Provisional translation

World Economic Trends
The 2015 Autumn Report (Summary)
Cabinet Office

Chapter 1 Chinese Economic Slowdown and the World Economy

- The world economy recovered moderately in 2015 with the support of a rebound in U.S. and European economies, while the moderate deceleration of Chinese economic growth and declines in resource prices pushed down emerging and other economies. China's real economic growth slowed down to around 7%.
- The share of exports bound for China has increased worldwide. Resource-rich countries have particularly become dependent on the Chinese economy (Fig. 1) and vulnerable to the impact of its slowdown (Fig. 2).
- The so-called Li Keqiang index (combining electricity consumption, the volume of railway cargo and the balance of medium to long-term loans) declined sharply. Even if the volume of railway transportation in the index is replaced with the volume of overall cargo transportation, the index posted a moderate fall (Fig. 3).
- China's large-scale economic stimulus package after the global financial crisis has resulted in excessive investment, production and indebtedness. Of overproducing industries, the steelmaking sector might be exporting excess output abroad (Fig. 4).

Fig. 1 Exports' Dependence on China

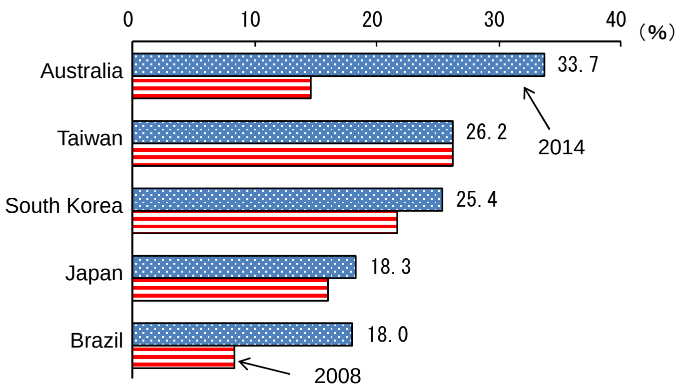


Fig. 2 Australia's Exports to China

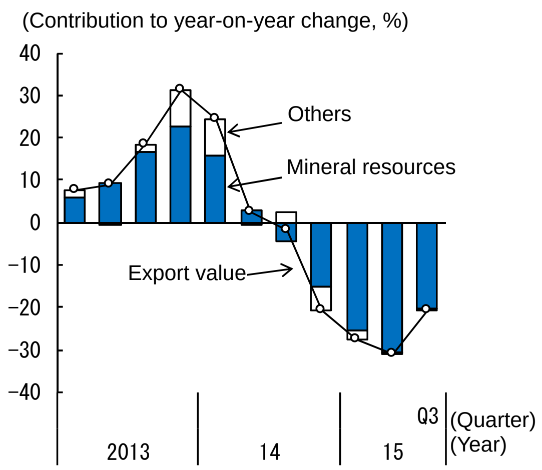


Fig. 3 The Li Keqiang Index (estimate)

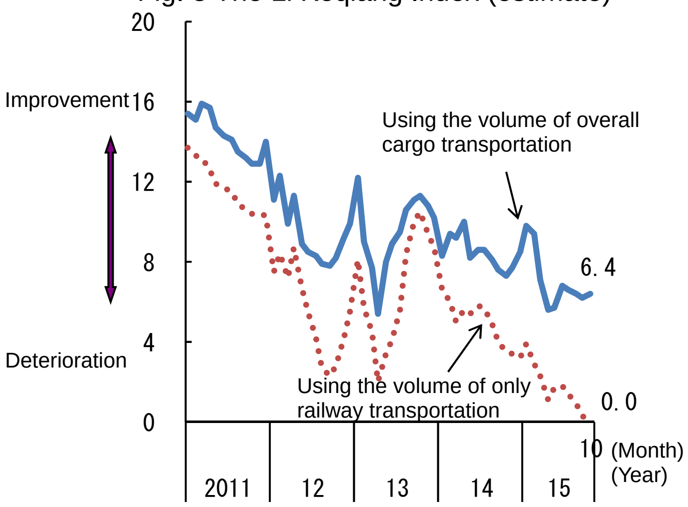
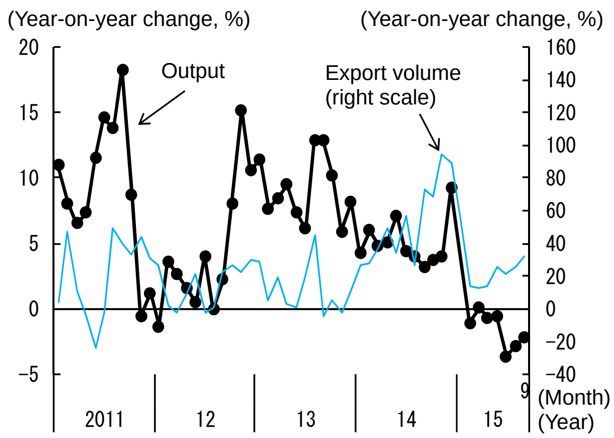


