

# Outlook of the Global Economy and the Japanese Economy for 2019



## Summary

In 2018, the global economy continued to grow amid increasing uncertainties as we observe three major trends of concern.

In 2019, a slowdown looks likely in the global economy, as the US and Chinese economies are losing their momentum. A big question is whether major countries can cooperate and jointly take prompt actions to cope with a possible financial and economic crisis once it emerges.

In Japan, the New Year will mark the beginning of the post-Heisei era. With so many societal issues and policy agenda remaining unsolved, Japan should continue to take robust and forward-looking steps towards a sustainable society.

# 1. Reviewing Year 2018 :

## The global economy : Three major trends of Concern

In 2018, three trends became clearer that could affect the global economy over the medium to long term. The first trend is the US-China rivalry over hegemony. While a similar race occurred between Athens and Sparta in the distant past, old and new super powers have repeatedly engaged in conflict over hegemony. The year 2018 will be considered as the beginning of the US-China rivalry.

The second trend is that democracy and capitalism have started showing signs of fatigue. Dissatisfaction with the existing politics resulted from political establishment is partially the result of widening inequality. This has increased support for populist policies and an inward-looking policy stances. Some emerging economies have begun to look to China as a role model, which has achieved rapid growth under its authoritarian economic system.

The third trend is competition for leadership over massive data. While the value of data has increased as a source of competitiveness, new risks have emerged. Data breaches through IoT devices and public opinion manipulation by fake news are good examples. China accumulates data of her citizens under government initiative. Europe and the United States, on the other hand, are focusing on prevention of data leakage to outside their countries . The GDPR<sup>\*1</sup> enforcement and regulation on digital tech giants, such as Google and Apple, exemplify these efforts.

To summarize, 2018 was a year where the three trends materialized under the growing uncertainties about the future.

## US-China confrontation : Extending beyond trade war

The biggest factor of uncertainty is the US-China trade friction that has become serious since the beginning of 2018. From July to September, the situation escalated to a point where the two countries mutually imposed high-rate tariffs on more than half of their total trade value. As a result, the world's average tariff rate, which had been on a downward trend since the 1990s, began to rise.

In addition, US Vice President Mike Pence's remarks on the administration's policy towards China in October, gave the impression that the rivalry between the two countries was not limited to trade. The US signaled major concern over China's threat to international order due to their rise in technological competence, military power, and dominance over emerging economies achieved through unfair practices.

Meanwhile in China, the National People's Congress in March, removed term limits on the presidency of Xi Jinping, thus concentrating more power to him. In doing so, China hopes to realize "socialist modernization" by 2035, when population decline is anticipated to be in full-swing; strategies include the strengthening of its innovative prowess and the expansion of its middle class.

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\*1 General Data Protection Regulation; effective from May 2018.

## **A decade after the “Global Financial Crisis” : Economic recovery and legacy**

The year 2018 was the tenth anniversary of the “Global Financial Crisis”. Through massive quantitative easing, the economies of developed countries have recovered, and the total global market capitalization has also increased to almost 10 quadrillion yen. However, despite the recovery of the macro economy, it has left social problems such as widening of inequity.

In southern Europe and the United States, unemployment has continued to drag on since the loss of job opportunities resulting from the Global Financial Crisis. The employment rate for working age men have not recovered to the pre-Global Financial Crisis level.

If social inequality exceeds what is deemed tolerable, it will form a wave of movements seeking new politics to replace existing policy- and law-makers. This opposition to existing politics became the driving force behind the election of the US President Trump, leading the US to shift towards protectionism.

Meanwhile, China has strengthened its economic system of state-controlled capitalism. The legacy of the Global Financial Crisis and the US-China rivalry may seem unrelated, but there is the possibility of an underlying connection.

## **A year of elections : Division of society shaking up politics**

In 2018, political events took place one after another. In the US midterm election, the Democratic Party recaptured a majority in the House, while the Republican Party maintained a majority in the Senate. The Republican Party fared well in this midterm election, which tends to result in tough outcomes for the incumbent party.

Looking closely at the US House poll results, there was a clear division between whites and non-whites as well as between urban and rural areas regarding which parties they voted for. This confirms the divisiveness in American society.

In Italy, a coalition government including the Five Star Movement was formed, which advocates a populist policy agenda. Similarly in Germany, the AfD<sup>\*2</sup>, a far-right political party, expanded its number of seats in regional elections. In Europe, the division and anxiety of society also continue, especially over refugees.

