Outlook of the Global Economy and the Japanese Economy for the New Year

Summary

In 2017, the global economy expanded steadily despite increased geopolitical risks.

In 2018, the global economy is expected to maintain modest growth, while many risk factors also continue.

The New Year marks the milestone of the 150th anniversary of the Meiji Restoration. Japan must take a big step toward opening a new era.

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1. Reviewing Year 2017 :

1. Global Economy : Return of the Great Moderation

At the start of 2017, there was widespread anxiety surrounding the global economy. Western countries were facing growing uncertainties that the United States may turn to hardline protectionism policies under the Trump administration. Another risk was that the gaps may widen among EU countries depending on the outcome of the French presidential election. Trend towards an inward-looking policy seemed to have prevailed in many countries.

In conclusion, however, the global economy remained strong, supported by the expectations of the US tax cuts and China's economic stimulus policies.

The year-to-year real GDP growth rate of the global economy in 2017 is estimated to be +3.6% according to the IMF, which is higher than +3.2% of 2016[*1]. Since the volatility of the growth rate continues to be small, corporations and investors can afford to be more aggressive in taking various risks.

Some economists view and describe the current stable expansion as the return of “Great Moderation”.

2. Financial Markets : Bullish Sentiment Continues to Overcome Uncertainties

Under the strong economy, the risk appetite of investors has strengthened in the financial markets.

The US Dow Jones Industrial Average surpassed the 24,000 level, reaching an all-time high. The Nikkei average also hit its high for the first time in 26 years. Although the uncertainties, such as policy management of the United States and the Brexit negotiation at EU, remained high, bullish moves for aggressive risk taking surpassed risk-aversive moves in the financial markets in 2017.

The factors that supported the continued bullish behavior of the investors include: (1) Expectations of the US tax cut, (2) Confidence that the normalization of monetary policy by the US Federal Reserve will proceed at a slow but steady pace and (3) Expectations for high growth in the IT sector. In particular, in addition to the US companies referred to as “GAFA,”[*2] Chinese IT companies such as Tencent and Alibaba also performed well in the market. Competition among major platformers in the digital era is getting tougher mainly in the United States and China.

*1 IMF “World Economic Outlook Database, October 2017”.

*2 An acronym created by taking the initial letters of Google, Apple, Facebook, and Amazon.

3. United States : The Trump Administration Remains Popular among Consistent Supporters in the Republican Party, despite its Unconventional Policy Management,

The Trump administration failed to deliver during its first year many policies it has committed. A large number of vacancies in key positions remain unfilled, and the administration often faced conflict even within the Republican Party. As a result, major policy plans including repealing of the Obamacare and the large scale investments in the social infrastructure have yet to be implemented. The tax reform bill barely got through at the end of 2017.

Despite the disappointing record in policy management, the support rate for the Trump administration remained high, which is comparable to the Reagan administration, helped by the consistent supporters within the Republican Party. While the national unemployment rate has improved to the lowest level since 2000, the labor-participation rate of bread winners (i.e. males, ranging 35-44 years old), still remained at a low level. These "negative historical effects"[*3] and continued disparities in the labor market are the major background of the wide gaps embedded in the US society. The Trump administration has been firmly supported by those groups who feel they have been neglected.

4. China : Aiming for "Center Stage" as a Major Global Power

In 2017, China stepped further aiming for center stage as a major global power to replace the United States, which has been taking an inward-looking direction.

At the 19th National Congress of the Communist Party of China in the autumn of 2017, President Xi Jinping positioned himself as the "core of the party center." On the economic policies, Xi explained his determination for stronger "guidance and leadership by the Party" to establish a solid "modernized socialist power" by the 100th anniversary of the founding of the country (2049). He intends to have China lead the world in not only economy but also politics, culture, and the living standard.

Aspiration for a "great revival of the Chinese" people is the key momentum pushing China to aim for "Center stage." Throughout the 4,000-year history of China, it was only the 150 years after the Opium War that she was classified as a small economy.

During the Ming Dynasty and Qing Dynasty eras, China kept 30 percent share in the global GDP. After decreasing momentarily to 5% in 1950, the ratio has recovered to 25% in 2016. [*4] The Xi administration now looks to be more confident in setting the "great revival of the Chinese people" as an achievable target.

5. Trade : Japan Promotes Free Trade in contrast to Protectionism trend of the US

In the global trade arena, while the United States has been inclined to protectionism, Japan has promoted free trade. The United States pushed through drastic measures such as

*3 Workers who lost their jobs in a large-scale recession, such as 2008 financial crisis, tend to face difficulties in getting back to their jobs even after the economy recovers. Due to lack of opportunities to build skills during the recession, these workers are forced into long periods of unemployment or working under low wages.

