

FY2017 - FY2019 Economic Outlook

While the global economy will continue to expand, keep a close eye upon shifts in the financial market

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This paper pertains to MHRI's *FY2017, FY2018, FY2019 Economic Outlook (Summary)* (February 15, 2018). We have subsequently revised our outlook on March 8, 2018 to reflect the *Second Preliminary Quarterly Estimates of GDP* for the Oct-Dec Qtr of 2017.

The global economy is strong and should remain on firm footing in 2019

Even though the pace of economic growth among major countries in the Oct-Dec quarter of 2017 fell from the previous quarter, the global economy generally remains strong. In particular, personal consumption and capital investment grew strongly in the US, providing reasons to believe that the actual state of the economy is following a domestic demand-led expansion. Despite forecasts of a slight slowdown, the Chinese economy turned out to grow at a pace on par with the previous quarter due to the expansion of external demand reflecting the strength of the global economy. Up until January, the global manufacturing PMI - which indicates business conditions among corporate enterprises - remained above the improvement-deterioration threshold of 50 both among the developed market (DM) and emerging market (EM) countries.

Looking forward, the composite leading indicators of the OECD - which provide an outlook on economic conditions six months ahead - continued to rise, albeit gradually, for 18 consecutive months up to December, indicating that the global economy will continue to pick up for the time being. MHRI's outlook forecasts that the global economy will continue to expand in 2018, and also remain on firm footing in 2019 (**Chart 1**). However, the expansion momentum will gradually moderate due to China's economic slowdown and peak-out of the IT cycle.

In our recent update of our *Economic Outlook*, we made upward revisions to our forecasts for 2018 in many of the countries in view of the current strength of the global economy and the impact of the tax system reform in the US. In the US, the large scale tax cuts in the tax system reform should facilitate capital investment among corporations and serve to underpin personal consumption. At the same time, growth expectations among corporations should rise and extend the expansion phase of the capital investment cycle. Likewise in 2019, the economy should continue to grow above its potential rate of growth.

Turning to countries and regions other than the US, the Eurozone economy is forecast to grow at a solid pace around 2% p.a. in 2019. However, the rate of economic growth should gradually slow down. One of the background factors to the strong growth in 2017 was the materialization of investment demand which had been

put off due to the rise of uncertainties. In 2019, in addition to the gradual ebb of pent-up demand, the appreciation of the euro will also slightly dampen economic growth. Having said so, consumer spending should continue to expand on the back of the rise of employment and keep the economy on solid footing. Turning to China, the Central Economic Work Conference (December 2017), which discussed the direction of China's economic policy, turned out to accept a slightly slower pace of economic growth, leading to our view that measures to curb investment and excessive production capacity will be stepped up. The Chinese economy is forecast to gradually moderate, albeit at a pace which still ensures its plan to double income during the period from 2010 to 2020. As for the Asian economies (excluding China), the growth momentum driven by exports should ease as the global economic expansion gradually peaks out in 2019. However, the ASEAN5 should enjoy firm consumer spending reflecting the favorable employment environment. Turning to India, the economic downturn in 2017 stemming from temporary factors should run its course, leading to a recovery in 2018. Viewing the Asian economy as a whole, the pace of expansion should gradually moderate in 2019.

[Chart 1: Outlook on the global economy]

Calendar year	(Y-o-y % change)			
	2016 (Actual)	2017 (Estimate)	2018 (Forecast)	2019 (Forecast)
Total of forecast area	3.4	3.9	4.0	3.9
Japan, US, Eurozone	1.5	2.2	2.2	2.0
US	1.5	2.3	2.5	2.4
Eurozone	1.8	2.5	2.2	1.8
Japan	0.9	1.6	1.4	1.1
Asia	6.2	6.1	6.2	6.0
China	6.7	6.9	6.5	6.4
NIEs	2.2	3.1	2.8	2.5
ASEAN5	4.9	5.3	5.3	5.1
India	7.9	6.3	7.3	7.3
Australia	2.6	2.3	2.8	2.7
Brazil	-3.5	1.0	2.3	2.6
Mexico	2.9	2.1	2.1	2.4
Russia	-0.2	1.5	1.7	1.5
Crude oil price (WTI, USD/bbl)	43	51	65	72

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

Keep a close eye upon shifts in the financial market

The risk factors to global economic growth are: (1) turbulence in the financial market, (2) China's economic slowdown, and (3) geopolitical risks. In particular, it is necessary to monitor closely movements in US long-term interest rates and stock market which are showing signs of a shift.

Since the turn of the month in February, US long-term interest rates have been rising on the back of sanguine views on the future course of the economy and rise of crude oil prices, and the weaker US dollar. Concerns that US fiscal expansion will raise the fiscal risk premium in the future may also be serving as a factor for the rise of long-term interest rates. The rise of interest rates triggered a temporary plunge of US stocks which had been viewed as over-valued, leading to a global stock market fall. It appears that the sharp rise of the VIX index - a barometer of investors' risk tolerance - also provided more fuel to accelerate the stock market fall.

