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FY2017, FY2018 Economic Outlook

Even though the global economy is continuing to grow, the "new normal" is a world of low inflation and low interest rates

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Even though the overall global economy should continue to grow, the upward momentum will gradually moderate

The global economy grew strongly in terms of GDP growth in the Apr-Jun quarter of 2017. Japan, the US and the Eurozone all recorded growth above the previous quarter. Furthermore, despite forecasts of a slowdown, the Chinese economy also grew on par with the previous quarter on a year-on-year basis. Even though the rise of the global manufacturing PMI moderated up to July, it is still indicating the underlying strength of the economy.

Looking forward, the composite leading indicators of the OECD, which provide an outlook on economic conditions six months ahead, are still following an upward trend up to June. Mizuho Research Institute's (MHRI) outlook on the global economy in FY2017 and FY2018 also forecasts a mild recovery due to the recovery of developed market (DM) countries and the recovery of commodity-producing countries. However, the upward momentum will gradually moderate as the Chinese economy slows down and the IT cycle runs its course in 2018 (**Chart 1**).

[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	3.5	3.4	3.8	3.8
Japan, US, Eurozone	2.3	1.5	2.0	1.9
US	2.9	1.5	2.1	2.2
Eurozone	2.0	1.8	2.0	1.8
Japan	1.1	1.0	1.7	1.2
Asia	6.2	6.2	6.1	6.1
China	6.9	6.7	6.8	6.4
NIEs	2.0	2.3	2.6	2.4
ASEAN5	4.8	4.9	5.0	5.1
India	7.5	7.9	7.1	7.5
Australia	2.4	2.4	2.2	2.8
Brazil	-3.8	-3.6	0.5	1.9
Mexico	2.6	2.3	1.9	2.1
Russia	-2.8	-0.2	1.0	1.5
Crude oil price (WTI, USD/bbl)	49	43	50	52

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

MHRI has held the view that the global economic recovery from the second half of 2016 stems from factors such as the improvement of the IT cycle, the upturn of the Chinese economy, and rise of commodity prices. Of these positive factors, the IT cycle and upturn of the Chinese economy should gradually peak out. Firstly, regarding the IT cycle, IT-related indicators in South Korea and Taiwan are showing signs of a peak-out. Among the plausible background factors are thought to be a pause in China's smartphone boom, sluggish sales of current iPhone models prior to the launch of its new model. On the other hand, global semiconductor sales are moderating but are still following an upward trend. Although a slowdown is expected ahead, the sale of the new iPhone scheduled this autumn in addition to the rise of demand for Internet of Things (IoT), in-vehicle devices, and cloud servers should serve as underpinnings and keep the slowdown benign. Therefore, it is not necessary to be overly concerned about the impact of the slowdown of the IT cycle upon the global economy.

The Chinese economy has been picking up from the second half of 2016. However, the relatively strong growth in the Apr-Jun quarter of 2017 may have been enabled by inventory growth. Furthermore, given the upturn of commodity market conditions, the slight easing of production adjustments in the mineral resources and raw materials sectors is leading to a sharp contraction of the positive production-to-inventory balance of the overall manufacturing sector. Judging from these conditions, domestic demand is forecast to come under downward pressures stemming from inventory adjustment. The Chinese economy is also subject to a large number of structural problems such as excessive production capacity, the accumulation of housing stock in small and medium-sized cities, and excessive debt, which are all serving as negative pressures upon growth. In addition, ever since monetary policy was shifted from "prudent" to "prudent and neutral" at the end of last year, market interest rates have been guided slightly higher and the financial environment has been tightening due to stronger financial oversight. These factors will likely serve as restraints upon investment. Even so, while the government is taking deleveraging steps and trying to curb a housing bubble, it is expected to take measures to support the economy because of concerns regarding the adverse effect of a sharp tightening upon the real economy and financial system. Thus, the Chinese economy is forecast to gradually slow down. Even though China's economic slowdown will serve as a drag upon the global economy, its impact upon the overall global economy should be limited due to the moderate pace of slowdown.

Inflationary pressures will not rise despite the recovery of the global economy

As explained above, while the upward momentum will gradually ebb, the global economy should remain on an expansion track. However, despite these conditions, global inflation rates are actually falling, or are being sapped of upward pressures. In the background to the low inflation level is a complex web of interacting factors including the lingering negative output gap which had expanded after the financial crisis and the ripple effect of the fall of commodity prices (mainly crude oil), and the decline of growth expectations stemming from the shortage of investment. In particular, the heavy drag upon the inflation rate among the DM countries is attributed to structural changes in the relationship between employment and wages. A look at the relationship between the rate of wage growth and the ratio of job openings to applicants in Japan, the US and Germany (job vacancies in Germany) reveals that the improvement of jobs due to economic recovery is not leading readily to the rise of wages as in the past in all of these countries.

