MHRI Brief January 1, 2018

2018 Economic Outlook

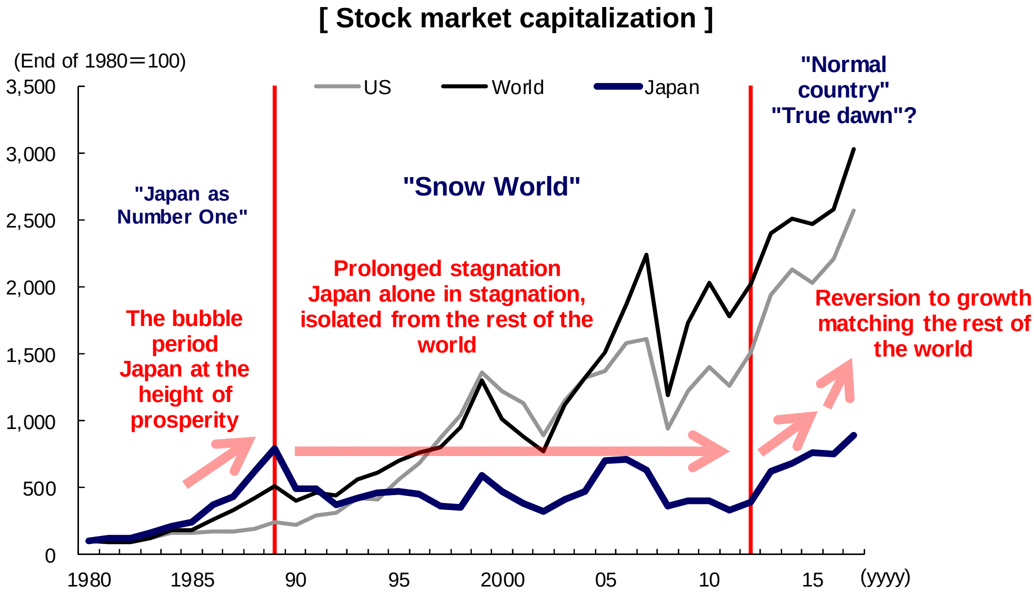
The global economy will remain on firm footing – Will Japan draw closer to a “true dawn”?

Mizuho Research Institute Ltd.

1. Chief Economist’s perspective - Will Japan draw closer to a “true dawn” ?

(1) Japan was trapped in a “Snow World” during the lost two decades since the days of “Japan as Number One” in the 1980s

Bank of Japan (BOJ) Deputy Governor Hiroshi Nakaso used the expression “true dawn” in his speech in October 2017. An evaluation of the expression “true dawn” is difficult due to the existence of various perspectives. Given the economic contraction stemming from balance sheet adjustments following the burst of the bubble in 1990, Japan found itself isolated in a snow-bound “spell” of asset deflation and yen appreciation in contrast to the rest of the world where the stock markets continued to rise. After more than a quarter of a century since the 1990s, there may be signs of improvement in Japan’s snow-bound mindset as a result of five years of *Abenomics* which has melted the “snow” of asset deflation and the yen appreciation, as well as expectations that the current reforms may continue for several more years into the 2020s. These may be construed as signs of a “dawn.” Of course, the chances are extremely slim that Japan will return to the days of “Japan as Number One” in the booming 1980s. Even so, in 2018, we may see a more wide-spread perception that Japan has returned to a normal state with its growth trend matching the rest of the world after years frozen in snow (refer to the graph on the next page). The year 2018 marks the 150th anniversary of the Meiji Restoration. In addition to the 2020 Tokyo Olympic Games, the environment for economic revitalization with a vision extending to the 2020s is beginning to change views on Japan.



Note: Market capitalization for 2017 is the figure as of the end of November. 2017
Source: Made by MHRI based on WFE, Bloomberg, and Tokyo Stock Exchange.