Fig. 4 China's Crude Steel Output and Export



- ➢ The Chinese government has set production capacity reduction targets for overproducing industries. Given the current demand size and production capacity, these targets are insufficient (Tab. 5). The Chinese government plans to eliminate excess production capacity with such measures as the consolidation of steelmakers.
- ➢ Outstanding private sector debt has expanded to a level similar to that in Japan during the asset-bubble period (Fig. 6). Loans for real estate development have partially become bad debts. As there are massive loans other than those provided through banks, it may be difficult to grasp the real situation.

- ● China needs to address the decline and aging of the population and avoid the so-called middle-income country trap (in which a country fails to change its development pattern and become a developed country after achieving middle-income country status).
  - ➢ The share of working-age population peaked in 2015. The overall population is expected to age rapidly. The draft 13th Five-year Plan (2016–2020) calls for repealing the one-child policy.
  - ➢ Wage hikes are eroding labor-intensive industries' competitiveness. Import sources of developed countries' light industry products are shifting from China to ASEAN (Association of Southeast Asian Nations) countries (Fig. 7). The total factor productivity's (TFP's) contribution to economic growth has declined (Fig. 8).

Tab. 5 Excess Production Capacity

	(1) Production capacity	(2) Actual production volume	(3) Desirable production capacity (estimated) for an adequate capacity utilization rate (80%) as indicated by (2) actual production volume (3) = (2) / 0.8	(4) Excess production capacity (estimated) (4) = (1) - (3)
Crude steel (100 million tons)	11.6	8.2	10.25	1.4
Aluminum (10,000 tons)	3,500	2,438	3,047.5	452.5

Note: The Chinese government's production capacity reduction targets include 20 million tons for ironmaking, 30 million tons for steel and 420,000 tons for electrolytic aluminum.

Fig. 6 Private Sector Debt as a Percentage of GDP

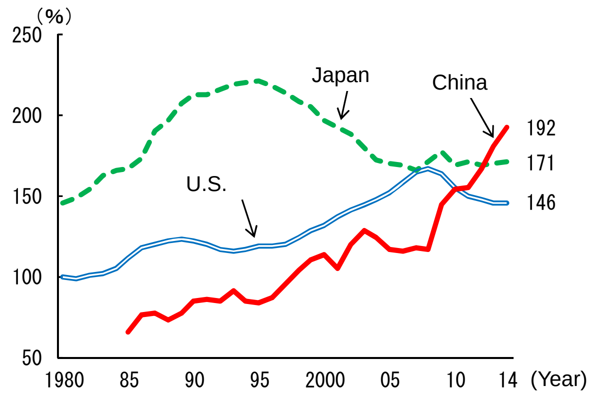


Fig. 7 Japan's Imports (textile products)