Behind the structural shift leading to the sluggish rise of wages lies the worldwide fall of the labor share over the long term. Various factors such as technological innovation, globalization, and institutional factors may be serving to drag down the labor share. According to analysis by the International Monetary Fund (IMF), at least half of the decline of the labor share among DM economies may be explained by capital-labor substitution (the relative decline in price of investment goods accompanying technological innovation). Among the emerging market (EM) countries, the expansion of capital intensive industries along with the global integration of production networks is said to be the main factor behind the decline of the labor share. Turning to technological innovation, factors such as the "winner-gets-all" market structure (the concentration of value-added in a handful of companies driving the formation of industrial clusters and ecosystems), the progress of the "gig economy" (working styles using the Internet where free-lance independent contractors work on short-term jobs), and efforts to address the oft-cited uncertainty of R&D in the fourth industrial revolution may be facilitating the fall of the labor share (rise of capital share) in recent years. In addition, there are institutional factors such as the decline of workers' bargaining power due to the rising emphasis upon shareholder rights and the fall of labor unions' organizational strength, and the trend toward building ample internal reserves reflecting rising uncertainties regarding antitrust laws in software fields due to legal disputes over activities of US tech giants in Europe. Since the fall of the labor share is due largely to structural factors, as shown above, the stagnant rise of the inflation rate will likely persist over the medium to long term future.

Japan's economic growth is forecast to grow a strong +1.7% in FY2017, and continue to grow at a rate of +1.2%, above its potential rate of growth in FY2018

The Japanese economy grew a strong +1.0% q-o-q (+4.0% p.a.) in the Apr-Jun quarter of 2017 (based on the *First Preliminary Quarterly Estimates of GDP*), recording positive growth for six straight quarters for the first time in 11 years. While external demand served as a drag upon growth for the first time in six quarters reflecting the pause in recovery of the IT sector, private-sector demand rose dramatically due to the upturn of personal consumption and capital investment. Public demand also grew strongly, given the progress of the economic stimulus measures. The GDP data for the Apr-Jun quarter may be evaluated as confirmation that the global economic recovery from the second half of last year is spreading to Japan's domestic demand.

Forecasting the Japanese economy beyond the Jul-Sep quarter, the overseas economic recovery should continue to spread to Japan's exports and capital investment. Even though exports declined in the Apr-Jun quarter due to the slowdown in the IT sector, exports should return to a recovery track from the Jul-Sep quarter. In addition to the strength of exports of devices for data centers and in-vehicle devices, the launch of the new iPhone in the second half of the year should serve as underpinnings for IT-related exports. As for capital investment, the expected progress of projects related to the 2020 Tokyo Olympic Games and urban redevelopment, the increase of energy-saving and labor-saving investment reflecting the deepening labor shortage should serve as upside factors. In fact, quantitative analysis indicates that in the manufacturing sector, the higher the sentiment of labor shortage is, the more capital investment is facilitated. Turning to personal consumption, the improvement of consumer confidence is expected to serve as a positive factor, in view of the upturn of durable goods consumption, improvement of employment conditions, and solid stock market trends. In particular, the current recovery of personal consumption is driven by households working for small and medium-sized enterprises (SMEs), providing reasons to believe that a virtuous cycle is taking shape, where wage rises among SMEs are leading to the recovery of personal consumption. Despite fluctuations due to weather factors, personal consumption will most likely follow a gradual recovery. In view of the foregoing, the rate of Japan's economic growth is forecast to rise from +1.3% in FY2016 to +1.7% in FY2017 (**Chart 2**).

[Chart 2: Outlook on the Japanese economy]

(%)