(2) In 2018, Japan will return to a "normal country" after a decade since the Lehman Crisis

In retrospect, 2016 was a challenging year for Japan, with the yen appreciating sharply from the beginning of the year, necessitating a retreat from *Abenomics* . Overseas, analysts described this situation as the "death of *Abenomics*," and the BOJ was compelled to reexamine its policy in a comprehensive assessment. In 2017, while the global economy recovered, approval ratings of the administration under Prime Minister Shinzo Abe declined, and overseas analysts grew skeptical about the survival of the Abe administration. However, given the victory by the ruling coalition in the general elections in October 2017, *Abenomics* appeared to come back to life. During my visit to the US in November, I was surprised at the change in overseas investors' views on the Japanese stock market. There have been definite changes in views on two factors, one external and the other domestic. Externally, if Prime Minister Abe wins a third consecutive term in the presidential election of the ruling Liberal Democratic Party (LDP) in 2018, he could form a stable government that can last up to 2021, with Japan joining the "Club 21" to catch up with the governments of other major countries, such as the US and China. At home, while five years of *Abenomics* fell short of resuscitating the sentiment that sagged due to nearly 20 years of balance sheet adjustments, expectations emerged that the government will maintain its focus on economic activities until the 2020s. As referred to as adaptive expectations, the expectations are that the resuscitation of the mindset from the sharp decline over the past two decades may only be achieved through continued reform efforts of at least 10 years.

Prime Minister Abe, who has now become the third longest-serving prime minister in the postwar period past former Prime Minister Junichiro Koizumi, is set to mark the longest term in office in the postwar period at the end of 2019 and may even become the longest since the Meiji Restoration. The Japanese themselves need to realize once again that Japan's relative presence in the world is improving in terms of government stability. Globally, 2018 marks a 10-year milestone since the collapse of Lehman Brothers in 2008 (the "Lehman Crisis"), indicating signs of a shift from crisis-mode. In 2018, the world will see a new capital market in the post-

Lehman Crisis period, and Japan will emerge out of the prolonged post-bubble recession since the 1990s. These reflect the strength of the global economy after its emergence out of a phase of “simultaneous mourning”. At the same time, however, we should stay alert to excesses stemming from excessive optimism. In terms of global politics, the world will shift into a new global order encompassing not only the US and Europe but also China, Russia and India, with a vision toward the 2020s. Under the new global order, there is no end to concerns regarding geopolitical risks around the world.

The year 2018, the last phase of the *Heisei* period, will set a new stage both for Japan and the world, requiring new ideas running toward the 2020s. While the 2020 Tokyo Olympic Games provide the chance to develop forward-looking outlooks for the first time since the burst of the bubble, it may now be necessary for all to develop a chronological time perspective toward the future.

(Hajime Takata, Chief Economist)

2. Messages from MHRI's overseas offices – Focal points in 2018

(1) From New York: Tax reform and US politics and economy in 2018

With only a few weeks remaining in 2017, discussions on tax reform, one of the key campaign pledges of US President Donald Trump, suddenly moved into high gear. The Trump administration has had few noticeable political achievements in the year since Donald Trump's election as president. Tax reform, if realized, will represent a major political victory ahead of the midterm elections in November 2018, regarded as a vote of confidence for the administration. Failure of the tax reform entails the risk of President Trump invoking protectionist trade measures, including a departure from the North American Free Trade Agreement (NAFTA). In addition, it could have an adverse impact on the US stock market that had advanced strongly in part because of high expectations on tax cuts, thereby posing a potential risk to the US economy. If agreement is reached on tax reform, thus eliminating any risk of turbulence, the likelihood of US politics and the US economy remaining stable would increase. That said, however, there still remains the risk that President Trump will go for protectionist policies for the purposes of chalking up a record of the administration's achievements or diverting voter attention from political scandal, including the "Russia-gate" issue.

(Atsushi Niigata, Chief Representative, New York Office)

(2) From London: Political uncertainty will continue to smolder in Europe in 2018

The European economy beat most expectations to grow strongly in 2017. In the French presidential election, regarded as the biggest political risk in Europe, centrist candidate Emmanuel Macron scored an overwhelming victory over far-right Front National (FN) leader Marine Le Pen to become the new president. In the German general elections in September, however, right-wing populist party Alternative for Germany (AfD) made enormous strides. Similarly in the elections held in October in Austria and Czech Republic, anti-immigrant rightist parties gained strength. These results apparently indicate deep-seated dissatisfaction with immigrant and refugee policies as well as austere fiscal policies of the European Union (EU).

In the spring of 2018, Italy is set to hold general elections. The results will require close attention as opinion polls indicate that the populist Five Star Movement (M5S), as well as the Northern League, another anti-EU party, are drawing considerable public support. What should be watched in the autumn of 2018 is the direction of the "Brexit" negotiations between Britain and the EU. Unless they conclude an agreement on post-Brexit trade relations or agree on the establishment of a transitional period, the risk of a "disorderly exit" will increase significantly. We need to keep a close eye upon political events in Europe in 2018.

