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Highlights of 2016 world economy that started with unexpected turbulences

Hiroshi Morikawa, Lead economist
Institute for International Monetary Affairs

The financial markets of 2016 started in a great turbulence with stock prices falling globally, the yen appreciating despite main forecast for depreciation, and the oil prices falling to 30 dollars a barrel. In the following a, let me examine the focal points of the Chinese economy and the crude oil market that are going to gather attention this year and show you a chart that will give you some food for thought on the dollar-yen exchange rate which may affect the Japanese economy.

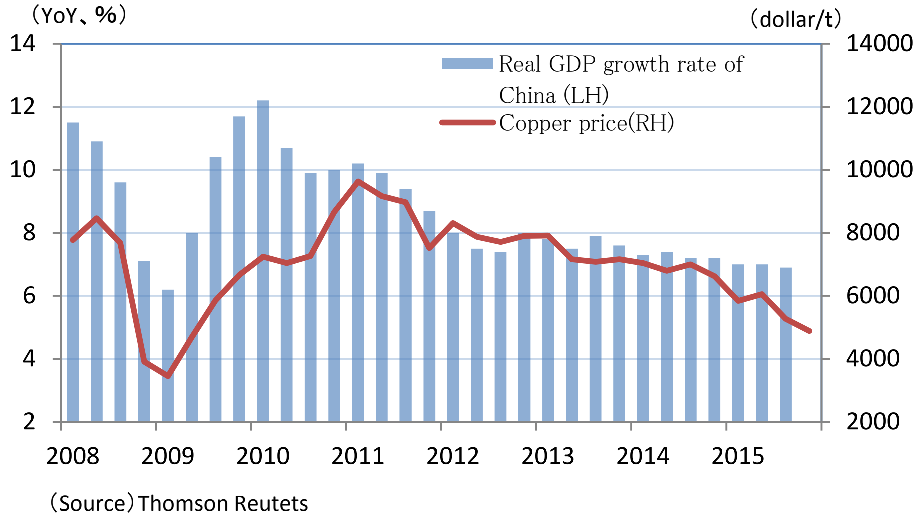
（1） Chinese economy and copper price

The incident that triggered turbulence in the global market at the start of the year was probably the sharp drop of the Chinese stocks. Last August, the Chinese government implemented measures to address a China Shock (of the fall of stock prices) by stopping the sales of stocks by large stock holders for a half year, which restriction was to expire on January 8. During the period of this time buying the government may have expected the economy to recover, but the manufacturing PMI continued to deteriorate, even with the highly expected non-manufacturing PMI dropping to 50.2 in December. The disappointment for this weak economy combined with the expiration of the period for stop measures on stock selling may well have caused a crash in the stock market.

Further deterioration of the Chinese economy would pose a big uncertainty on the Japanese economy as well as on the world economy. But tracing a true movement of the Chinese economy is pretty difficult because of the reliability of its statistics.

In this regard, some of the overseas analysts put a high value on the copper price. The copper price is said to be determined by the demand from China, and therefore it is regarded as a mirror that reflects the growth rate of the Chinese economy. The copper price has fallen to the level of $4,200 per ton ($4,342/t on 12th), suggesting that the declining trend has continued. It would be useful to keep an eye on the movement of copper price.

Chart 1 Chinese Growth Rate and Copper Price



(2) Oil Price

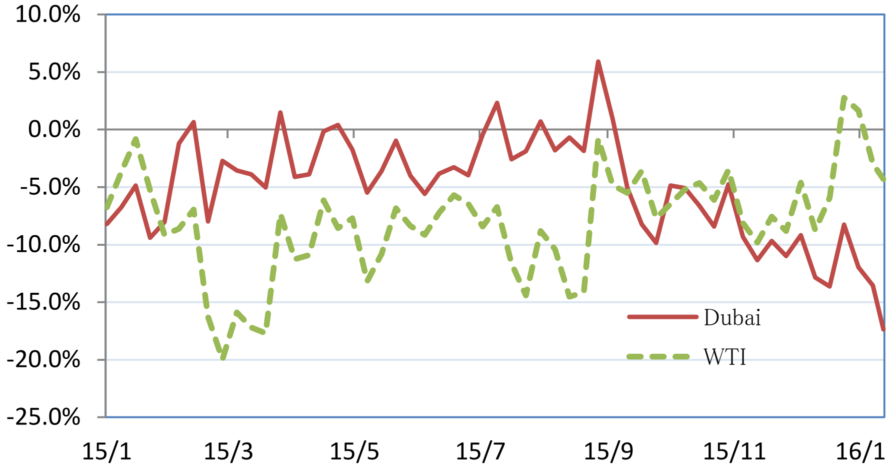
The slowdown of the Chinese economy has provoked a decline of oil prices, aggravating the fiscal balance of oil producing countries. These countries are reported to have started to withdraw their investments by the government funds to make up for their budget deficits, which is partly responsible for the decline of the Japanese stock prices. The falling oil prices are caused not only by a stagnant demand but also by an increased supply of oil.

Until the first half of last year the biggest "villain" who caused the price fall by increasing oil production was the US, but since then the main producers have been changing. This is suggested by the movement of price gaps between the WTI (produced in the US) and Dubai Crude Oil against the North Sea Brent Oil.