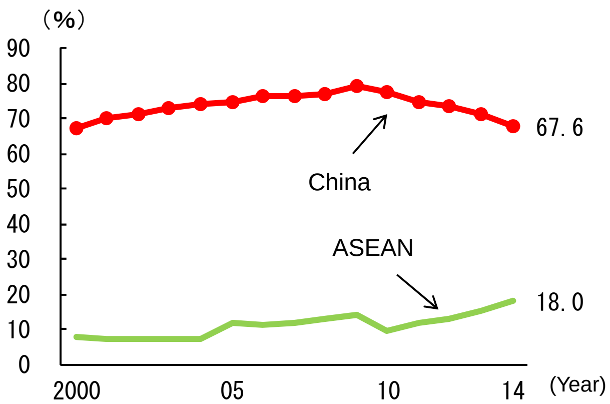
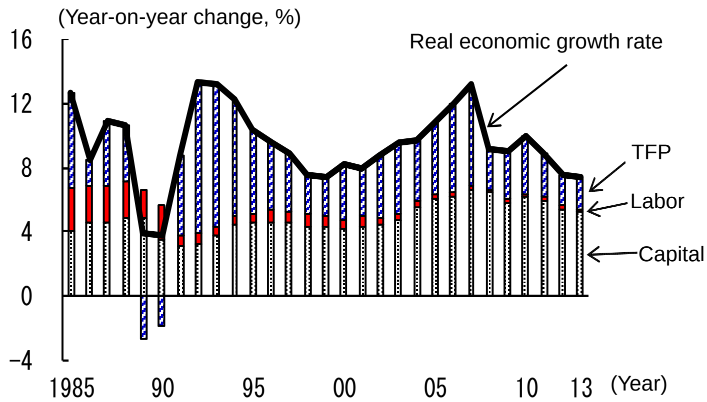


Fig. 8 Factor Analysis of Real Economic Growth Rate



- The Chinese government is promoting transition to an innovation-led economic growth model, leading to a substantial increase in input including investment in research and development. While output of innovation is also expanding (Fig. 9), the problem lies in the quality of such output (Fig. 10).

● A transition from an investment-led economy to a consumption-led one is in progress.

- Tourism and other services are growing rapidly in line with urbanization, and income growth (Fig. 11). The number of overseas travelers has increased sharply. Chinese tourists' share of global tourism spending rose from 3.5% in 2007 to 13.2% in 2014. Meanwhile, Japan-bound tourists' share of overseas travelers dropped from 4.2% in 2007 to 2.0% in 2013 (Fig. 11).
- Tertiary industries' share of the Chinese economy is lower than in other developed countries and has the potential to substantially increase in the future (Fig. 12).