(Yasuo Yamamoto, Chief Representative, London Office)

(3) From Singapore: Future course of Vietnam's auto market under the full enforcement of AFTA

Although tariffs within the Association of Southeast Asian Nations (ASEAN) were abolished in 2010, in principle, under the ASEAN Free Trade Area (AFTA) agreement, the tariff abolition for some items was postponed for the late-coming members of Cambodia, Laos, Myanmar and Vietnam (CLMV) as a measure to mitigate the impact of sudden changes. However, this transitional measure will come to an end, and all tariffs will be abolished in the CLMV countries as well in 2018. Drawing particular attention is the abolition of tariffs on finished vehicles in Vietnam, which has a relatively large and growing auto market. Automakers manufacturing vehicles in Vietnam (approximately 20 automakers) must address the increase of highly-competitive auto imports from Thailand. As steps to support domestic automakers, the government of Vietnam decided to (1) raise the special consumption tax rate on large vehicles, many of which are imported, while lowering the tax rate on small vehicles, many of which are domestically produced vehicles, and (2) abolish the import tariffs on automotive components and parts. Even so, domestic automakers are likely to face fierce competition and are exposed to pressures for industry reorganization. The overall Vietnamese economy may also come under some pressure from a possible deterioration in the trade balance due to increased imports of finished vehicles and a decrease in revenues due to the tariff abolition.

(Hiroshi Inagaki, Senior Economist)

(4) From Beijing: The start of General Secretary Xi Jinping's second term in office

With the start of his second term in office following the CPC National Congress in autumn 2017, Communist Party of China (CPC) General Secretary Xi Jinping is poised to set the government into action subsequent to the appointment of key government positions and adoption of the budget at the National People's Congress (NPC) in March 2018. Xi Jinping displayed his strong resolve to lead China's development by introducing the *Thought on Socialism with Chinese Characteristics for a New Era* carrying his name and setting out the goal of turning China into a "great modern socialist country" to rival the world's leading nations by the middle of the 21st century. However, a plethora of issues must be addressed. In addition to economic reforms such as the shakeout of zombie enterprises, elimination of excessive debt, market economy-based financial sector reforms and reform of state-owned enterprises, there is a broad range of extremely difficult issues such as social and environmental problems including the eradication of rural poverty and stronger measures against environmental pollution, and diplomatic relations with the US such as trade friction and the North Korea crisis. As the year 2018 marks the 40th anniversary of the launching of the reform and opening-up policy, which set China on the course of high economic growth, there are high expectations toward the acceleration of market-based economic reforms and further opening-up to the world. In 2018, attention will focus upon Xi Jinping's delicate balancing act of addressing these difficult challenges while maintaining economic stability.

(Yusuke Miura, Senior Economist)

3. Outlook on the global economy in 2018 – While the global will stay on firm footing, the financial markets and the Chinese economy require close attention

◆ In 2018, the global economy is expected to remain strong overall, sustaining the cyclical recovery since the second half of 2016. In addition to the growth of developed market (DM) economies above their potential growth rates and the recovery of commodity-producing countries reflecting the rise of commodity prices, domestic demand in ASEAN member states and the upturn of the Indian economy should provide underlying support in Asia. However, we expect the recovery momentum of the global economy to gradually ebb in view of the anticipated slowdown of the Chinese economy and prospects of a peak-out of IT demand, though still basically firm, in 2018.

◆ Risk factors include (1) turbulence in the financial and asset markets, (2) downside risks of the Chinese economy, and (3) geopolitical risks. Regarding (1), it is necessary to pay attention toward the possibility of a US stock market crash. As for (2), there is the risk that the tightening of structural reforms by the Chinese government may have a larger-than-expected negative impact upon the economy.

