Mizuho Economic Outlook & Analysis

December 2016

FY2016, FY2017 Economic Outlook
The global economy will gradually pick up.
Will Trump change the world?

The Japanese economy will lift off from the landing and follow a gradual recovery

- As the global economy should start to pick up toward 2017, president-elect Donald Trump's fiscal expansion stance may serve as a driver of the global economy. On the other hand, in the event the US takes a protectionist trade stance, the risk of the contraction of global trade may arise. The Japanese economy is projected to lift off from the landing and follow a gradual recovery due to the improvement of the IT cycle and the impact of the economic stimulus measures. Even so, it will be necessary to continue to watch any signs of downside risks.

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1. The global economy improved in the Jul-Sep quarter of 2016

The global economy picked up in the Jul-Sep quarter of 2016, as shown by the improvement of business confidence among both the emerging market (EM) and developed market (DM) economies. Among the DM economies, the pace of real GDP growth rose in Japan, the US and the Eurozone. US growth rose above 2% for the first time in four quarters. In the Eurozone, economic growth rose slightly above the previous quarter, driven mainly by consumer spending. The Japanese economy achieved positive growth for three consecutive quarters, mainly due to the improvement of external demand.

The Chinese economy grew +6.7% y-o-y, levelling off for the third quarter in a row, indicating the firmness of the economy buttressed by investment in infrastructure stemming from the government's economic stimulus measures. In other Asian economies, even though the rate of economic growth sagged in Singapore and South Korea due to temporary factors, the pace of growth accelerated in many of the countries due to the upturn of exports. Furthermore, the economies of Russia and Brazil which had been falling have started to show signs of bottoming out due to the upturn of prices of commodities such as crude oil.

While the global economy should follow a gradual recovery in 2017, developments may change depending upon the US policy agenda.

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	3.6	3.4	3.3	3.6
Japan, US, Eurozone	1.6	2.1	1.4	1.6
US	2.4	2.6	1.5	2.1
Eurozone	1.2	2.0	1.6	1.1
Japan	-0.0	0.6	0.7	1.0
Asia	6.4	6.1	6.1	6.0
China	7.3	6.9	6.7	6.5
NIEs	3.4	1.9	1.9	2.1
ASEAN5	4.6	4.8	4.8	4.6
India	7.0	7.2	7.6	7.5
Australia	2.7	2.4	2.8	2.5
Brazil	0.1	-3.8	-3.2	1.2
Russia	0.7	-3.7	-0.7	1.0
Crude oil price (WTI, USD/bbl)	93	49	43	55

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.

2. While the global economy should follow a gradual recovery in 2017, developments may change depending upon US policy agenda.

In 2016, the pace of global economic growth (the total of MHRI's forecast area, regional average) is forecast to stand at +3.3% y-o-y, falling for the second year in a row. In 2017, we expect a rise to +3.6 y-o-y for the first time in three years (**Chart 1**). The main engines of the acceleration of growth are the improvement of the US economy and the rise of Brazil and Russia's economic growth out of negative territory. Although we expect a gradual global recovery in 2017 as our main scenario, the total growth of Japan, the US and the Eurozone and the overall growth of the Asian economies will fall below the level in 2015, thus generally lacking in strength and remaining vulnerable to downside risks. Furthermore, both upside and downside scenarios are possible depending upon the policy direction of president-elect Donald Trump.

Even though US economic growth is expected to come under downward pressures and remain around 1.5% on a full-year basis in 2016 due to the appreciation of the dollar and the fall of crude oil prices in the first half of 2016, the pace of economic growth should return to the 2%-level in 2017. As long as the dollar and crude oil remain on a gradual upward trend, exports and capital investment will continue to pick up, leading to solid consumer spending reflecting the improvement of employment conditions, which keep supporting the economy. If the fiscal expansion policy measures expected under the new administration are implemented, the fiscal spending would serve to push up economic growth from around the end of 2017. If the tax cuts are not retroactive, it would lift the rate of economic growth from around the turn of the year in 2018. (If there are retroactive measures, it would push up GDP from around mid-2017.) Furthermore, in the event expectations drive up asset prices, it would serve to stimulate the economy very soon. On the other hand, in the event future uncertainties deepen as a result of protectionism, xenophobia and isolationist foreign policy & national security stance, they would serve as a negative risk upon the economy. Our latest economic outlook does not factor in these policy implications in our forecast. However, our outlook shall be updated upon a careful analysis of the scale and reality of the policies.

