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2019 Economic Outlook

The greatest risk to the global economy in 2019 - a return to 2016?

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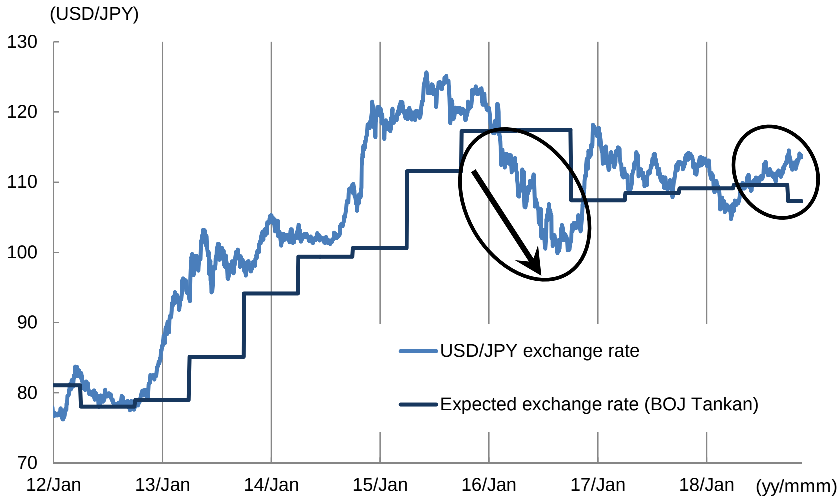
1. Chief Economist's perspective – a transition from the Heisei era which endured the collapse of the bubble

(1) The greatest risks in 2019 are a global economic slowdown and a return to 2016

The stagnation since the collapse of the *Heisei* economic bubble stemmed from a vicious cycle brought about by a super-strong yen and asset deflation. On the other hand, the achievements of *Abenomics* since 2012 benefited from the virtuous cycle where the yen weakening beyond the expected exchange rate sent stock prices higher. In other words, the success of *Abenomics* was achieved as extreme monetary easing severed the vicious cycle of the super-strong yen and stock market fall. It was in 2016 that the virtuous cycle since 2012 was interrupted for the first time. **Chart 1** shows that the virtuous cycle of the yen-weakening fell apart in 2016. The concerns today are the downturn of both the Chinese economy and IT cycle which had served as the drivers of the global economic recovery. As in 2016, the largest risk in 2019 is an interruption of the virtuous cycle due to the appreciation of the yen above the expected exchange rate. Looking at **Chart 1**, there is some relief that the expected exchange rate is

[Chart 1: Changes in USD/JPY exchange rate and the expected exchange rate]



Note: The expected exchange rate is based on BOJ Tankan's Manufacturing, Large Enterprises. See the assumed exchange rate in the March survey for the first half and in the September survey for the second half.
Source: Made by MHRI based on Bank of Japan, Datastream

still following a virtuous cycle. Yet, there is the risk of a return to 2016 in the event the US Federal Reserve shifts its interest rate appreciation cycle. The concern in 2019 is a return to 2016, or more specifically, a deterioration of business sentiment and a return of the nightmare scenario where the monetary and financial authorities were compelled to resort to extreme monetary easing (including negative interest rates) and the postponement of the consumption tax hike.

(2) In 2019, the transition from the *Heisei* period will encourage Japan to return to a "normal country" from a bubble-collapse mindset

In the foregoing section, I wrote that the global economy may enter an adjustment phase in 2019. Of course, this does not mean a global recession such as a financial crisis. However, considering that even the US economy, the primary driver of the global economy, has been pushed up by fiscal measures beyond its real strength, there is the probability of the global economy coming to a turning point toward 2020. As for Japan, there are lingering concerns that the Japanese economy may fall into a recession after the Tokyo 2020 Olympic and Paralympic Games (the "Tokyo Olympic and Paralympic Games"). There are even pessimistic views that the Japanese economy will fall into decline from 2020 and relapse into a "Frozen" world. This stems from the reasoning that in addition to an anticipated loss of momentum in construction demand after the Tokyo Olympic and Paralympic Games, the full-blown decline of the population and hollowing out of industry will lead to the ebb in global presence of the Japanese economy, in a far cry from revitalization.

On the other hand, I am keeping a distance from such pessimistic view and do not expect Japan to fall back into the "Frozen" world. After weathering debt adjustment pressures, the balance sheets of Japanese corporations and households are now sounder and displaying greater endurance than before. Amid structural shifts dubbed the "Fourth Industrial Revolution", emerging moves toward productivity improvement, centering on workstyle reform, represent a major shift. Furthermore, looking outward, the proximity to Asia, that can be expected to post high growth on the back of the rise of the middle class, places Japan in an advantageous position. If Japan can capitalize on its geographical advantage to take in Asia's growth potential, it could change Japan's future vision significantly. There are expectations that the change of era along with the new Emperor's accession in 2019 will usher in a change of mindset from the long years under a "Frozen" world to a "normal era" in line with developments overseas.

