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FY2017, FY2018 Economic Outlook

The global economy will continue to grow throughout 2018

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The global economy is growing strongly and should remain on firm footing in 2018

The global economy overall is maintaining robust conditions. A look at the rate of GDP growth of major economies in the Jul-Sep quarter of 2017 reveals that both the US and Eurozone economies grew strongly surpassing their potential rates of growth, albeit slowing slightly from the previous quarter: the US economy +3% q-o-q p.a. (+3.1% q-o-q p.a. in the previous quarter), the Eurozone economy +2.5% q-o-q p.a. (+2.6% q-o-q p.a. in the previous quarter). Even though China's economic growth also fell slightly to 6.8% y-o-y from the previous quarter (+6.9% y-o-y), the results reveal that factors such as the rise of government consumption served to keep the economy on firm footing. The global manufacturing PMI, which indicates business conditions among corporate enterprises, improved to the highest level since 2011, driven by corporations in developed market (DM) countries.

Mizuho Research Institute Ltd. (MHRI) has been indicating that the global economic expansion stems from China's economic recovery and improvement of the IT cycle. These movements served to facilitate the self-sustained recovery of DM countries, which in turn led to the rise of asset prices such as stocks and real estate. Since the rise of asset prices also has a positive impact upon the economy through the expansion of consumer spending because of its wealth effect, a favorable cycle is taking hold between the real economy and the financial/asset markets.

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 September. MHRI's outlook on the global economy also forecasts that the global economy will remain on firm footing in FY2018 (**Chart 1**). The above-potential growth of DM countries and the recovery of commodity-producing countries reflecting the rise of commodity prices, as well as the domestic demand of ASEAN and recovery of India will serve as underlying support. However, the upward momentum will gradually moderate due to prospects that the Chinese economy will slow down and that the IT demand, albeit firm, will peak out in 2018.

Looking more closely at each of the countries, the US economy is forecast to continue to expand at a solid pace, growing +2.2% y-o-y, surpassing its potential rate of growth which falls below 2%. In the household sector, personal consumption should follow firm footing on the back of the growth of disposable income, rise of asset prices and the improvement of consumer confidence. We also predict that capital investment will continue to grow at a solid pace – mainly in machinery investment – as corporate enterprises take a more optimistic stance regarding investment. The Eurozone economy is also forecast to continue growing at a pace above potential. However, the pace of Eurozone growth is forecast to fall from +2.3% y-o-y in 2017 to +1.9% y-o-y in 2018. Personal consumption is forecast to slow down as the rise of inflation sends downward pressures upon household real income, and business fixed investment is also forecast to moderate due to a backlash to the sharp rise of intellectual property investment. Furthermore, while both exports and imports should follow an upward trend, the contribution of external demand to economic growth is predicted to contract since the rate of increase in imports will surpass the rate of increase of exports due to the replenishment of inventories. Turning to China, given the reinforcement of reforms to restrain investment and adjust excessive production capacity by the administration of Xi Jinping which consolidated its power through the Communist Party congress, the Chinese economy is forecast to gradually moderate in 2018, 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), even though China's economic slowdown will serve as downward pressures, the slowdown of exports should remain benign due to the strength of IT-related demand in the DM economies. In the ASEAN5, infrastructure investment and the positive effect of economic integration should push up demand within the region, leading to the stable growth of the economy. In India, the pace of economic growth in 2018 should accelerate mainly in consumer spending, given the fading impact of the abolition of large denomination banknotes which surfaced in 2017. As a result of the foregoing, the Asian economy as a whole should follow firm footing in 2018, with its slowdown being benign, as the countries and regions of Asia (excluding China) alleviate the moderation of the Chinese economy.

[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	3.9
Japan, US, Eurozone	2.3	1.5	2.1	2.0
US	2.9	1.5	2.2	2.2
Eurozone	2.1	1.8	2.3	1.9
Japan	1.1	1.0	1.5	1.4
Asia	6.2	6.2	6.1	6.0
China	6.9	6.7	6.8	6.4
NIEs	2.0	2.3	3.0	2.5
ASEAN5	4.8	4.9	5.2	5.2
India	7.5	7.9	6.6	7.3
Australia	2.4	2.5	2.3	2.8
Brazil	−3.8	−3.6	0.7	2.0
Mexico	3.3	2.9	2.0	2.0
Russia	−2.8	−0.2	1.5	1.5
Crude oil price (WTI, USD/bbl)	49	43	51	59