[Outlook on the global economy]

(Y-o-y change)

CY	2015 (Actual)	2016 (Actual)	2017 (Forecast)	2018 (Forecast)
Total of forecast areas	3.6	3.4	3.9	3.9
Japan, US, Eurozone	2.4	1.5	2.2	2.0
US	2.9	1.5	2.2	2.3
Eurozone	2.1	1.8	2.4	2.0
Japan	1.4	0.9	1.7	1.4
Asia	6.2	6.2	6.1	6.1
China	6.9	6.7	6.8	6.4
NIEs	2.1	2.2	3.1	2.6
ASEAN5	4.8	4.9	5.3	5.3
India	7.5	7.9	6.3	7.3
Australia	2.5	2.6	2.3	2.8
Brazil	-3.5	-3.5	1.0	2.2
Mexico	3.3	2.9	2.0	2.0
Russia	-2.8	-0.2	1.5	1.5
Japan (FY)	1.4	1.2	1.8	1.3
Crude oil price (WTI, USD/bbl)	49	43	51	59

Note: The total of the forecast areas is calculated based on the 2015 GDP share (PPP) by the IMF
Source: Made by MHRI based on the IMF

4. Outlook on the Japanese economy in 2018 – The recovery will continue on the back of solid domestic demand

◆ In 2018, the Japanese economy should continue to follow a gradual recovery as the strength of domestic demand offsets the slowdown of external demand from the strong growth in 2017.

◆ Looking closer at the components, export growth is likely to slow down from 2017. In addition to the peak-out of exports of IT-related parts and products which grew strongly in 2017, the slowdown of the Chinese economy is also expected to serve as downward pressures upon exports. Turning to domestic demand, capital investment should follow firm footing due to the progress of projects related to the 2020 Tokyo Olympic Games and urban redevelopment as well as additional labor-saving investment. Personal consumption is also expected to pick up gradually reflecting the improvement of consumer confidence due to the rise of the stock market and improvement of the labor market.

◆ The core consumer price index (CPI) (all items, excluding fresh food) is expected to see a higher increase than in the previous year mainly because of the recovery of energy prices. Mizuho Research Institute Ltd. (MHRI) expects the core CPI to rise by around 1% y-o-y from around mid-year to early autumn.

◆ The current economic expansion is characterized by the tightening of labor supply and demand and the moderate improvement in wage increases and prices, which may be interpreted as early signs of a "true dawn" for the Japanese economy.

[Outlook on the Japanese economy]

		2015	2016	2017	2018	2016		2017				2018				2019
		FY				Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar
GDP (real)	Q-o-q % ch	1.4	1.2	1.8	1.3	0.2	0.3	0.4	0.7	0.6	0.2	0.2	0.4	0.3	0.3	0.3
	Q-o-q % ch p.a.	--	--	--	--	0.9	1.4	1.5	2.9	2.5	0.7	1.0	1.4	1.3	1.0	1.3
Domestic demand	Q-o-q % ch	1.3	0.4	1.4	1.3	-0.1	0.0	0.3	1.0	0.1	0.2	0.2	0.4	0.4	0.3	0.4
Private sector demand	Q-o-q % ch	1.4	0.4	1.7	1.4	-0.3	0.3	0.3	0.9	0.3	0.3	0.3	0.4	0.3	0.3	0.4
Personal consumption	Q-o-q % ch	0.8	0.3	1.1	0.8	0.4	0.1	0.4	0.9	-0.5	0.2	0.2	0.3	0.3	0.3	0.3
Housing investment	Q-o-q % ch	3.7	6.2	1.9	-0.7	3.0	0.2	0.9	1.3	-1.0	-0.1	-0.6	-0.0	-0.3	0.6	0.2
Capital investment	Q-o-q % ch	2.3	1.2	3.6	2.9	-0.2	1.5	0.2	1.2	1.1	0.9	0.9	0.7	0.6	0.4	0.4
Inventory investment	Q-o-q contribution, % pt	0.2	-0.3	0.0	0.1	-0.5	-0.1	-0.1	-0.0	0.2	-0.0	-0.1	0.1	0.0	0.0	0.1
Public sector demand	Q-o-q % ch	1.1	0.5	0.7	0.9	0.4	-0.7	0.2	1.1	-0.5	-0.1	0.1	0.4	0.4	0.3	0.3
Government consumption	Q-o-q % ch	1.9	0.5	0.5	1.1	0.5	-0.3	0.2	0.2	0.0	0.2	0.3	0.3	0.3	0.3	0.3
Public investment	Q-o-q % ch	-1.6	0.9	1.2	0.1	0.3	-2.4	0.3	4.6	-2.4	-1.4	-0.3	0.7	0.7	0.3	0.3
External demand	Q-o-q contribution, % pt	0.1	0.8	0.4	-0.0	0.3	0.3	0.1	-0.2	0.5	-0.0	-0.0	-0.0	-0.0	-0.1	-0.1
Exports	Q-o-q % ch	0.7	3.4	4.8	2.0	2.1	3.0	1.9	-0.1	1.5	0.7	0.3	0.6	0.5	0.2	0.0
Imports	Q-o-q % ch	0.3	-1.1	2.5	2.1	0.1	1.3	1.3	1.5	-1.6	1.1	0.4	0.8	0.7	0.6	0.4
GDP (nominal)	Q-o-q % ch	3.0	1.0	1.8	1.1	-0.1	0.5	0.1	0.8	0.8	0.1	0.2	0.2	0.3	0.6	0.3
GDP deflator	Y-o-y % ch	1.5	-0.2	-0.1	-0.1	-0.1	-0.1	-0.9	-0.4	0.1	-0.1	0.3	-0.1	-0.3	-0.0	0.0
Domestic demand deflator	Y-o-y % ch	0.0	-0.5	0.5	0.4	-0.8	-0.4	-0.0	0.3	0.5	0.4	0.6	0.4	0.6	0.4	0.3