In the immediate future, despite some cyclical worries, 2019 is the year when we set our sights on what is coming in 2020 and beyond and the year when we become aware of a shift toward a new phase, including the change of the era name. In retrospect, the change of the era name from *Showa* to *Heisei* witnessed a phase of voluntary restraint as Japan as a whole went into mourning following the demise of Emperor Showa. This time around, on the other hand, we may expect a mood of celebration in response to the first living succession in 200 years and the new Emperor's accession to the throne. Japan will host the Rugby World Cup in 2019, and the Tokyo Olympic and Paralympic Games will be held in 2020. In addition, Osaka recently won its bid to host the 2025 World Expo. It should be noted that Japan is now counting down the menu ushering in a new era.

The year 2019, the last phase of the *Heisei* period, will set a new stage both for Japan and the world, requiring new long-term ideas running toward the 2020s. It may now be necessary for all corporations and investors alike to develop their own time axes for their business operations toward the 2020s.

(Hajime Takata, Chief Economist)

2. Messages from MHRI's overseas offices – focal points in 2019

(1) From New York: US politics and economy after the midterm elections

The US Congress is "divided" in 2019 following the midterm elections, with the Republicans expanding their majority in the Senate and the Democrats taking control of the House of Representatives. While the "divided Congress" may pave the way for increased infrastructure investment favored by the Democrats and tax cuts for the middle class that they should find it difficult to oppose, prospects for the second round of large tax cuts have dimmed. Meanwhile, the potential flash point in terms of relations with President Donald Trump is the right of the Democrats in the House of Representatives to initiate the proceedings to impeach the President. The US economy is expected to set a new record for the longest-running economic expansion in June 2019, bolstered by robust personal consumption. However, there were signs of a peak-out of business activities in the second half of 2018, such as the slowdown of capital investment. It is necessary to look out for the risk that intensified confrontation between the Trump administration and the Democrats could further restrain capital investment, leading to an economic slowdown.

(Atsushi Niigata, Chief Representative, New York Office)

(2) From London: where is the European Union (EU) heading?

2019 will likely be the year that will shape the future of the EU. The UK is set to leave the EU at the end of March, marking the first time for the EU to see the secession of a member state. It is feared that far-right and populist forces may advance in the European Parliament elections in May. While the draft medium-term EU budget for 2021-2027 sets forth increased allocations to immigration policy and science and technology promotion, deliberations are expected to face difficulties amid conflict of interest among member states. From October, the term of office will expire successively for European Central Bank (ECB) President Mario Draghi, European Commission President Jean-Claude Juncker, and European Council President Donald Tusk, setting the stage for selecting the new lineup of leaders who will lead the EU into the 2020s. The new leadership will have a heavy responsibility to guide the EU to greater integration by overcoming a variety of challenges.

(Yasuo Yamamoto, Chief Representative, London Office)

(3) From Singapore: Thai election may be put off again due to stagnant popularity of pro-military parties

The general election is set to take place between February and May 2019 in Thailand, which has been under military rule since the coup in May 2014. In Thailand, the Thaksin-affiliated government that rallied farmers in rural areas suffering from low income invited the revolt of urban residents who staged large-scale demonstrations to protest the government's pork-barreling policy and corruption, which ultimately led to a coup by the military which intervened to restore order. While current Prime Minister Prayuth Chan-o-cha of the military government hopes to retain the reins of power after the general election, his popularity is on the decline. Pro-military political parties are unlikely to gain a majority of seats by themselves, and no major party appears to come forward to form a coalition with pro-military parties at present. The military government has postponed the general election several times in the past. The possibility cannot be ruled out entirely of the military government putting off the general election once again.

(Hiroshi Inagaki, Senior Economist)

3. Outlook on the global economy in 2019 – recovery momentum likely to ebb gradually

◆ In 2019, the global economy is expected to see its recovery momentum ebb gradually, due to the slowdown of the Chinese economy and slowing demand for semiconductors serving as downward pressures. However, the global economy should retain its underlying strength, with the US economy providing support with its ongoing consumption-led growth. Even for the Chinese economy that is expected to slow down, our main scenario outlook only expects a moderate pace of slowdown due to the reinforcement of monetary and fiscal measures to support the economy.

◆ The risks to growth are the intensification of US-China trade tensions, a sharp slowdown of the Chinese economy, European political turmoil, including Brexit and Italy's budget deficit problem, and spread of concerns regarding the emerging market (EM) economies. The current situation has many similarities with the global slowdown in 2015-2016, including China's economic slowdown, the fall of the IT cycle into a slowdown, sharp fall of crude oil prices and European political turmoil. It is necessary to watch closely the risk of the global economy slipping into a similar slowdown.