## **The Japanese economy : Numerous broken records and many natural disasters**

The Japanese economy in 2018 broke a number of records in terms of economic indices. If the economic recovery phase continues through December, it will match the longest period (73 months) of post-war economic recovery ever. The active job offerings-to-applications ratio reached the highest level in 44 and a half years. Economic recovery has also spread to the local economies. The number of inbound tourists to Japan exceeded 30 million in 2018, and the minimum hourly wage exceeded ¥750 in all prefectures for the first time.

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\*2 Alternative für Deutschland (Alternative for Germany).

Meanwhile, Japan was hit by many natural disasters. The average temperature in Japan is on an upward trend in the medium to long term, and record heavy rains can no longer be referred to as “abnormal” weather anymore. It has become clear that we should reconsider how to utilize national land, accepting the fact that disasters are becoming more common.

## 2. Outlook for 2019 :

### Global economy entering a slowdown phase

Overall the global economy has enjoyed expansion through 2018, but it will probably enter a slowdown phase in 2019. Rising costs resulting from the trade friction between the United States and China will be a heavy burden for the economies of both countries. It is expected that the effects of tax cuts in the United States will wear off, and a slowdown in investment is also anticipated in China. Thus, a slowdown in the two economic superpowers, which account for 40% of the global economy, should come as no surprise. Furthermore, if the UK's withdrawal from the EU takes place without agreement, not only the UK but also the whole European economy will suffer a slowdown.

Although our base scenario of the global economy is a moderate slow down, there is an increasing risk of falling into recession beyond a “moderate” degree. The following four key points should be noted.

#### Key point 1 : US-China rivalry

The first key point is the possibility that the US-China rivalry may intensify and become long standing. The US punitive tariffs against China were scheduled take place in January 2019. This would raise tariff rate on \$200 billion worth of imports into the United States from China from the current 10% to 25%. Although a 90-day grace period was established, there is still the possibility that tariff increase may be triggered after March. Punitive tariffs against China is a two-edged sword that will not only strike a blow to China but will also rebound back to the United States.

If the additional tariffs are expanded to all imported goods in the future, it will inevitably increase US consumer prices, and a heavy brake will be applied on consumption, which has been driving the strong performance of the US economy. If these occur, it is possible that the world GDP may fall by about 0.5 percentage points due to the downswing in the US and Chinese economies.

The essence of the US-China rivalry is not a short-term trade friction but rather a comprehensive competition for hegemony involving advanced technologies and security. China may surpass the United States in economic scale by 2030. In the field of science and technology, it will be a close race between the two countries over AI and the quantum computer. The United States has admitted that China leads in next-generation high-performance (Exascale) computing and commercial drones.\*3

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\*3 U.S.-China Economic and Security Review Commission「2017 ANNUAL REPORT」

Regarding military power, the absolute advantage of the United States is challenged by the rise of China. And in direct investment toward emerging economies, China, which has been advancing its One Belt One Road Initiative, leads the United States. In light of these factors, the US-China rivalry is likely to become a long-term competition over the next 20 to 30 years.

## Key point 2 : Chinese economy

The second key point is the risk of the Chinese economy going beyond an economic slowdown, instead making a hard landing. 2019 will probably be a year of hardship for China. Although per capita GDP is expected to surpass the milestone level of \$10,000<sup>\*4</sup>, the negative impact on the Chinese economy due to the US-China rivalry will likely become more severe in the future.

It is expected that the Chinese government will move toward supporting the economy through additional fiscal and monetary policies in the future, but it will be difficult to spell out large-scale economic measures, as the fiscal deficit grows.

As the economy slows, an increasing number of companies are becoming unable to generate enough profit to cover their interest payment. However, China is facing a dilemma where excessive economic measures can worsen structural problems, such as nonperforming loans and excess production capacity.

If Chinese government errs steering its economy, the risk of falling below the 6% economic growth level will increase, a measure of China's social stability.

## Key point 3 : International financial markets

The third key point is the risk of adjustment and confusion in the international financial markets. Interest rates in the United States are currently at easing credit levels relative to the actual economic climate. However, if interest rate hikes are implemented twice in 2019, the interest rate will approach 3%, which is considered neutral with respect to the economic climate.