The Eurozone economy is forecast to slow down for two years in a row in 2016 and 2017. In 2016, even though the economy showed signs of acceleration due to the fall of crude oil prices at the beginning of the year, the rise of uncertainties reflecting the UK's decision to exit the EU ("Brexit") led to a gradual slowdown of the pace of economic recovery. Even though consumer spending should continue to recover in 2017, lingering uncertainties due to Brexit may lead to restraints upon corporate investment and serve as downward pressures upon the rate of economic growth. Moreover, since the fiscal deficit of the Eurozone as a whole is expected to contract slightly, it will also be difficult to expect fiscal policy to push up the economy.

The rate of China's economic growth should remain more or less unchanged as the government reinforces its economic support measures toward the end of 2016. However, the economy should start to slow down again as the stock adjustment in the manufacturing sector in 2017 pushes down the rate of economic growth. Even so, the slowdown should remain mild due to a slight upturn of exports and support provided by infrastructure investment. Despite the likelihood that the tax cut on car purchases which supported consumer spending in 2016 will be extended in 2017, its impact upon the economy should be benign.

Turning to the Asian economies excluding China, exports should gradually pick up along with the recovery of IT demand and upturn of US growth in 2017. Moreover, the weakening of Asian currencies due to the restart of US interest rate hikes should also serve as a positive factor. On the other hand, the Asian economies (excluding China) should continue to flatten out in view of the contraction of the impact of fiscal and monetary policy measures.

3. Will the new Trump administration serve as a game changer?

In recent years, countries around the world have resorted to economic stimulus measures comprised mainly of monetary policy measures amid low global economic growth and low inflation stemming from stagnant investment among the DM economies and the slowdown of EM economies. However, since last year, there has been a global rise of awareness toward fiscal policy, amid concerns regarding the sustainability of asset purchases and the adverse effect of the negative interest rate policy (NIRP) mainly among Japan and the Eurozone which have continued to implement large scale monetary easing policies. Amid these circumstances, Donald Trump – an advocate of massive fiscal expansion – was elected as US president. The scale of tax cuts advocated by Mr. Trump surpasses the tax cuts under Reaganomics of the Reagan administration. If implemented, it would not only push up the rate of US economic growth but may also trigger a shift of global monetary and fiscal policy. In such event, the rate of global economic growth could be pushed up, possibly lifting the economy out of stagnant growth at least on a temporary basis.

Nevertheless, it should be noted that such fiscal expansion policy measures are accompanied by side effects. Reaganomics led to the expansion of the twin deficits in the budget and trade balance. The Trump administration's fiscal expansion policy also possesses the possibility of depressing the future course of the economy due to the rise of interest rates caused by the expansion of the fiscal deficit. Along with the so-called "crowding out effect", an excessive appreciation of the US dollar would have an adverse impact not only upon the US economy but also the EM economies through the acceleration of inflation, the excessive debt problem and capital outflow.

On the other hand, some commend Reaganomics for raising corporate competitiveness, thus spurring innovation from the 1990s onward and contributing to the rise of productivity. Amid concerns regarding secular stagnation, it is uncertain whether the new Trump administration's fiscal expansion measures and deregulation will succeed in raising US productivity. Even so, it is also true that these measures possess such possibilities mentioned above.

As explained above, if president-elect Donald Trump's fiscal expansion stance succeeds in shifting the global monetary and fiscal policy currents, it may serve as a driver of the global economy. On the other hand, if the US takes a stronger protectionist stance, the risk of the contraction of global trade may arise. Keep a close eye upon forthcoming developments on whether the new Trump administration will serve as a game changer of the global economy in both favorable and unfavorable connotations.

4. Japan's economic growth is forecast to level out in FY2016 (+0.9%) and pick up in FY2017 (+1.0%) given the full-fledged implementation of economic stimulus measures

The Japanese economy grew +0.5% q-o-q (+2.2% in annualized terms) in the Jul-Sep quarter of 2016 (the *First Preliminary Quarterly Estimates of GDP*, the "*1st QE*"), remaining in positive territory for the third quarter in a row. Given the upturn of exports, external demand (q-o-q contribution +0.5%pt) served as a strong driver of growth. The results suggest that the Japanese economy is about to lift off from the landing continuing since mid-2015. However, since the upturn of exports stems largely from temporary factors such as shipments of parts for new smartphone models, and in view of the weakness of the twin pillars of domestic demand – consumer spending and capital investment – we still cannot say that the Japanese economy has returned to a self-sustained recovery in the Jul-Sep quarter.

Forecasting the Japanese economy from the Oct-Dec quarter onward, while the temporary factors which pushed up growth in the Jul-Sep quarter will gradually fade, the implementation of public works accompanying the economic stimulus measures will serve as underpinnings, leading to a gradual recovery of the economy. Even so, it will be necessary to keep a close eye upon downside risks.

Looking closer at the components of demand, while we said that exports in the Jul-Sep quarter picked up due to temporary factors cited above, the export recovery should remain tepid due to persisting drags such as the weakness of global capital investment.