Fig. 9 Number of Patent Applications

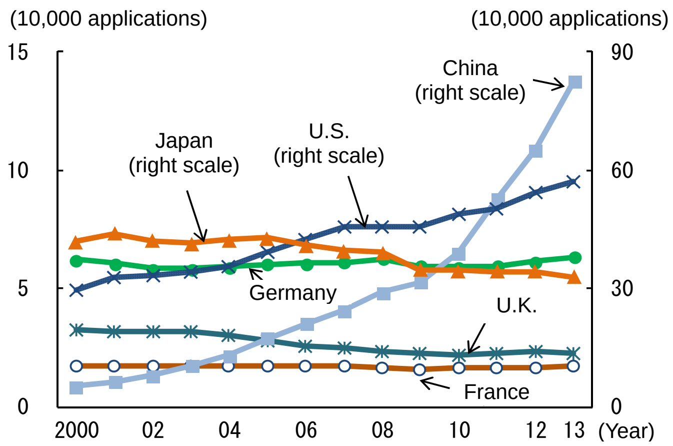


Fig. 10 Patent Royalty Income

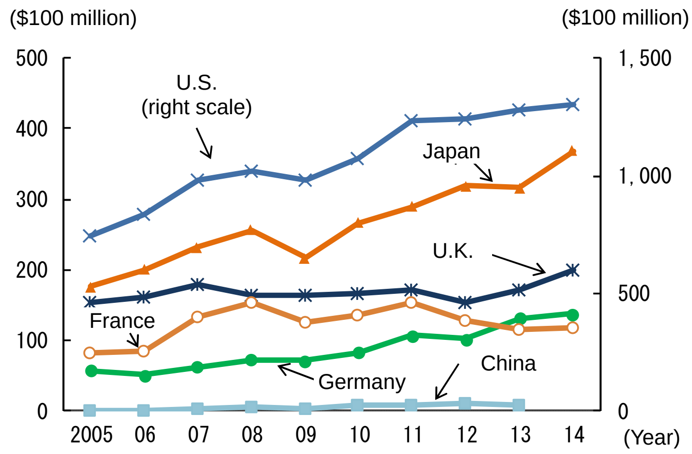


Fig. 11 Number of Chinese Overseas Travelers

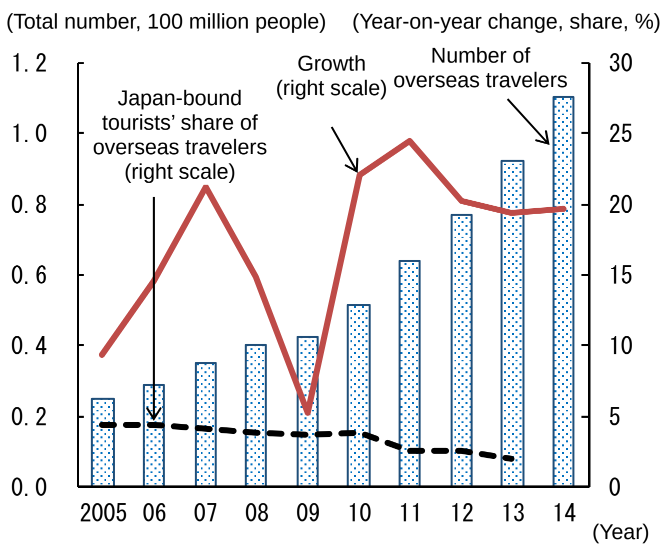
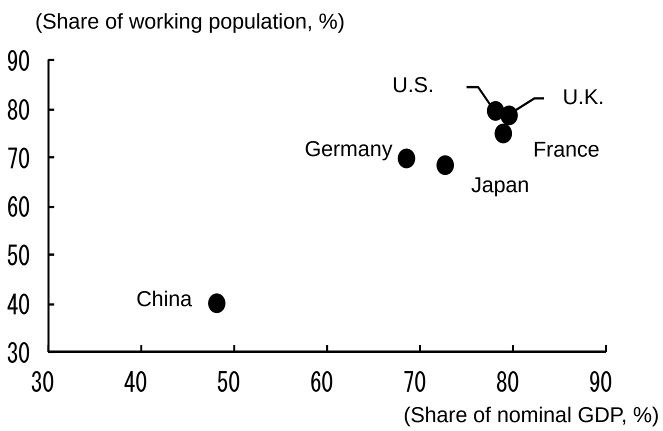


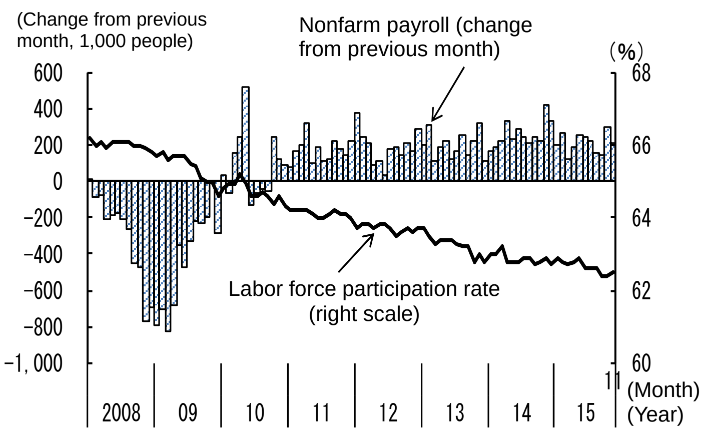
Fig. 12 Tertiary Industries' Share



Chapter 2 U.S. Monetary Policy Normalization and Emerging Economies

- The U.S. economy has been recovering for more than six years as labor market improvements have led to private consumption growth (Fig. 1).
  - ➢ Wages are rising sharply in manpower-short specialized services, as well as retail and other industries where minimum wage hikes are spreading (Fig. 2).
  - ➢ Although private fixed investment recovery had been described as insufficient compared with corporate profits growth, it has posted a recovery trend with a time lag behind corporate earnings (Fig. 3). In addition, investment is shifting from traditional investment such as structures to intellectual property investment (including that in research and development, and software) (Fig. 4).

