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FY2017, FY2018 Economic Outlook

While the global economy is expanding, keep a close eye upon developments in the US and China

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Despite a soft patch in the US economy, the overall global economy is following a recovery track

The global economy revealed mixed results in terms of GDP growth in the Jan-Mar quarter of 2017. While many of the major economies including the Eurozone, China and Japan managed to maintain growth on par with or above the previous quarter, US economic growth fell sharply. Even so, the US slowdown was only temporary (a so-called "soft patch") stemming from seasonal factors in the Jan-Mar quarter. From the Apr-Jun quarter, the US economy is forecast to return to a growth track on the 2%-level. We are thus inclined to believe that the cyclical recovery of the global economy since the second half of last year is continuing to date.

Looking forward, we forecast that the global economy will continue to expand in 2018 (**Chart 1**). Mizuho Research Institute Ltd. (MHRI) has been indicating that the global economic recovery stems from factors such as the improvement of the IT cycle, the upturn of the Chinese economy and the bottoming out of commodity prices. Of these factors, the Chinese economy is of particular significance. As for the US economy, our view rests upon the premise that the Trump administration's tax cuts etc. will underpin the economy. Thus, in the following pages, we shall set forth our views on the Chinese economy and the Trump administration's policy agenda which are two important factors swaying the future direction of the global economy.

The Chinese economy and the Trump administration's policy agenda hold the key to the future direction of the global economy

Firstly, as for the Chinese economy, our main scenario outlook is a gradual slowdown. One reason that the Chinese economy is cited as a positive factor from the second half of last year is the progress of production and inventory adjustments in the commodities & materials sectors. The replenishment of inventories due to the improvement of the production-inventory balance led to the increase of imports and served as a positive factor for the global economy. However, the positive impact of the production-inventory balance should gradually fade toward 2018, leading to the moderation of China's economic growth. As for infrastructure investment which is another driver of growth, it will serve as support to avoid an excessive slowdown of the economy in the run-up to the National Congress of the Communist Party of China in the autumn of 2017. Even so, the support should gradually decline going forward. Of course, given the availability of funds raised in 2016 and the capability of the National Development and Reform Commission to secure funds through the expansion of the Special Construction Fund, it would be possible to support the economy by increasing infrastructure investment in the event the pace of economic slowdown turns out to be faster than initially expected.

However, given China's relatively high level of economic growth (+6.9% y-o-y) in the Jan-Mar quarter of 2017, the achievement of the 2017 growth target of "around 6.5%" is now easily within reach. As such, the Chinese government appears to be shifting its weight toward its conventional policy agenda of improving the quality of its economy such as curbing asset bubbles through structural reforms and regulations. Turning to measures to address asset bubbles, many Chinese cities are tightening housing purchase restrictions once again from March 2017, reflecting the rise of housing prices from 2017 despite a slight cool-down following the previous round of housing purchase restrictions from the end of September 2016. Furthermore, in view of the fact that China's accommodative monetary policy served as one of the background factors of the bubble, the authorities are guiding market interest rates higher and stepping up financial regulations on leveraged transactions and shadow banking. The foregoing spate of restrictions and tightening measures will most likely serve as a drag upon the future course of the Chinese economy. As a matter of fact, China's major economic indicators remained high in April but generally grew at a slower pace, suggesting that signs of a peak-out of the Chinese economy are starting to emerge. Although our main scenario outlook is that the pace of global economic slowdown will be mild due to support by policy measures, the risk of an excessive economic slowdown due to the dampening effect of the tightening measures requires a certain level of attention in view of the rising impact of the Chinese economy upon the global economy.

Turning to the Trump administration's policy agenda, while progress is evident in regulations and trade which may be implemented by executive orders, tax cuts and infrastructure-related measures, which are hoped to buoy the economy, are stalled due to the need for coordination with Congress. While the Trump administration's proposed tax plan unveiled on April 26th adheres more or less to its campaign pledge, discussions are stalled on how to fund the fiscal costs running up to approximately USD5.5 trillion during the coming 10-year period according to this plan. Even though the Trump administration asserts in its Budget Message submitted on May 23rd that the expansion of the fiscal deficit may be avoided by spending cuts mainly in benefits toward low income earners and tax revenue growth stemming from the economic impact of various measures to promote growth, this is unlikely. Coordination with Republican conservatives who stand by fiscal neutrality is expected to be a difficult task. Looking forward, the odds are high that the scale-down of tax cuts will be discussed, leading to the possibility that the passage of the bill will be put off until late this year. Therefore, the impact of the tax cuts will only become evident from 2018.

Judging from the fact that the Trump administration and Congressional Republicans are united in the direction of tax cuts, MHRI's main scenario outlook forecasts that tax cut measures to a certain extent will be passed by Congress and prop up the economy, albeit a delay in timing of implementation. However, there is the possibility of a larger-than-expected scale-down of the tax cuts in the course of coordination with Congress, and there is also the risk that the ebb of expectations toward the Trump administration's policy agenda will have an adverse impact upon corporate business sentiment and consumer confidence. It will be necessary to keep a close eye upon policy developments including the outcome of the Russiagate scandal which is currently gathering attention.