Turning to domestic demand, public sector demand should follow firm footing due to the early implementation of the initial FY2016 budget and the additional economic stimulus measures. Capital investment should gradually pick up, albeit accompanied by some fluctuation, considering the steady demand to renew existing equipment.

Consumer spending should also recover gradually along with the improvement of the employment environment. However, given the sharp rise in price of household necessities such as fresh food due to the bad weather in the summer, we should be cautious about the lingering risk that household thrift-consciousness may rise again.

In view of the foregoing, the pace of Japan's real GDP growth is forecast to flatten out from FY2015 at +0.9% in FY2016 (**Chart 2**). Even though we expect the economy to pick up in the second half of the fiscal year, the stagnation in the first half of the fiscal year drags down the full-year growth rate of FY2016. On the other hand, we expect a slight rise of economic growth in FY2017 (+1.0%) along with the full-fledged implementation of the economic stimulus measures. The rate of contribution by public demand to GDP growth is expected to rise slightly above 40% in both FY2016 and FY2017 (approximately 20% in FY2015), revealing that the Japanese economy will continue to be supported by public demand during our forecast horizon.

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)	(Actual)	(Forecast)	(Forecas)	(Forecast)
Real GDP	-0.9	0.9	0.9	1.0	0.9	0.1	1.4	0.8	1.1	1.3
Domestic demand	-1.5	0.8	0.8	1.1	1.3	-0.2	1.1	1.1	1.0	1.1
Private sector demand	-1.9	0.8	0.6	0.9	1.5	-0.4	1.1	0.7	0.8	1.0
Personal consumption	-2.9	-0.1	0.6	0.9	-0.7	-0.4	1.1	0.6	1.0	1.1
Housing investment	-11.7	2.4	6.6	-5.2	7.2	0.1	12.6	1.2	-9.5	-2.0
Capital investment	0.1	2.1	0.5	1.6	1.8	2.6	-0.9	1.5	1.7	1.4
Public sector demand	-0.3	0.7	1.5	1.7	0.8	0.5	1.2	2.6	1.5	1.3
Government consumption	0.1	1.6	1.3	1.3	1.4	2.4	0.6	1.7	1.2	1.1
Public investment	-2.6	-2.7	2.1	3.5	-1.5	-7.7	3.9	6.4	3.1	2.1
Net exports (contribution)	0.6	0.1	0.1	-0.0	-0.4	0.3	0.3	-0.4	0.0	0.0
Exports	7.9	0.4	0.6	2.6	-4.2	0.7	-1.0	3.9	2.1	2.4
Imports	3.4	0.0	0.0	2.8	-1.7	-0.8	-2.5	6.0	1.9	1.3
GDP (nominal)	1.5	2.3	1.0	0.9	2.5	0.9	1.2	0.3	1.1	1.2
GDP deflator	2.5	1.4	0.0	-0.1	1.6	1.2	0.3	-0.2	-0.2	0.0
Industrial production	-0.5	-1.0	0.5	1.9	-1.2	-1.0	0.4	1.3	0.9	0.6
Unemployment rate	3.5	3.3	3.1	3.0	3.4	3.3	3.1	3.0	3.0	3.0
Current account balance (JPY trillion)	8.7	18.0	20.0	18.0	15.9	19.5	19.1	19.9	17.0	17.9
Domestic corporate goods prices	2.7	-3.2	-2.7	1.4	-2.9	-3.6	-4.0	-1.4	1.0	1.8
Consumer prices (ex fresh food)	2.8	-0.0	-0.2	0.9	-0.0	-0.1	-0.5	-0.1	0.6	1.1
Consumer prices (ex fresh food, ex consumption tax hike)	0.7	-0.0	-0.2	0.9	-0.1	-0.1	-0.5	-0.1	0.6	1.1
Consumer prices (ex food (ex alcohol) and energy, ex consumption tax hike)	0.5	0.5	0.2	0.2	0.5	0.6	0.3	0.0	0.1	0.3
Long-term interest rate (%)	0.48	0.29	-0.07	-0.05	0.40	0.18	-0.12	-0.05	-0.05	-0.05
Nikkei stock average (JPY)	16,273	18,841	16,900	18,400	19,730	17,951	16,500	17,400	18,050	18,800
Exchange rate (JPY/USD)	110	120	105	106	122	118	105	105	105	107
Crude oil price (WTI, USD/bbl)	81	45	47	58	53	38	46	49	54	61

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.

5. The new Trump administration's policy agenda will serve as both upside and downside factors for the Japanese economy

US president-elect Donald Trump's policy agenda draws attention as a major factor possessing tremendous implications upon the future of the Japanese economy. Among the key points to be watched are (1) the financial market's response, (2) US economic growth, (3) the direction of trade policy, and (4) the rise of uncertainties.