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

The risk factors: financial market anomalies, China's economic slowdown, geopolitical conditions

The risk factors to global economic growth are: (1) turbulence in the financial and asset markets, (2) China's unexpected economic slowdown, and (3) geopolitical risks. Firstly, as for (1), it is necessary in particular to keep a close eye upon a sharp fall of the US stock market. While the rise of the US stock market stems from the expansion of the global economy and improvement of corporate earnings, stock prices are overvalued from the perspective of stock valuation, making a market adjustment possible at any time. A likely trigger would be the rise of speculation that the US Federal Reserve will accelerate its pace of interest rate hikes. Turning to (2), as we wrote above, while the Chinese government is expected to spur its structural reforms subsequent to the Communist Party congress, there is the risk that the negative impact upon the economy may turn out to be larger than initially expected by the government. Considering that China's economic slowdown during the period from 2015 to early 2016 led to the slowdown of the global economy through various channels such as trade, commodity prices and financial markets, it would be necessary to stay alert even to a slight slowdown of the Chinese economy. Lastly, (3) the deterioration of conditions surrounding North Korea is the largest risk factor. The escalation of the North Korea crisis would lead readily to the appreciation of the yen due to risk aversion, and thus may serve as a negative factor for the Japanese economy and corporate earnings. In the event of military conflict, there is the possibility of attacks upon South Korea. In such case, it may send downward pressures upon the global economy through supply chain disruptions. Furthermore, it is necessary to keep a close eye upon conditions in the Middle East, such as the conflict between Saudi Arabia and Iran, and the rise of Kurdish independence movements. The deterioration of conditions in the Middle East may serve to raise risks such as the rise of crude oil prices, and European political risks through the problem of immigration. As for European politics, in addition to the general election in Italy which may serve as a disruptive factor, it would be necessary to keep a closes eye upon the risk of a collapse of Britain's negotiations to leave the EU leading to a "disorderly Brexit" (an abrupt change of tariffs and regulations) from the spring of 2019.

Japan's economic growth is forecast to grow a strong +1.5% 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 +0.3% q-o-q (+1.4% p.a.) in the Jul-Sep quarter of 2017 (based on the *First Preliminary Quarterly Estimates of GDP*), recording positive growth for seven straight quarters for the first time in approximately 17 years. Personal consumption declined and capital investment slowed down due to a backlash to the increase in the Apr-Jun quarter. The growth of public demand also dipped into negative territory due to the fading impact of the economic stimulus measures. On the other hand, net exports served as a large positive contribution, reflecting the recovery of IT-related exports. The GDP data for the Jul-Sep quarter may be evaluated as confirmation that the Japanese economy is maintaining its recovery momentum as it reaches the second longest economic expansion surpassing the Izanagi Boom (November 1965 to July 1970).

Forecasting the Japanese economy beyond the Oct-Dec quarter, the Japanese economy should remain on a gradual recovery track as exports continue to increase on the back of the recovery of overseas economies, and domestic demand also returns to an upward trajectory. Looking closer at the components of demand, in addition to the strength of demand for devices for data centers and in-vehicle devices, the supply of parts for the new iPhone should serve as drivers of exports. Furthermore, demand related to recovery from the hurricanes in the

US may lead to an uptick in automotive exports. Capital investment should return to a recovery track due to the expected progress of projects related to the 2020 Tokyo Olympic Games and urban redevelopment, and the increase of labor-saving and productivity-enhancing investment reflecting the deepening labor shortage. Turning to personal consumption, the improvement of consumer confidence reflecting factors such as the rise of the stock market, and the stabilization of fresh food prices from October, should serve as positive factors. 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 +1.5% in FY2017 (**Chart 2**). 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 investment for 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% in FY2018, remaining above the rate of potential growth which is estimated to be around 1%.

In a speech in October, Bank of Japan (BOJ) Deputy Governor Hiroshi Nakaso said that the Japanese economy is nearing a "true dawn". Likewise in MHRI's analysis, Japan's current economic recovery is characterized by the shortage of labor, and gradual improvement of the wage hike rate and prices. These characteristics indicate a change of corporate behavior from the stagnation in the "Lost Two Decades" and may be evaluated as signs of a "true dawn". However, the recovery of personal consumption still lacks strength. The pending task required to achieve the "true dawn" is to spread the signs of economic recovery to the entire household sector. For the time being, the focal point in the achievement of a "true dawn" would be how much the impact of the strong corporate earnings can be spread throughout the economy. In particular, the improvement of corporate earnings are expected to support personal consumption through the rise of the stock market (according to MHRI's analysis, the current rise of the stock market should raise personal consumption by 0.15%pt in the Oct-Dec quarter of 2017).