Given the economic expansion and improvement of corporate earnings in the background to the rise of the stock market, and the plausibility that such conditions will continue for some time, our main scenario outlook is that the recent stock market fall is merely a speed adjustment and that the ebb of over-valuation will in fact contribute to extending the rise of the stock market. However, in the event that the stock market fall turns out to be deeper and longer, the slowdown of personal consumption stemming from the reverse wealth effect and restraints upon capital investment due to the deterioration of corporate business sentiment could serve as downward pressures upon the global economy. While it appears that US stocks are starting to regain stability, it will be necessary to keep a close watch since the market will most likely remain unstable for some time.

Furthermore, although US fiscal expansion will serve as upward pressures upon the economy in the short run, the negative effects of the ballooning fiscal deficit may send downward pressures upon the economy over the medium to long run. The US government's plan to balance fiscal conditions rests on extremely optimistic premises. Given the twin-deficit experience in the past, the current financial market turbulence may be reflecting market participants' risk consciousness to a revival of such conditions. Thus, for the time being, we would need to closely monitor movements in US politics, economy and the financial market.

Despite a slowdown, the Japanese economy should maintain positive growth for the fifth straight year

The Japanese economy grew +0.5% q-o-q p.a. in the Oct-Dec quarter of 2017 (based on the *First Preliminary Quarterly Estimates of GDP*), recording growth in positive territory for the eighth consecutive quarter for the first time since the bubble economy (1986 2Q to 1989 1Q). In addition to the recovery of personal consumption, capital investment also recorded positive growth for five quarters in a row. Even though exports recovered at a faster pace reflecting the rise of IT-related demand, the contribution to growth by external demand turned slightly negative due to the surge of imports. While the rate of growth itself slowed down due also to the fading impact of inventory investment, the actual state of the economy may be evaluated as continuing a solid recovery.

Looking forward, the Japanese economy should remain on a gradual recovery track. Turning to exports, a worrying trend is the deterioration of the shipments-to-inventories balance (growth of shipments minus growth of inventories) of the electronic parts & devices industry which had thus far acted as the driver of exports. However, since this stems most likely from the rapid accumulation of inventories against a background of robust demand, it is unlikely that it will enter an adjustment phase anytime soon. Although IT-related exports will slow down from last year, the pace of slowdown should turn out to be benign, given the strong demand for data centers and in-vehicle devices. Apart from IT, general machinery such as semi-conductor manufacturing devices and industrial robots should continue to fare well, as indicated by the increase in value of machinery orders from overseas. The Trump administration's tax cuts should support US capital investment and personal consumption, and thus serve as tailwinds upon Japan's exports. The odds are high that overall exports will still continue to rise despite a slowdown in the pace of increase.

Domestic demand should remain on solid grounds, even though the odds of an acceleration are slim. While capital investment is often said to lack momentum despite the strength of corporate earnings, it is necessary to take note that the weight of non-operating gains/losses in corporate earnings is rising in recent years. The current recovery momentum of capital investment is more or less in accordance with the profitability of operating

earnings, namely “core business”. Despite the gradual rise of cyclical adjustment pressures accompanying the accumulation of capital stock, we are inclined toward the view that capital investment will continue to pick up, as the recovery of the overseas economies, labor-saving measures and the progress of projects related to the 2020 Tokyo Olympic Games serve as positive factors. Turning to personal consumption, household thrift-consciousness is rising sharply, reflecting the rise of fresh food and gasoline prices. Prospects of the rise of energy prices will serve as headwinds upon consumer confidence. Having said so, forecasts of a slight rise of income growth due to wage hikes mainly among small and medium-sized enterprises, and demand for renewal of durable goods will most likely keep consumer spending from falling further.

The consumption tax hike scheduled in October 2019 is forecast to push down the rate of real GDP growth in FY2019 by approximately 0.2% pt mainly with respect to consumption. Although the last-minute rush of demand in the first half of the fiscal year and the reactionary fall in the second half of the fiscal year will offset each other, the fall stems from the decline of real income due to the tax hike. However, in view of the fact that the breadth of the tax hike this time is 2% and that reduced tax rates will be applied mainly upon food items, the impact should turn out to be smaller than in the past.

In view of the foregoing, even though Japan’s economic growth will slow down from the strong growth projected in FY2017 (+1.7% y-o-y), we forecast growth of +1.3% in FY2018 surpassing Japan’s potential rate of growth. In FY2019, Japan’s economy is forecast to grow +0.8% and maintain growth in positive territory for the fifth year in a row (**Chart 2**).

