Prospects for individual economies

United States

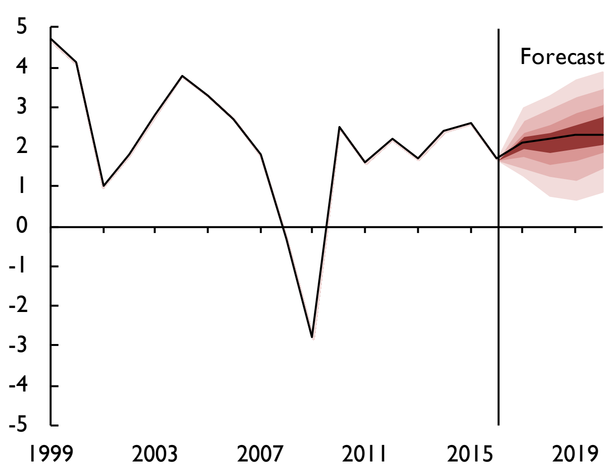
The unexpected election as President of Donald Trump added considerable uncertainty to the country's economic outlook. As discussed above in the Overview, much remains unclear about the policies to be implemented by the new administration and legislated by Congress. Our baseline forecast assumes currently established policies and does not incorporate any assumptions about policy changes, although it does take into account recent information on expectations formed in financial markets. Figure 4 presents our baseline, modal forecast for GDP growth with associated error bounds, indicating that there is a non-zero probability that US GDP growth could be as high as 3.0 per cent or as low as 1.3 per cent in 2017.

President Trump has promised substantial change in many policy areas, including fiscal, trade, and immigration policies, and his unexpected victory has led to reactions in financial markets which reflect expectations that at least some policies will evolve broadly in the directions he has indicated. This is true particularly of fiscal policy (see Box B in this *Review* for the macroeconomic implications of possible changes in US fiscal policy), where expectations of more expansionary policy, including corporate and personal income tax cuts and action to raise infrastructure investment, appear to have contributed to significant increases in longer-term interest rates and rises in equity prices in the United States and other advanced economies. Figure 5 illustrates developments in equity prices, the US dollar's exchange rate, and 10-year government bond yields following the election and by mid-January compared to election day, 8 November.

The increased uncertainty about future economic developments in the US does not, however, seem to have increased volatility in US financial markets. The VIX index – a measure of implied volatility in the US stock market – spiked at above-average values in the week before the November elections but subsequently fell back to unusually low values. Similarly, NIESR's US volatility index showed no increase either over the election period or later (see Box C in this *Review*).

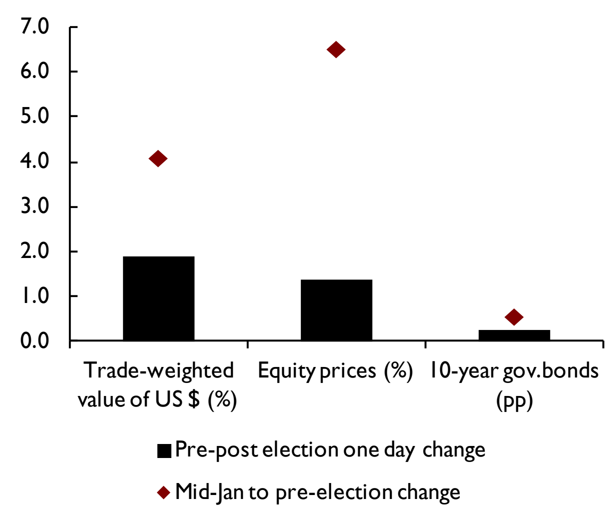
With regard to recent economic developments, GDP growth seems to have strengthened significantly in the second half of last year after three weak quarters. In the

Figure 4. US: GDP growth fan chart (per cent per annum)



Source: NiGEM database, NIESR forecast and NiGEM stochastic simulations.
Note: Each bound represents a cumulative decile of the probability distribution around the February 2017 forecast.