[Chart 1: Outlook on the global economy]

(Y-o-y % change)

Calendar year	2015 (Actual)	2016 (Actual)	2017 (Forecast)	2018 (Forecast)
Total of forecast area	3.4	3.4	3.7	3.8
Japan, US, Eurozone	2.2	1.6	1.9	1.9
US	2.6	1.6	2.1	2.2
Eurozone	2.0	1.8	1.7	1.7
Japan	1.1	1.0	1.5	1.4
Asia	6.2	6.1	6.1	6.1
China	6.9	6.7	6.6	6.4
NIEs	2.0	2.3	2.5	2.5
ASEAN5	4.8	4.9	4.9	5.0
India	7.5	7.5	7.4	7.5
Australia	2.4	2.4	2.3	2.8
Brazil	-3.8	-3.6	0.6	2.0
Mexico	2.6	2.3	1.8	2.1
Russia	-2.8	-0.2	1.0	1.5
Crude oil price (WTI, USD/bbl)	48.8	43.4	52.6	55.0

Note: The total of the forecast area is calculated upon the 2015 GDP share (PPP) by the IMF
Source: Made by MHRI based upon releases by the IMF

Japan's economic growth is forecast to rise from the previous year, growing +1.5% in FY2017, and should maintain high growth of +1.3% in FY2018

The Japanese economy grew +0.5% q-o-q (+2.2% p.a.) in the Jan-Mar quarter of 2017, recording positive growth for five straight quarters for the first time in 11 years. In addition to the recovery of exports which continued to serve as a driver of growth, personal consumption picked up from the doldrums at the end of last year. The commencement of construction of the Tokyo Olympic Village and the gradual progress of the economic stimulus measures also serve as positive factors. The GDP data for the Jan-Mar quarter underscores that the Japanese economy is following a recovery path.

Turning to the Japanese economy in FY2017, the recovery of the overseas economies should continue to lead to the recovery of Japan's exports and capital investment. In addition to the upturn of China's mining & manufacturing sector and the ongoing improvement of the global IT cycle, US capital investment is also picking up, and should ripple through to Japan's production, exports and capital investment. Within Japan, the progress of projects related to the Tokyo Olympic Games and urban redevelopment and expectations toward the rise of investment to address the labor shortage and raise efficiency will serve to push up capital investment. As a matter of fact, sentiment regarding the shortage of labor is currently as high as the bubble period, and corporate businesses are raising the proportion of investment for automation such as industrial robots. As for personal consumption, despite the upturn of durable goods consumption and improvement of consumer confidence backed by factors such as the bullish stock market, the rise of energy prices predicted in the second half of FY2017 will most likely serve as a damper. Even though public investment will serve to push up growth, progress may lag due to the shortage of construction workers. In view of the foregoing, the rate of Japan's economic growth is forecast to rise from +1.3% in FY2016 to +1.5% in FY2017 (**Chart 2**).

[Chart 2: Outlook on the Japanese economy]

(%)

	FY2015	FY2016	FY2017	FY2018	FY2016		FY2017		FY2018	
					1H	2H	1H	2H	1H	2H
	(Actual)	(Actual)	(Forecast)	(Forecast)	(Actual)	(Actual)	(Forecast)	(Forecast)	(Forecast)	(Forecast)
Real GDP	1.2	1.3	1.5	1.3	1.7	1.5	1.6	1.2	1.4	1.3
Domestic demand	1.1	0.5	1.1	1.3	1.0	0.2	1.5	1.1	1.3	1.6
Private sector demand	1.1	0.8	1.1	1.3	1.6	0.6	1.4	0.9	1.3	1.7
Personal consumption	0.5	0.6	0.9	1.0	1.0	0.8	1.0	0.8	1.0	1.1
Housing investment	2.8	6.5	-0.3	-2.2	10.5	4.2	0.1	-5.1	-2.4	1.2
Capital investment	0.6	2.3	3.4	2.2	2.4	3.8	3.2	3.3	2.1	1.4
Public sector demand	1.2	-0.1	1.1	1.3	-0.6	-1.1	1.7	1.9	1.3	1.1
Government consumption	2.1	0.6	1.0	1.3	-0.6	0.5	1.0	1.3	1.3	1.3
Public investment	-1.9	-3.2	2.0	1.6	-0.3	-7.1	4.8	4.2	1.3	0.4
Net exports (contribution)	0.1	0.8	0.4	0.0	0.7	1.3	0.0	0.0	0.0	0.0
Exports	0.7	3.1	4.9	1.8	-0.4	11.3	3.5	1.7	2.2	1.2
Imports	0.2	-1.4	2.6	1.7	-4.4	3.8	2.7	1.1	1.4	2.9
GDP (nominal)	2.7	1.2	1.9	1.9	1.5	0.9	2.9	0.6	3.0	0.9
GDP deflator	1.5	-0.2	0.4	0.5	0.2	-0.4	0.3	0.4	0.5	0.6

Note: 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).
Source: Made by MHRI based upon Cabinet Office, *National Accounts of Japan*

In FY2018, while the tailwinds provided by the Chinese economy and improvement of the IT cycle should subside, domestic demand should continue to follow firm footing. In addition to the continuation of urban redevelopment and capital investment to address the labor shortage, personal consumption is expected to rise slightly reflecting the end of the public pension premium hikes. Based upon the foregoing, the rate of economic growth is forecast to stand at +1.3%, remaining above the rate of potential growth which is estimated to be around 1%.