The price-earnings ratio (Shiller PER<sup>\*5</sup>) of US stock prices are already at a high level equivalent to eve of the Great Depression of 1929. There is a possibility that stock prices may suffer drastic adjustment upon monetary policy change. If the long-term interest rate rises further as a result of factors such as US expansive fiscal policy, the risk will increase the amount of funds flowing out of emerging economies.

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\*4 Japan topped \$10,000 in 1983.

\*5 Shiller PER is an indicator used to analyze whether a stock is undervalued or overvalued. It is an index obtained by dividing the substantiated stock price by the average earning per share for 10 years, taking price fluctuations into consideration.

## Key point 4 : EU

The fourth key point is the possible fragmentation of the EU due to disharmony among its members. In the UK, the possibility of the “No-Deal Brexit” is increasing because of the strong domestic opposition to the proposed withdrawal agreement which the government negotiated. In that case, the GDP of the UK may fall 1.7 percentage points while that of the EU may be pushed down 0.3 percentage points<sup>\*6</sup>.

Furthermore, it seems that the EU will be without a leader since German Chancellor Angela Merkel resigned as party head of the leading CDU<sup>\*7</sup> weakening her influence. There were high expectations for President Macron of France, however, he has been losing support due to large-scale anti-government demonstrations (“Yellow Vest” protests) that began in late 2018.

As for the elections to the European Parliament scheduled for May, far-right forces are also expected to gain more seats. If the forces that adopt inward-looking policies gain momentum in the absence of a leader, the EU will fail to strengthen its integration. Furthermore, as a worst-case scenario, the possibility of a second or third EU “exit” cannot be ruled out.

## Can the crisis be controlled?

If a financial or economic crisis occurs in 2019, its impact could be serious. First, in the developed countries, there is not much room for manipulating monetary and fiscal policies to stimulate the economy to alleviate the impact of slowdown. Second, due to the inward-looking policies of major countries including the United States, G20 and other international cooperative systems have fallen into dysfunction. It is uncertain whether various countries can cooperate and take prompt action to cope with crisis once it emerges.

## The Japanese economy: Concern in the second half of the year

Thanks to improved income and employment environment, the Japanese economy in 2019 is expected to grow by 1% (0.7% for the fiscal year), which is comparable to the potential growth rate. However, the outlook for the second half of 2019 is uncertain, since a consumption tax rate hike is scheduled to take place in October, amid the expected slowdown of the global economy.

The outcome of full-scale trade negotiations between Japan and the United States is an important factor that could affect the Japanese economy. There is a possibility that US-Korea FTA and USMCA<sup>\*8</sup> type import quotas may be applied to auto and other exports from Japan to the United States.

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\*6 Felbermayr et al. (2017) “Economic Effects of Brexit on the European Economy”

\*7 Christian Democratic Union (Germany)

\*8 US-Mexico-Canada Agreement (New NAFTA).

If auto exports to the United States are reduced by half, the total negative impact on Japanese companies will be a loss of ¥7 trillion in profit in total for Japanese companies. As a more fundamental measure against US protectionism, it is important for Japan to argue in favor of forming a framework of trade based on free and fair rules. The argument can be based on the tailwinds Japan is enjoying formed by the CPTPP<sup>\*9</sup> (TPP11) and the Japan-EU EPA<sup>\*10</sup>, which came into force at the end of 2018.

## 2019 is the beginning of a “post-Heisei era”, aimed at realizing a sustainable Japan

During the 30-years of the Heisei era, Japan suffered numerous natural disasters and the aftermath of the collapse of the bubble economy. Although the economic situation has improved recently, major issues still remain unsolved such as coping with the declining birthrates and an aging society, achieving fiscal soundness, and restoring international competitiveness<sup>\*11</sup>.

On the other hand, in the post-Heisei era, it is likely that Japan will be appreciated in the international community as one of the few countries that has successfully promoted free trade and avoided bitter divisions in society. Japan will be in the spotlight in the international community in 2019, with such events as the G20 and the Imperial Succession. If individuals and businesses can take forward-looking steps towards a sustainable society, it will be an auspicious start to the beginning of a “post-Heisei era”.

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\*9 Comprehensive and Progressive Agreement for Trans-Pacific Partnership.

\*10 Japan-EU Economic Partnership Agreement.

\*11 According to “IMD World Competitiveness Rankings”, the overall ranking of Japan was first in 1989, but temporarily dropped to 27th. It is 25th in the latest 2018 year.

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