	FY2015	FY2016	FY2017	FY2018	FY2016		FY2017		FY2018	
	(Actual)	(Actual)	(Forecast	(Forecast	1H (Actual)	2H (Actual)	1H (Forecast)	2H (Forecast)	1H (Forecast)	2H (Forecast)
Real GDP	1.3	1.3	1.7	1.2	1.6	1.5	2.5	0.6	1.3	1.4
Domestic demand	1.2	0.5	1.7	1.2	0.7	0.4	3.0	0.5	1.4	1.5
Private sector demand	1.2	0.8	1.9	1.3	1.4	0.8	3.1	0.8	1.3	1.5
Personal consumption	0.6	0.7	1.5	1.1	1.0	1.1	2.3	0.5	1.2	1.3
Housing investment	2.8	6.5	2.0	-1.7	10.5	4.1	3.6	-3.1	-2.2	1.0
Capital investment	0.6	2.5	4.7	1.6	1.6	5.3	5.9	1.7	1.8	1.2
Public sector demand	1.2	-0.3	1.0	1.0	-1.3	-0.9	2.5	-0.4	1.6	1.2
Government consumption	2.0	0.4	0.7	1.1	-0.9	0.2	0.8	0.9	1.3	1.1
Public investment	-1.9	-3.2	2.2	0.7	-2.2	-5.1	9.9	-5.4	2.8	1.7
Net exports (contribution)	0.1	0.8	0.1	-0.0	0.9	1.2	0.0	0.0	0.0	0.0
Exports	0.7	3.2	3.9	1.6	0.3	10.7	1.6	2.3	1.6	1.1
Imports	0.2	-1.4	3.6	1.9	-4.5	3.9	4.4	1.8	2.1	1.7
GDP (nominal)	2.7	1.1	2.0	1.6	1.1	1.1	3.2	0.4	2.3	1.5
GDP deflator	1.5	-0.2	0.2	0.5	0.1	-0.4	0.2	0.3	0.4	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 external demand is forecast to slow down reflecting the moderation of the IT sector and China's economic recovery, domestic demand should remain on firm footing. In addition to the continuation of the aforementioned urban redevelopment and capital investment to address the labor shortage, personal consumption is also expected to remain on a recovery path reflecting factors such as the end of the public pension premium hikes. Based upon the foregoing, the rate of economic growth is forecast to stand at +1.2%, remaining above the rate of potential growth which is estimated to be around 1%.

A look at the risk factors reveals that uncertainties are easing. However, in China, uncertainties still run high and require close attention with respect to the backlash to the current rise of inventories, the impact of the housing market tightening measures, and macroeconomic management subsequent to the National Congress of the Communist Party of China.

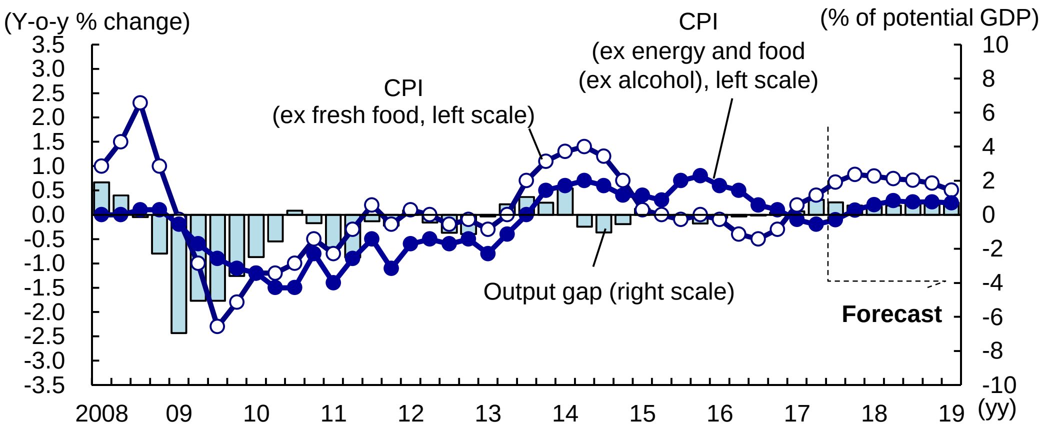
Apart from food and energy prices, the underlying trend in inflation will remain moderate

According to calculations by MHRI, the output gap (the difference between actual and potential GDP) stood at +0.9% of potential GDP (which means an excess of demand by approximately JPY4.6 trillion) as of the Apr-Jun quarter of 2017 (**Chart 3**). The level of the output gap has been revised upward as we modified the estimation method of the potential capacity utilization rate of the manufacturing sector.

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 +0.5% as of July 2017, reflecting the recovery of crude oil prices. On the other hand, when excluding the impact of energy prices, prices are continuing to hover low. 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.

The US-style core CPI is not rising much despite the excess of demand in the output gap. This stems most likely from the formation of a social norm where "neither wages nor prices are being raised" as a result of the fall of perceptions on wages and inflation in the corporate and household sectors due to wage cuts and deflation during the period from the late 1990s to the early 2000s following the collapse of Japan's bubble economy. Furthermore, these perceptions on wages and prices are being reinforced by various factors including institutional price setting in nursing care and price competition in the restaurant and retail sectors. In view of the foregoing, the y-o-y rise of the core CPI is forecast to rise temporarily to the upper half of the 0%-level in the second half of FY2017 as the recovery of crude oil prices ripples through to electrical power rates. With respect to the full-year, we forecast a rise from FY2016 (-0.2%) to +0.7% in FY2017. Since the impact of the rise of energy prices will linger in FY2018, the y-o-y change of 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 (FY2017: 0.0%, FY2018: +0.3%). The stable achievement of the Bank of Japan's inflation target of 2% will still require considerable time, given the high hurdle to dispel the "norm" of low inflation.

[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*