However, a look at the risk factors reveals that uncertainties still run high such as the direction of the US Trump administration and China's macroeconomic management. Furthermore, brinkmanship diplomacy is still continuing regarding North Korea's nuclear missile development. Although the impact of the North Korea issue upon the economy should be contained as far as conditions do not spiral out to extreme cases such as military clashes, developments should be monitored closely as a tail risk.

Despite the rise of the core CPI mainly in energy prices, the underlying trend in inflation will remain moderate

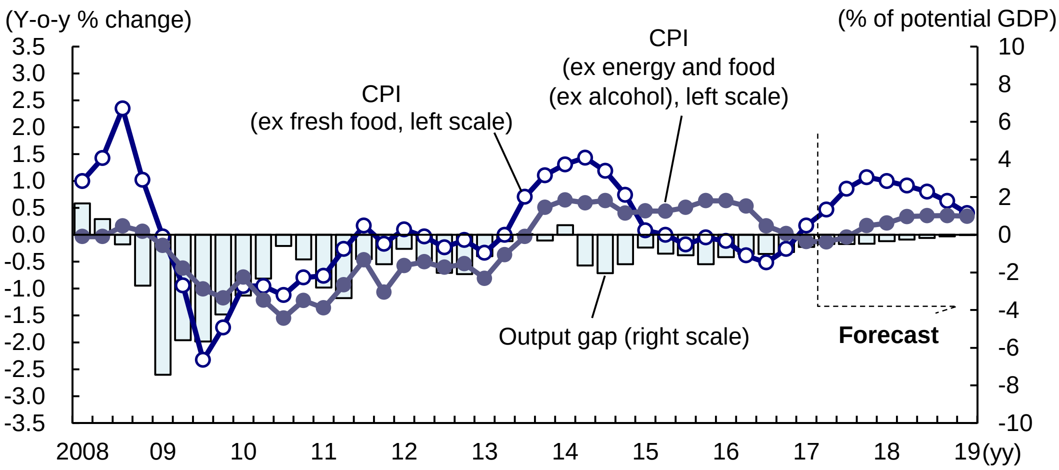
According to calculations by MHRI, the output gap (the difference between actual and potential GDP) stood at -0.6% of potential GDP (which means an excess of supply by approximately JPY3 trillion) as of the Jan-Mar 2017 (**Chart 3**). The excess supply in the output gap is projected to more or less diminish by the end of the forecast horizon up to the Jan-Mar quarter of 2019 given the continuation of Japan's economic recovery.

The y-o-y change of the core CPI (general, excluding fresh food) has emerged out of negative territory from the turn of the year in 2017 and reached +0.3% as of April 2017, reflecting the recovery of crude oil prices. Even so, when excluding the impact of energy prices, price levels are continuing to hover low due to deep-rooted household thrift-consciousness and reduction of communication fees. The y-o-y change of the US-style core CPI (the CPI excluding energy and food (excluding alcohol)) has dipped into negative territory from February 2017, for the first time since August 2013.

Looking forward, the following factors may serve as upward pressures upon the core CPI: the upturn of crude oil prices rippling through to electrical power rates, and part of the higher import costs stemming from the depreciation of the yen after the US presidential election being passed along to the price of food and durable goods. The y-o-y rise of the core CPI is forecast to rise temporarily to the 1%-level in the second half of FY2017. With respect to the full-year, we forecast a surge from FY2016 (-0.2%) to +0.8% in FY2017. Since the impact of the rise of energy prices will linger in FY2018, the core CPI should continue to rise at a pace close to 1% at +0.7%.

On the other hand, even though the US-style core CPI excluding the impact of energy prices should turn positive on a y-o-y basis, the pace of rise is expected to be slow. Our view stems from the fact that the rise of wages - which is indispensable for the stable rise of prices - is sluggish. According to a tally by the Japanese Trade Union Confederation (RENGO), the annual wage hike rate was 0.30% in 2017, falling slightly from 0.32% in the previous year (the same RENGO-base, 5th tally). The wage hike rate is insufficient in light of the inflation rate which is forecast to be around 1% in the second half of FY2017. Household thrift-consciousness should continue for some time, serving as a drag upon the improvement of the US-style core CPI.

[Chart 3: The output gap and CPI]



Note: The CPI excludes the impact of the consumption tax hike. The output gap is estimated by MHRI.
Source: Made by MHRI based upon Ministry of Internal Affairs and Communications, *Consumer Price Index,* Cabinet Office, *National Accounts*