Fig. 1 Employment



Source: U.S. Department of Labor

Fig. 2 Wage Trend by Industry

(Comparing the averages for Aug-Oct in 2014 and in 2015)

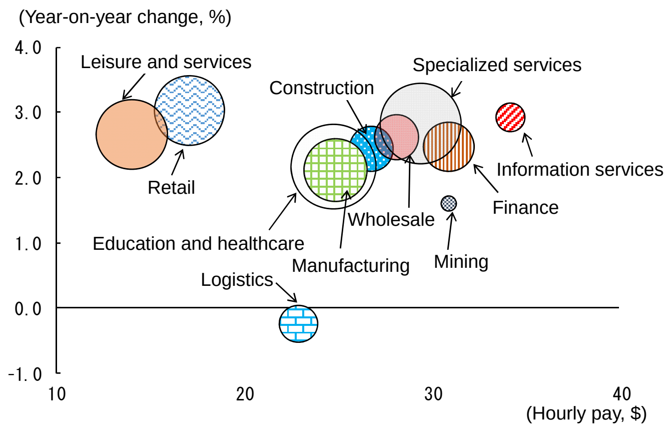


Fig. 3 Private Fixed Investment (Nonresidential) and Corporate Earnings Trends

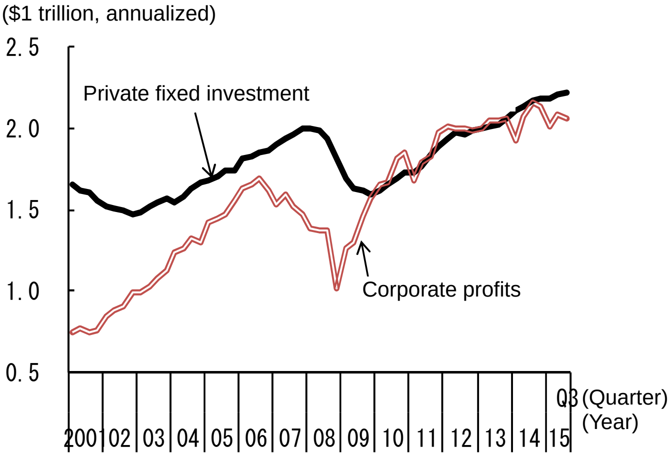
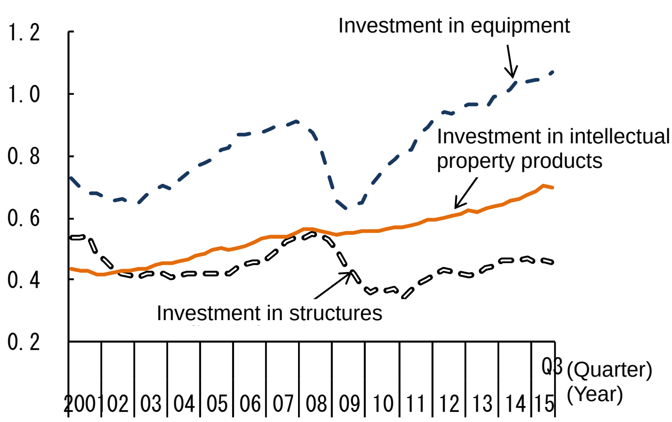
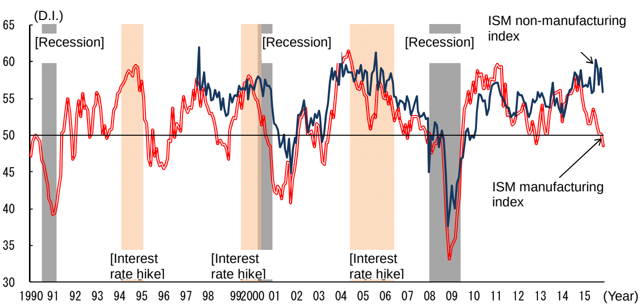


Fig. 4 Breakdown of Private Fixed Investment (Nonresidential)



- In response to the robust domestic economy, the Federal Reserve is expected to start raising interest rates by the end of this year. The market focus is shifting to the future monetary policy normalization process including the pace of rate hikes.
  - In the past tightening phases, business confidence indexes turned downward within one year after the first rate hike, but in some cases the indexes turned upward again without falling into a recession (Fig. 5).
  - International organizations have expressed concerns over the impact of U.S. monetary policy normalization on financial and capital markets in emerging countries. Some emerging countries have insufficient foreign exchange reserves, indicating emerging countries have various risk tolerance levels. Many of them have tight fiscal and monetary policy constraints (Tab. 6).
  - Unlike past financial crisis situations, many emerging countries have shifted to a floating foreign exchange rate system. In addition, international arrangements and frameworks have been enhanced to prevent or mitigate the contagion of financial crises.