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 2018 – The global stock market rise and low interest rate environment are expected to continue

◆ In the financial markets, the stock market rise and low interest rate environment are expected to continue reflecting the recovery of the global economy in 2018. While it is necessary to keep a close eye upon the impact of the progress of exit strategies in US and European monetary policy, the rise of US and German long-term interest rates should remain subdued in 2018 and beyond, given the absence of signs of the acceleration of inflation. Japanese long-term interest rates are expected to level off as the BOJ maintains the stance of reining in the rise of interest rates.

◆ The US Federal Reserve Board (FRB) is expected to reduce its asset holdings and raise the federal funds rate up to around 2% by the end of 2018. The European Central Bank (ECB) will likely continue to reduce its asset purchases. We expect the BOJ to keep its monetary policy stance unchanged and that BOJ Governor Haruhiko Kuroda will remain in office beyond his current term. The BOJ may do another round of comprehensive assessment of its policy in light of the results of the *Shunto* annual spring wage negotiations and foreign exchange rate trends.

◆ The Japanese and US stock markets are expected to remain on an uptrend on the back of the improvement of corporate earnings. However, US stock prices appear overvalued in terms of valuation. Since the rise of US interest rates may trigger a stock market adjustment, such possibility must be watched closely as a risk factor.

◆ As for JPY/USD exchange rates, the rise of the US dollar is likely to be limited given the sluggish rise of US interest rates. Watch closely for the appreciation of the yen as markets turn risk-off due to the escalation of the North Korea crisis.

[Outlook on the financial markets]

		2016	2017	2018	2017		2018				2019
		FY	FY	FY	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar
Japan											
Uncollaterized overnight call rate	(End of period, %)	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Euroyen TIBOR	(3-mo, %)	0.06	0.06	0.06	0.06	0.06	0.06	0.06	0.06	0.06	0.06
Interest rate swaps	(5-yr, %)	-0.02	0.10	0.10	0.09	0.10	0.10	0.10	0.10	0.10	0.10
Newly-issued JGBs	(10-yr, %)	-0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
Nikkei average	(JPY)	17,520	21,000	23,100	19,880	22,100	22,600	22,800	23,000	23,200	23,500
US											
Federal funds rate	(End of period, %)	0.75~1.00	1.50~1.75	1.75~2.00	1.00~1.25	1.25~1.50	1.50~1.75	1.75~2.00	1.75~2.00	1.75~2.00	1.75~2.00
Newly-issued government bonds	(10-yr, %)	1.97	2.30	2.50	2.24	2.35	2.40	2.50	2.50	2.50	2.50
Dow Jones average	(USD)	18,845	22,600	24,800	21,890	23,500	24,200	24,400	24,600	24,900	25,200
Eurozone											
ECB key policy interest rate	(End of period, %)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
German government bonds	(10-yr, %)	0.15	0.40	0.50	0.45	0.40	0.40	0.45	0.45	0.50	0.50
Foreign exchange rate											
JPY/USD	(JPY/USD)	108	112	115	111	113	114	115	115	115	115
USD/EUR	(USD/EUR)	1.10	1.15	1.18	1.18	1.17	1.16	1.16	1.18	1.19	1.20

Note: Figures in the shaded areas are forecasts. The forecasts are the averages of the relevant periods. However, the uncollaterized 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