*4 Calculated by Mitsubishi Research Institute based on Angus Maddison: "Historical Statistics of the World Economy" and IMF: "World Economic Outlook Database, October 2017" (data for 2016 only) withdrawal from TPP and re-negotiation of NAFTA. If the US eventually withdraws from NAFTA, the proportion of the US trade with countries under FTA may reduce to 10% of the total amount of the US trade.

In the meantime, Japan concluded an EPA with the EU and managed to reach a basic TPP agreement among 11 countries excluding the United States. As a result, the proportion of Japanese trade with countries under FTA is expected to increase to 33%. Based on the estimates by our GTAP model[*5], ASEAN countries will benefit significantly from TPP even without the United States. Japan is now expected to play an increased role as a facilitator for free trade.

2. Outlook for 2018 :

1. Global Economy in 2018 : Sustained Growth Expected against Wide Range of Risk Factors

Our main scenario for the global economy is that the Great Moderation will continue in 2018. Stronger domestic demand bolstered by improved employment and household income is prevailing worldwide. With the implementation of US tax cuts serving as an additional tailwind, we expect the global economy to maintain its growth at the same rate as in 2017. At the same time, however, the positive impacts of the economic stimulus in China will gradually fade out and monetary control in the United States and other western countries is expected to be more conservative. Thus, the effect of expansionary economic and monetary policy will gradually weaken through 2018.

In addition, political and geopolitical risks are widespread in many corners of the world, implying serious negative impact on the sustained growth scenario. Possible regime changes in major European countries, growing military tension in the Korean Peninsula, and further turmoil in the Middle East are examples of the risk factors to change the market sentiment abruptly towards bearish. A volatile market will inevitably put downward pressure on the global economy.

2. US Economy : Tax Cuts will Sustain Stable Economy

With the rocky passing of the tax reform bill, the risk of corporations and households losing confidence, which has been a major concern, may have been avoided. The US will most likely sustain stable economy in 2018.The centerpiece of the latest tax reform is the reduction of the corporate tax rate to be implemented for the first time since the Reagan administration.

The effective corporate tax rate in the United States was the highest among the G7 countries, but now it has become the second lowest after the UK. It remains unclear whether the reduction of the corporate tax rate would lead to capital investment. However, there is also tax reduction on dividends from overseas subsidiaries. So through share buy-backs, corporations can enjoy high share price. Economic benefits from these tax cuts, including personal income tax reduction may amount to +0.7% points of the GDP.

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*5 GTAP is a model for determining the medium- to long-term equilibrium conditions of the economy, referred to as a computable general equilibrium (CGE) model. Economic effects are calculated by comparing the state where the economy has undergone structural adjustment (such as the relocation of capital and labor) due to changes in the tariff rate with the state of the economy before the adjustment.

3. US Monetary Policy : The Steering of the Monetary Policy Towards Normalization is in the hands of the Incoming Chairman of the Fed

Another point of interest concerning the US economy in 2018 is the normalization of monetary policy. Jerome Powell, the next Fed chairman, who is scheduled to be inaugurated in February, must lead this task.

The Fed will use two policy tools. The government securities held by the Fed should decrease from $4.4 trillion to $3.1 trillion over the next three years if we do not encounter problems. Increases in interest rates, on the other hand, will be dealt in a flexible manner with both economy and inflation in mind.

The US core inflation forecast for 2018 is +1.8% from the previous year. Although an increase of nearly 2% is expected, the decrease in the inflation rate expected in the household sector has weighed down the overall price increase. The increases in interest rates in 2018 will likely be gradual at 0.25% per six months.

4. Global Inflation Environment : Tug-of-War Continues Between Positive/Negative Factors

Although the GDP gaps among Japan, the United States, and the eurozone are expected to turn positive for the first time in 11 years, there are differences in their respective outlook of their inflation rates[*6]. While the United States expects an inflation rate of nearly 2%, the eurozone expects it to be +1.3%, and Japan +0.7%. They all fall short of their central banks' 2% targets.

There are various reasons for the low inflation. While a high unemployment rate exceeding the natural unemployment rate continues in the eurozone, the pace of wage hikes remains slow in Japan despite the tight labor supply-demand situation. There are views that the expected inflation rates have fallen structurally, including also the United States. The inflation environments in various countries will be the key point in understanding their respective monetary policies in 2018.

5. International Finance : Will the normalization of US monetary policy affect emerging economies?

As the United States promotes normalization of its monetary policy, it is necessary to pay attention to the risk of funds flowing out from emerging market. Will there be a recurrence of the Bernanke shock[*7] of 2013?