Fig. 5 Interest Rate Hikes and Business Confidence (ISM indexes)



Tab. 6 Risk Tolerance of emerging countries

	Ratio of foreign exchange reserves to outstanding short-term debt		Fiscal balance as a percentage of GDP (%)		CPI and inflation target (%)	
	2008	2014	2007	2014	CPI hike (latest)	Target range
Brazil	5.3	6.3	▲ 2.7	▲ 6.2	9.9	2.5~6.5
India	5.6	3.5	▲ 4.4	▲ 7.0	5.0	2~6
Indonesia	2.4	2.3	▲ 0.9	▲ 2.1	4.9	3~5
South Africa	1.2	1.3	1.2	▲ 3.8	4.7	3~6
Turkey	1.3	0.8	▲ 2.0	▲ 1.0	8.1	3~7
Malaysia	2.3	(2013) 1.3	▲ 2.6	▲ 3.6	2.5	—
Russia	5.8	5.5	6.0	▲ 1.2	15.0	4.0

Chapter 3 European Economy Is Recovering Moderately

- The Euro economy sees a moderate economic recovery oriented by household consumption due to low oil prices and a weak euro's exchange rate (Fig. 1).
  - But private sector investment recovery is lagging (Fig. 2). The Euro economy aims to invest 315 billion euros in three years under the European Investment Plan, including the creation of a public-private investment initiative.
- Greece has avoided default for the immediate future as an additional bailout program has been agreed on. However, it faces the difficult challenge of achieving both fiscal consolidation and economic growth.

Fig. 1 Real Economic Growth

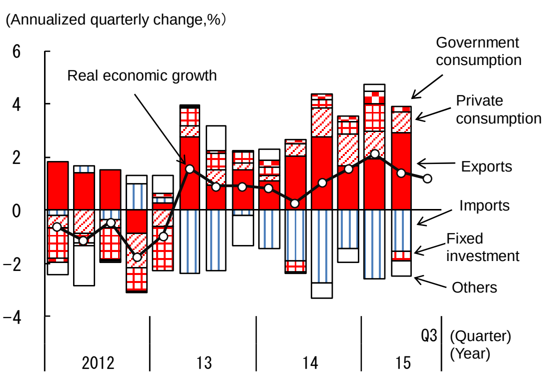
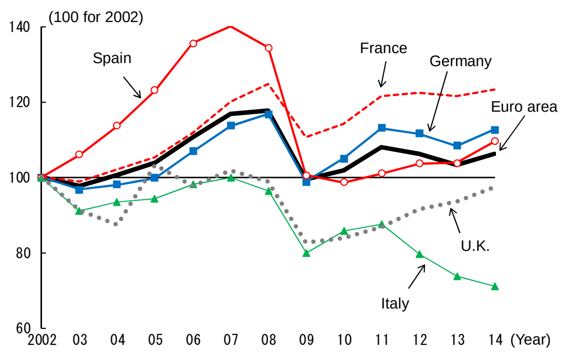


Fig. 2 Private Investment



Chapter 4 Future Outlook of Global Economy and Risks

Main scenario: The global economy will continue its moderate recovery due to a recovery in the U.S. economy and a moderate recovery in the Euro area.

Major risks and their impacts

(1) Impact of the U.S. monetary policy normalization

In the normalization process, international financial markets could fluctuate wildly through massive capital outflow from emerging countries, affecting the real economy.

(2) Future course of emerging economies including China

The Chinese economy could fail to achieve a transition to a stable growth path and decelerates considerably. Resource prices could remain weak. Emerging and resource-rich economies could thus decelerate further.

(3) Geopolitical risks

Economic impacts caused by terrorism and the refugee influx associated with political instability in the Middle East could spread further.

Both the Russian and Ukrainian economies could deteriorate further as economic sanctions on Russia over the Minsk Agreement continue.