[Chart 2: Outlook on the global economy]

(Y-o-y % change)

	2015	2016	2017	2018	2019
	Calendar year				
Total of forecast area	3.6	3.4	3.9	4.0	3.8
Japan, US, Eurozone	2.4	1.6	2.2	2.2	2.0
US	2.9	1.6	2.2	2.9	2.7
Eurozone	2.1	1.9	2.4	1.9	1.5
Japan	1.2	0.6	1.9	0.7	1.0
Asia	6.2	6.2	6.1	6.2	5.9
China	6.9	6.7	6.9	6.6	6.2
NIEs	2.1	2.4	3.2	2.7	2.3
ASEAN5	4.9	4.9	5.3	5.2	5.0
India	7.6	7.9	6.2	7.5	7.2
Australia	2.5	2.8	2.4	3.1	2.5
Brazil	-3.5	-3.3	1.1	1.4	2.4
Mexico	3.3	2.9	2.1	2.2	2.2
Russia	-2.5	-0.2	1.5	1.6	1.3
Japan (FY)	1.3	0.9	1.9	0.7	0.7
Crude oil prices (WTI, USD/bbl)	49	43	51	65	68

Note: Figures in the shaded areas are forecasts. The total of the forecast areas is calculated based on the 2016 GDP share (PPP) by the IMF

Source: Made by MHRI based on the IMF

4. Outlook on the Japanese economy in 2019 – despite continuing firmness, the pace of recovery may moderate due to the deceleration of exports

◆ Even though the Japanese economy should follow firm footing in 2019, reflecting the strength of consumption and investment demand, its pace of recovery is forecast to moderate due to the slowdown of external demand.

◆ Looking closer at the components, personal consumption should continue to follow firm footing due to prospects that disposable income will gradually increase reflecting the favorable employment environment. Despite a temporary fluctuation of personal consumption before and after the consumption tax hike, the impact is likely to be limited in comparison with the tax hike at the time of 2014 thanks to a variety of mitigation measures by the government. Capital investment is expected to show continued strength in view of deep-rooted corporate incentive for labor-saving investment. In contrast, exports are expected to stagnate going forward, reflecting the slowdown of the Chinese economy and a slower growth of IT demand, which had thus far served as the drivers of exports.

◆ The core consumer price index (CPI) (all items, excluding fresh food) is expected to see a slower increase, mainly due to a lull in rises in energy prices and policy measures serving as downward pressures, including free early childhood education.

[Chart 3: Outlook on the Japanese economy]

		2017 FY	2018	2019	2018 Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	2019 Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	2020 Jan-Mar
GDP (real)	Q-o-q % ch	1.9	0.7	0.7	-0.3	0.7	-0.6	0.5	0.5	0.3	0.6	-1.0	0.2
	Q-o-q % ch p.a.	—	—	—	-1.3	2.8	-2.5	2.0	1.9	1.1	2.4	-3.8	0.9
Domestic demand	Q-o-q % ch	1.5	0.7	0.8	-0.4	0.8	-0.6	0.4	0.4	0.4	0.9	-1.4	0.2
Private sector demand	Q-o-q % ch	1.8	0.9	0.6	-0.5	1.1	-0.7	0.4	0.4	0.4	1.1	-1.9	0.3
Personal consumption	Q-o-q % ch	1.0	0.6	0.7	-0.3	0.7	-0.2	0.4	0.2	0.4	1.5	-2.5	0.5
Housing investment	Q-o-q % ch	-0.7	-4.3	-1.5	-2.1	-1.9	0.7	1.2	0.7	1.4	-1.2	-4.2	-4.7
Capital investment	Q-o-q % ch	4.6	2.7	2.0	0.4	2.8	-2.8	1.2	0.6	0.5	1.0	0.3	0.3
Inventory investment	Q-o-q contribution, % pt	(0.1)	(0.0)	(-0.2)	(-0.2)	(0.0)	(0.0)	(-0.1)	(0.0)	(-0.1)	(-0.1)	(-0.1)	(0.0)
Public sector demand	Q-o-q % ch	0.5	0.1	1.2	0.0	-0.0	-0.2	0.4	0.6	0.3	0.2	0.2	0.0
Government consumption	Q-o-q % ch	0.4	0.7	0.8	0.2	0.1	0.2	0.2	0.2	0.3	0.2	0.0	0.1
Public investment	Q-o-q % ch	0.5	-1.7	2.9	-0.5	-0.5	-2.0	1.4	2.3	0.5	0.0	1.1	-0.4
External demand	Q-o-q contribution, % pt	(0.4)	(-0.0)	(-0.0)	(0.1)	(-0.1)	(-0.1)	(0.1)	(0.0)	(-0.1)	(-0.3)	(0.4)	(0.0)
Exports	Q-o-q % ch	6.4	1.9	1.8	0.5	0.3	-1.8	1.4	0.8	0.4	0.4	0.3	0.3
Imports	Q-o-q % ch	4.1	2.1	2.1	0.2	1.0	-1.4	1.0	0.6	0.9	1.9	-1.8	0.3
GDP (nominal)	Q-o-q % ch	2.0	0.7	1.1	-0.6	0.5	-0.7	1.1	0.3	0.2	0.4	-0.0	0.1
GDP deflator	Y-o-y % ch	0.1	0.0	0.4	0.5	0.0	-0.3	0.2	0.3	0.3	0.1	0.5	0.5
Domestic demand deflator	Y-o-y % ch	0.6	0.5	0.8	0.9	0.5	0.6	0.4	0.4	0.5	0.6	1.1	1.1