Since last September, the price gap of the Dubai Crude Oil produced in the Middle East has been expanding against the North Sea Brent Oil. Currently the gap has reached 17%, suggesting that there is a supply glut of the Dubai Crude Oil. In the background, there is a confrontation between Saudi Arabia and Iran.

The conflict between the two countries has been escalating these days, with no prospect for cooperation toward production cut. Comparatively cheap price of the Dubai Crude Oil represents a "barometer" of the battle for the market shares among the Middle East countries, and as long as this situation continues, there will hardly be any rebound of oil prices. This point should be kept in mind when we look at the future development of the crude oil.

Chart 2 Price Gaps among the Crude Oils



（資料）トムソン・ロイター

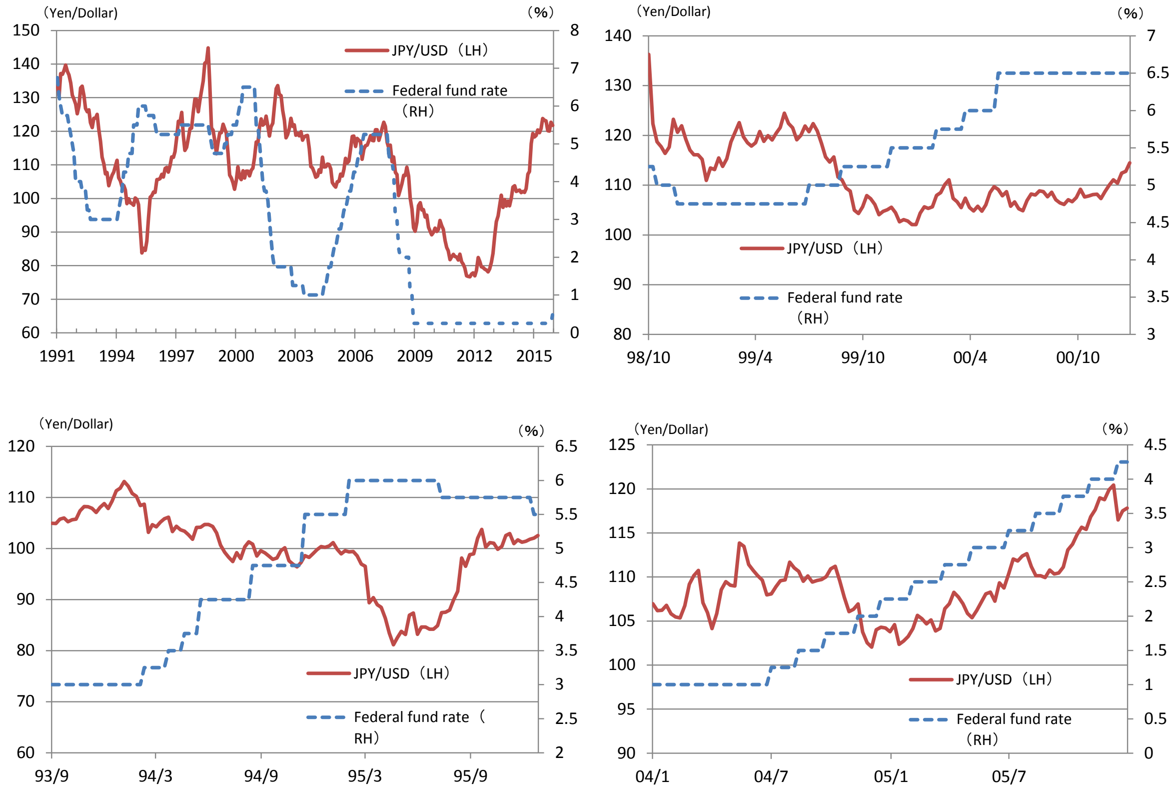
(3) The dollar-yen Exchange rates

There is a strong belief that the interest rate rise in the US will bring a lower exchange rate of the yen against the dollar. But when we look at the three phases of US interest rate rise since 1990s, main trend shows rather higher yen rate.

Chart 3 highlights the developments of the US federal funds and the yen exchange rates against the dollar at each phase of the US interest rate rise. Although the magnitude of the yen appreciation varies, at each phase the yen depreciation came to a peak before the rise of US interest rates, and after the rise, the appreciation of the yen followed. The turn to the depreciation came after a half year at the earliest, and in the case of 1994, it took more than two years before the yen reversed its trend to depreciation.

The reason for such appreciation of the yen despite the common belief seems to be that because the raise of interest rate tends to be carefully implemented taking into account the economic situation and after an adequate previous notification the market will incorporate the rise well in advance of it. As a result, it comes to a practice of “buy on the rumor and sell on the fact” .

Chart 3 Federal Fund Rates and the Yen-Dollar Exchange Rates



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This time, however, the pace of interest rate rise is quite slow and already a review of the scenarios has been in prospect reflecting the recent turmoil, so we may see a different development from the past three patterns. In any case, it will be necessary to make a forecast after analyzing and confirming the past data, without being caught up in our prejudices.