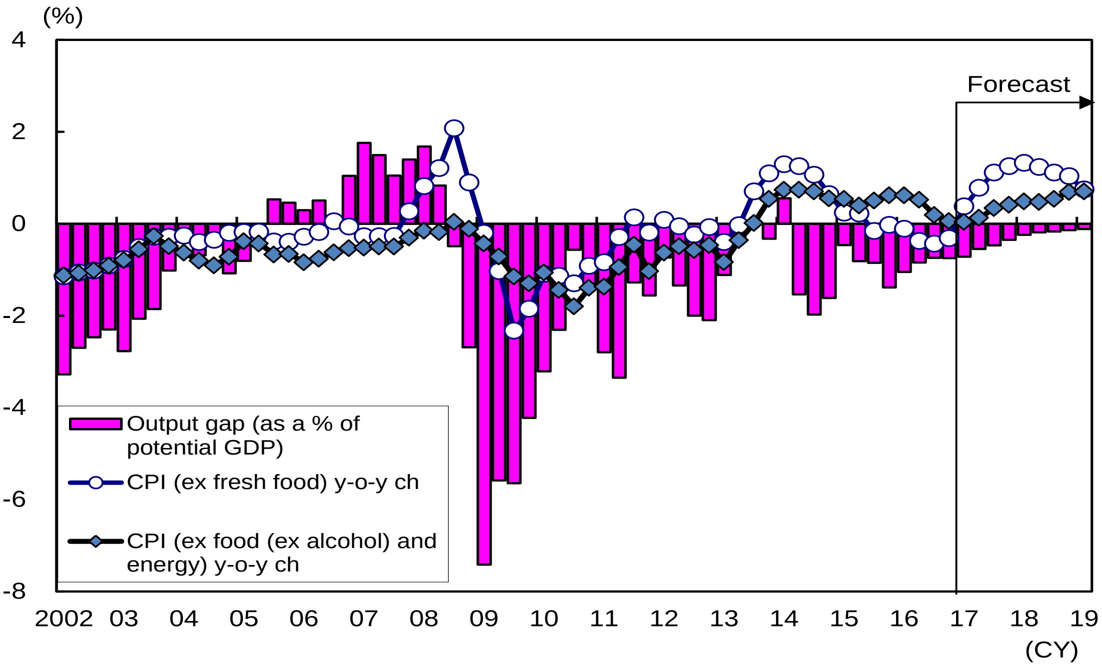
7. Core inflation rate (y-o-y change) should rise to around the 1%-level in FY2017 reflecting the weak yen and upturn of crude oil prices

According to calculations by MHRI, the output gap (the difference between actual and potential GDP) stood at -0.7% of potential GDP (which means an excess of supply by approximately JPY3.9 trillion) as of the Oct-Dec quarter of 2016 (**Chart 3**). Based upon MHRI's latest *Economic Outlook*, the excess supply in the output gap is projected to narrow gradually as the level of economic activity rises due to the ongoing recovery of the economy.

The y-o-y change of the core CPI (general, excluding fresh food) has been trending in negative territory since early spring of 2016, reflecting the fall of crude oil prices and appreciation of the yen. At the moment, however, the core CPI is subject to gradual upward pressures in view of the mild rise of crude oil prices, and the yen weakening subsequent to the US presidential election. Although the y-o-y change of the core CPI is still in negative territory (-0.2% y-o-y), it should rise to the 1%-level by the end of FY2017. On a full-year basis, while the core CPI should remain at -0.2% y-o-y in FY2016, it is projected to rise to +1.1% y-o-y in FY2017. However, we forecast a slight decline of the core CPI from FY2017 to +1.0% y-o-y in FY2018 as the rise of energy prices - accompanying the depreciation of the yen and upturn of crude oil prices - eases.

The y-o-y change of the core CPI will most likely fall short of the BOJ's outlook that it will reach approximately 2% "around FY2018". This stems from the likelihood that the rise of wages (especially base wages), which is the premise for the stable rise of prices, will remain moderate. In the 2017 spring labor-management wage negotiations (*shunto*), the improvement of earnings due to the weak yen will most likely be channeled back to employees by means of bonus payments rather than base wage hikes because of overseas political uncertainties. As such, we forecast the 2017 spring wage hike rate (including the annual regular wage increase) to dip slightly to 2.10% (2016: 2.14%). Although the 2018 wage hike rate is expected to rise reflecting the economic recovery in 2017, the odds are high that it will fall substantially below the level which is consistent with the 2% inflation target (which is approximately 4% including the annual regular wage increase).

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.