Note: Figures in the shaded areas are forecasts
Source: Made by MHRI based on the Cabinet Office, *National Accounts*

5. Outlook on the financial markets in 2019 – stock prices and long-term interest rates are both expected to rise at a gradual pace

- In the financial markets in 2019, even though both stock prices and long-term interest rates are expected to rise moderately mainly in the US as the economy follows firm footing, uncertainties regarding the future course of the global economy will serve as a drag. The rise of US stock prices is likely to moderate as the pace of improvement in corporate earnings slows down due to the fading impact of tax cuts. Despite expectations toward the rise of Japanese stocks along with the improvement of corporate earnings up until the first half of 2019, the stock market will tend to soften around the timing of the consumption tax hike.

- While US 10yr government bond yields are expected to move in the lower range of the 3% level against the backdrop of robust economic expansion, the breadth of rise is likely to be limited. German 10yr government bond yields are expected to rise moderately, factoring in the interest rate hike by the ECB. Yields on Japanese 10yr government bonds (JGBs) are likely to remain range-bound in the mid-1% level. Note that there is the possibility of the Bank of Japan (BOJ) reviewing its open-market operations to revitalize the markets.

- As for USD/JPY exchange rates, the US dollar is likely to rise against the yen due to US interest rate hikes on the back of favorable US economic fundamentals. As for EUR/USD exchange rates, the euro is expected to keep falling against the backdrop of deteriorating Eurozone economic fundamentals as well as concerns regarding European political uncertainties. However, the euro is likely to firm up by around the summer of 2019 by factoring in policy adjustments.

[Chart 4: Outlook on the financial markets]

		2017 FY	2018 FY	2019 FY	2018 Jul-Sep	2018 Oct-Dec	2019 Jan-Mar	2019 Apr-Jun	2019 Jul-Sep	2019 Oct-Dec	2020 Jan-Mar
Japan											
Uncollaterized overnight call rate	(End of period, %)	-0.06	-0.05	-0.05	-0.06	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05
Euroyen TIBOR	(3-mo, %)	0.06	0.07	0.06	0.08	0.05	0.06	0.06	0.06	0.06	0.06
Interest rate swaps	(5-yr, %)	0.10	0.13	0.15	0.12	0.13	0.15	0.15	0.15	0.15	0.15
Newly-issued JGBs	(10-yr, %)	0.05	0.10	0.15	0.09	0.13	0.15	0.15	0.15	0.15	0.15
Nikkei average	(JPY)	20,993	22,700	23,800	22,700	22,300	23,300	24,000	23,500	23,500	24,000
US											
Federal funds rate	(End of period, %)	1.50–1.75	2.50–2.75	3.00–3.25	2.00–2.25	2.25–2.50	2.50–2.75	2.75–3.00	3.00–3.25	3.00–3.25	3.00–3.25
Newly-issued government bonds	(10-yr, %)	2.41	3.10	3.35	2.90	3.20	3.30	3.30	3.40	3.40	3.30
Dow Jones average	(USD)	22,921	25,500	26,900	25,600	25,600	26,000	26,500	26,700	27,000	27,300
Eurozone											
ECB key policy interest rate	(End of period, %)	0.00	0.00	0.25	0.00	0.00	0.00	0.00	0.00	0.25	0.25
German government bonds	(10-yr, %)	0.44	0.45	0.75	0.40	0.40	0.55	0.60	0.70	0.80	0.80
Foreign exchange rate											
USD/JPY	(USD/JPY)	111	112	115	112	113	114	115	116	115	113
EUR/USD	(EUR/USD)	1.17	1.15	1.13	1.16	1.14	1.12	1.11	1.12	1.14	1.16

Note: Figures in the shaded areas are forecasts. The forecasts are the averages of the relevant periods. However, the uncollateralized overnight call rate, federal funds (FF) rate, and the policy interest rates of the European Central Bank are end-of-period rates.

Source: Made by MHRI based on Bloomberg