[Chart 2: Outlook on the Japanese economy]

(%)

	FY2016	FY2017	FY2018	FY2019	FY2017		FY2018		FY2019	
	(Actual)	(Forecast)	(Forecast)	(Forecast)	1H (Actual)	2H (Forecast)	1H (Forecast)	2H (Forecast)	1H (Forecast)	2H (Forecast)
Real GDP	1.2	1.7	1.3	0.8	2.1	1.2	1.5	1.0	1.5	-0.5
Domestic demand	0.4	1.3	1.1	0.9	2.2	0.6	1.3	1.1	2.0	-1.2
Private sector demand	0.3	1.5	1.3	0.9	2.2	1.0	1.4	1.2	2.2	-1.9
Personal consumption	0.3	1.1	0.8	0.6	1.5	0.4	0.9	0.8	2.5	-3.2
Housing investment	6.2	0.5	-1.5	0.3	1.5	-6.2	-0.8	2.0	6.5	-12.9
Capital investment	1.2	3.3	2.6	2.5	3.5	3.1	2.6	2.2	2.9	1.9
Public sector demand	0.5	0.6	0.6	1.0	1.9	-0.7	1.1	0.6	1.1	0.9
Government consumption	0.5	0.4	0.9	0.9	0.6	0.2	1.0	1.1	1.1	0.3
Public investment	0.9	1.3	-0.5	1.3	6.5	-4.1	1.4	-1.3	1.2	3.4
Net exports (contribution)	0.8	0.4	0.2	-0.1	0.0	0.6	0.2	-0.1	-0.4	0.8
Exports	3.4	6.3	3.6	2.4	4.2	7.5	2.4	2.2	2.4	2.4
Imports	-1.0	4.0	2.5	2.7	4.4	4.1	1.7	2.8	4.8	-1.7
GDP (nominal)	1.0	1.6	0.6	1.2	2.6	0.4	0.9	0.1	1.5	1.6
GDP deflator	-0.2	-0.1	-0.7	0.3	-0.1	-0.2	-0.7	-0.7	-0.4	1.1

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*

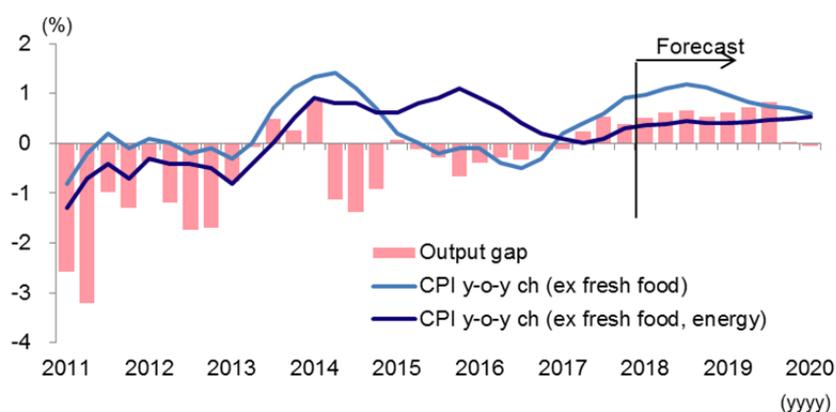
Apart from food and energy prices, the underlying trend in inflation will remain moderate

According to calculations by MHRI, the output gap (the difference between actual and potential GDP) stood at +0.4% of potential GDP (which means an excess of demand by approximately JPY2.0 trillion) as of the Oct-Dec quarter of 2017 (**Chart 3**). The output gap should gradually improve until the end of FY2018 due to the ongoing recovery of the economy. By FY2019, we expect a temporary expansion of the breadth of the

positive output gap due to a last-minute rush of demand prior to the consumption tax hike, and a subsequent drop to around zero.

The y-o-y change of the core CPI (excluding fresh food) has emerged out of negative territory from the turn of the year in 2017 and reached +0.9% as of December 2017, reflecting the recovery of crude oil prices. At the same time, CPI excluding fresh food and energy only rose +0.3%. Looking forward, crude oil prices are forecast to follow an upward path, due to factors such as the improvement of the supply-demand balance due to crude oil output cuts. As a result, the y-o-y change of the core CPI is forecast to rise mainly in energy prices, and temporarily reach the 1%-level in mid-FY2018. On a fiscal year basis, the core CPI in FY2018 should stand at +1.1% y-o-y (FY2017 estimate: +0.7% y-o-y). In FY2019, the core CPI is forecast to fall to +0.8% y-o-y (excluding the impact of the consumption tax hike, hereafter the same), reflecting the slowdown of the rise of crude oil prices. On the other hand, the CPI excluding fresh food and energy should reach +0.4% y-o-y in FY2018 (FY2017 estimate; +0.2% y-o-y) and more or less flatten out in FY2019 (+0.5% y-o-y), considering that the pace of wage rise is still modest. The stable achievement of the BOJ's inflation target of 2% will still require more time.

[Chart 3: The output gap and inflation rate]



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*

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