As a conclusion, the possibility of a wide-area currency crisis occurring in emerging markets in 2018 is small. In addition to the likelihood that the increase in interest rates in the US will remain moderate, the emerging economies with Asia at their center have enhanced their competitiveness in the international market and their basic economic has been strengthened.

*6 Core inflation rate excluding both food and energy

*7 Global financial markets were upset in 2013 when FRB Chairman Bernanke suggested slowing-down of quantitative easing.

Furthermore, we have also seen development of safety nets to prevent outflow of funds such as the Chiang Mai Initiative.

However, there is a possibility that funds will flow out selectively from countries whose economy is vulnerable and the dollar-denominated debt ratio is high such as Turkey and Russia.

6. Chinese Economy : What is the direction of the Chinese economy under the strengthened Xi regime?

In China, at the National Congress of the Communist Party of China (CPC), the Party has expressed its intention to further strengthen its intervention in economic activities. As a result, the risk of a sharp downturn in Chinese economy due to structural adjustments in the market has reduced in the short term. Though in 2018, a slowdown in growth due to the diminishing effect of the economic stimulus measures cannot be avoided, the Chinese economy is still expected to maintain a steady growth of around mid-6%.

In particular, China's progress in the field of cutting-edge technologies has been remarkable. China is also strengthening its competitiveness in the market of high-value-added products that has been dominated by developed countries. Converting weakness to strength, China is expected to take advantage of its underdeveloped social infrastructure and promote implementation of advanced technologies such as AI and self-driving cars.

Meanwhile, the excessive debt problem is still an issue for the Chinese economy. Though there is optimism that China’s non-financial sector debt (considered to be about $30 trillion) will decrease over time under party leadership, a fundamental solution has yet to be presented. Whether the risk of hard landing can be avoided through structural adjustment of the market and achieve soft landing will depend on the ability of the Xi administration.

7. European Economy : Unclear Future of EU Integration and Politics in Each Country

The European economy is expected to continue its moderate recovery. However, the weakening of the political foundations of the ruling parties of each country is the largest risk factor. In Germany, which is the cornerstone of EU, Chancellor Merkel’s grasp of leadership has declined, and there is a possibility of another election in the first half of 2018. In Italy, where a general election is scheduled by May, there is a high possibility that none of the parties will gain majority and talks on forming a coalition will face difficulty.

Each country must give priority to recovering their domestic political bases, and it is likely that the move toward EU integration will be stalled. The de facto deadline of UK’s Brexit negotiation is the end of October 2018. Though the condition for the exit has been agreed upon, depending on the outcome of the trade negotiation that will follow, UK may face an economic turmoil.

8. Japanese Economy : Can Japan Enhance Economic Growth Autonomously?

The Japanese economy will be entering the sixth year of economic recovery. According to the "Regional Economic Report (Sakura Report)" released by the Bank of Japan, three of the nine regions have achieved recovery, and the other six regions have expanded. Economic recovery has penetrated into regional areas. The real GDP growth rate in 2018 (calendar year) is projected at +1.2% over the previous year, with the economy continuing to grow centering on domestic demand as the engine. If economic recovery continues until the end of the year, it will become the longest postwar expansion.

Recovery in employment during the initial period of Abenomics centered on part time workers, but it appears to have spread to full time employees around 2016. Though the wheels of the economic expansion have started spinning in the right direction, both increase in wages and consumption in the household sector, are the keys to turn this into a more autonomous cycle.

9. Japanese Economy : Will there be Expansion of the Forward-looking Movement of Companies to Develop New Markets?

Improvement in corporate productivity is indispensable to achieve sustainable wage increases. Since there is limit to improve business operations in the existing market, it is important to develop new growth market. Unfortunately, however, according to Development Bank of Japan survey[*8], companies that are "working on developing new growth markets" are mere 30% of the whole.

However, these 30% that are positive about new market development have been accelerating their efforts toward the fourth industrial revolution. It is hoped that the positive moves of these 30% will spread to the remaining 70% in 2018.

10. Achieving a Prosperous Society by Co-Creating the Future Through Innovation

True innovation will enrich the society. For example, if the shared use of self-driving electric vehicles (EV) becomes widespread, a society that is safe and environment friendly will be realized. It will become possible for the seniors who find it challenging to drive can move around freely. Becoming free from driving, people will be able to use the freed up time to conduct other value added activities and hence achieve affluence.

The New Year will mark the 150th anniversary of the Meiji Restoration. It is hoped that this will become a year for Japan to take a big step toward co-creating the future through innovation.

*8 Development Bank of Japan: "Survey on Planned Capital Spending" (Conducted in June 2017)

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