Directly following the outcome of the presidential election, the moderate tone of Mr. Trump's victory speech has led to expectations toward a shift to a pragmatic stance, leading to a favorable evaluation by the financial market to the new Trump presidency (key point 1), raising expectations that his aggressive fiscal policy stance and deregulation will lift the US economy (key point 2).

However, the entire picture of the new administration is yet unclear. If the strict immigration measures advocated during the election campaign are implemented, US economic growth would be subject to downward pressures, leading to adverse effects upon the Japanese economy (key point 2). Also, in the event of a sharp rise of tariffs, it would push down Japan's exports through its impact upon global supply chains (key point 3). Depending upon Mr. Trump's comments, the sharp rise of uncertainties raising the risk of a wait-and-see stance regarding capital investment may not be ruled out (key point 4). Looking forward, it would be necessary to monitor the developments of the new administration and assess both the upside and downside risks upon the Japanese economy.

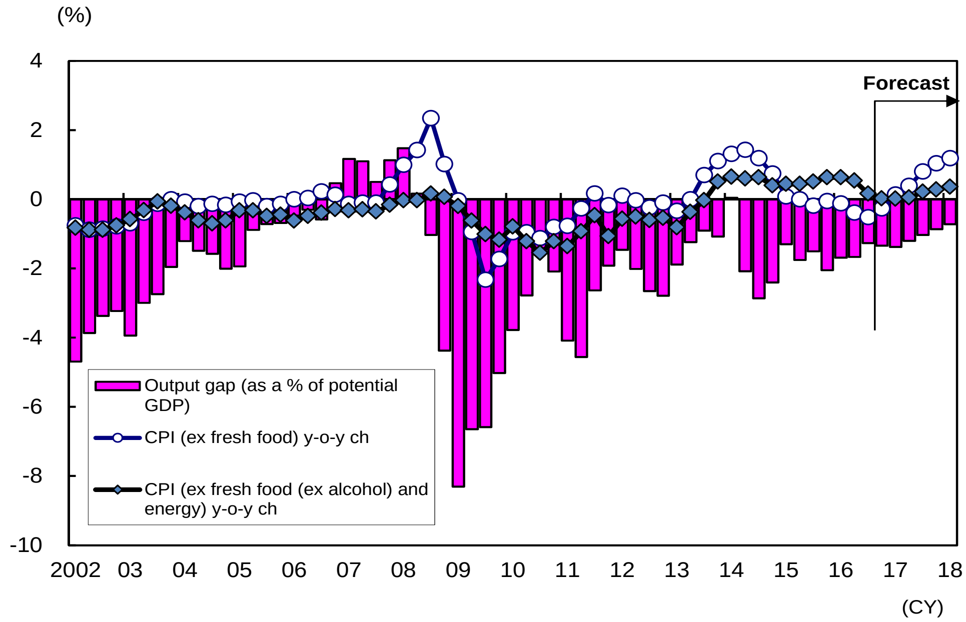
6. Core inflation rate should remain around the 1% y-o-y level in FY2017

According to calculations by MHRI, the output gap (the difference between actual and potential GDP) stood at -1.3% of potential GDP (which means an excess of supply by approximately JPY7 trillion) as of the Jul-Sep quarter of 2016 (**Chart 3**). Based upon MHRI's latest *Economic Outlook*, the excess supply in the output gap is projected to gradually contract as the level of economic activity rises due to a mild 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 early spring of 2016, reflecting the fall of crude oil prices and appreciation of the yen, and stood at -0.4% as of October 2016. Looking forward, the core CPI should be 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. The y-o-y change of the core CPI is forecast to edge up into positive territory after the turn of the year in 2017, rising 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 should rise to +0.9 y-o-y in FY2017.

However, for prices to rise stably, wages must rise at a faster pace than the rise of inflation. If the pace of wage increase falls short of the inflation rate, household real income would erode, and serve as negative pressures upon inflation thereafter due to restraints upon consumer spending. To forecast wage trends in 2017, the tightening of labor market conditions serves as a positive factor while the stagnation of corporate earnings and prices in 2016 are negative factors. In view of the foregoing, the wage hike rate in the 2017 labor-management wage negotiations in spring (*shunto*) is forecast to fall slightly to 2.10% (2016: 2.14%). In the event the wage hike rate turns out to be around 2.10%, the rise of base wages excluding the annual regular wage increase (around 1.8% to 2.0%) would be approximately 0.1% to 0.3%. The rise of wages would be insufficient in contrast to the inflation forecast in the second half of 2017 (1%-level).

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.