[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)	(Actual)	(Forecast)	(Forecast)	(Forecast)
Real GDP	1.3	1.3	1.5	1.2	1.8	1.3	1.9	1.2	1.3	1.1
Domestic demand	1.2	0.5	1.2	1.2	0.9	0.2	1.8	0.9	1.4	1.3
Private sector demand	1.2	0.8	1.2	1.3	1.6	0.5	1.5	1.2	1.4	1.3
Personal consumption	0.6	0.7	0.9	0.8	0.9	1.1	1.3	0.2	1.0	1.1
Housing investment	2.8	6.6	1.8	−0.9	10.6	4.3	2.3	−1.8	−1.4	0.8
Capital investment	0.6	2.5	2.9	2.8	2.5	4.2	1.7	4.2	2.8	1.6
Public sector demand	1.2	−0.4	1.1	1.0	−1.3	−0.9	2.6	−0.2	1.4	1.3
Government consumption	2.0	0.4	0.7	1.1	−1.1	0.3	1.0	0.7	1.3	1.3
Public investment	−1.9	−3.2	2.5	0.7	−1.8	−5.5	9.3	−3.3	2.1	1.1
Net exports (contribution)	0.1	0.8	0.4	0.0	0.9	1.1	0.0	0.0	0.0	0.0
Exports	0.7	3.2	4.8	2.0	0.5	10.4	3.0	3.2	2.0	1.0
Imports	0.2	−1.3	2.5	2.1	−4.4	4.0	2.6	0.9	2.7	2.2
GDP (nominal)	2.7	1.1	1.5	1.1	1.2	1.0	1.9	1.2	0.8	1.7
GDP deflator	1.5	−0.2	−0.1	−0.1	0.1	−0.5	−0.1	0.1	−0.3	0.0

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*

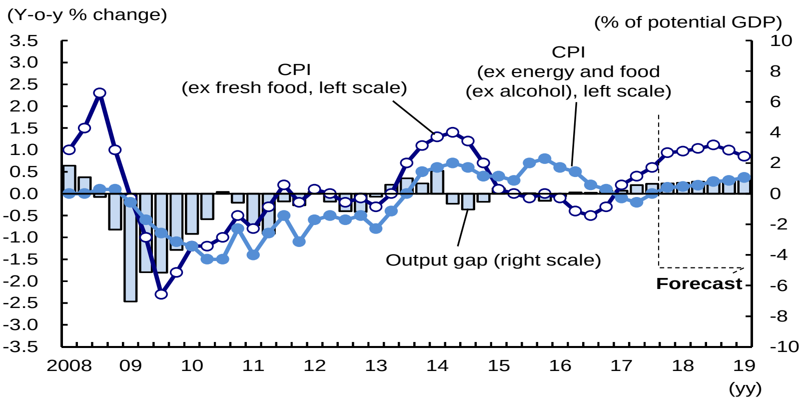
Apart from food and energy prices, the underlying trend in inflation will remain moderate

According to calculations by MHRI, the output gap (the difference between actual and potential GDP) stood at +0.6% of potential GDP (which means an excess of demand by approximately JPY3.4 trillion) as of the Jul-Sep quarter of 2017 (**Chart 3**). The output gap should remain in positive territory during the forecast horizon up to the Jan-Mar quarter of 2019 due to the ongoing recovery of the economy.

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 +0.7% as of September 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)) dipped into negative territory in February 2017 and is still at 0.0% as of September.

Looking forward, crude oil prices are forecast to follow a gradual upward path, due to factors such as the improvement of the supply-demand balance due to crude oil output cuts, and political destabilization in the Middle East. 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 FY2018. With respect to the full-year, we forecast the core CPI to rise from FY2016 (-0.2%) to +0.7% in FY2017 and rise +1.0% y-o-y in FY2018. 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%). This stems from expectations that the pace of wage increase - which is indispensable for the stable rise of prices – will turn out to be slower than presumed by the government and BOJ. The stable achievement of the BOJ's inflation target of 2% will still require considerable 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*