Figure 5. US: Changes in equity prices, US exchange rate and 10-year government bond yields since 8 November presidential election



Source: Datastream and authors calculations.
Note: Trade-weighted value of the US dollar is available only in monthly frequency, hence changes are given between Nov-Oct 2016 and Jan 2017-Oct 2016

https://doi.org/10.1177/002795011723900105 Published online by Cambridge University Press

third quarter of 2016, output grew at an annualised rate of 3.5 per cent – the strongest quarterly growth rate in two years. The strengthening of the expansion in the third quarter was accounted for largely by a recovery of net exports – with the fastest quarterly growth in exports in almost three years – and a turnaround in inventory accumulation; the growth of consumer spending remained strong while private fixed investment remained flat.

The labour market has continued to strengthen, although the growth of employment has slowed gradually further as slack has diminished. The average monthly increase in non-farm employment in the fourth quarter of 2016 was 165,000, compared with 180,000 in the year as a whole, 229,000 in 2015 and 251,000 in 2014. The 12-month growth rate of employment in December was 1.5 per cent, down from a peak of 2.3 per cent in early 2015. In late 2016, unemployment remained close to the lower bound of the FOMC's range-estimate of its longer-term level, which is 4.7–5.0 per cent: in November, it fell to 4.6 per cent, the lowest level since June 2007, before rising back to 4.7 per cent in December. The labour force participation rate remained broadly stable last year, fluctuating in the 62.6–63.0 range, above the September 2015 trough of 62.4 per cent but still low by the standards of the past 40 years. The decline in the rate since around 2000 seems to be largely due to secular demographic trends, particularly the ageing of the population, but the fact that participation has declined among young and middle-age cohorts continues to raise questions about the true degree of labour market slack.

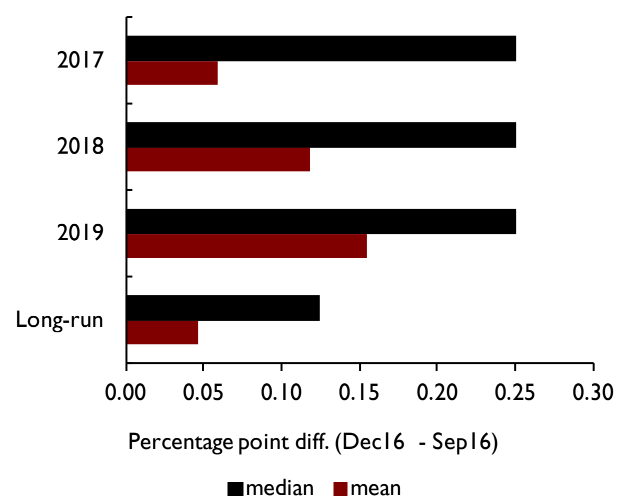
Recent wage developments provide additional evidence that labour market slack has diminished somewhat. The 12-month growth rate of average hourly earnings in the private sector fluctuated around 2.0 per cent between early 2011 and mid-2015, but since then it has trended upwards, reaching 2.9 per cent in December 2016, the largest increase since June 2009. This is still a moderate rate of increase, however, and the more comprehensive employment cost index, which takes account of employee benefits, shows less of an acceleration recently, to 2.3 per cent in the year to September 2016.

Consumer price inflation, on the Fed's preferred measure (the 12-month increase in the price index for personal consumption expenditures), has remained below the Fed's longer-term objective of 2 per cent. It rose from 0.9 per cent in June 2016 to 1.4 per cent in November, mainly on account of an upturn in energy prices. The corresponding core measure remained broadly stable between June and November at about 1.6 per cent. The narrower consumer price index has shown somewhat higher inflation rates – in the twelve months to December 2016, 2.1 per cent for the all-items index and 2.2 per cent for the core.

Market-based measures of inflation expectations have moved up significantly in recent months, although they generally remain below or only a little above 2 per cent. The 5-year breakeven inflation rate stabilised at about 1.9 per cent in the period between mid-December 2016 and mid-January 2017, up from about 1.3 per cent last September and the highest since August 2014. Survey-based measures, meanwhile, have been more stable.

At its December meeting, the Fed increased its target range for the federal funds rate by 25 basis points to 0.5–0.75 per cent – the only increase in 2016, even though the Fed started the year expecting four rate hikes. The FOMC's median projection for the federal funds rate at the end of 2017 was revised up by 25 basis points compared to its September projections, implying three hikes of 25 basis points this year. For 2018 and 2019, expectations of three 25 basis point increases each year remained unchanged. The Fed noted that changes in fiscal policy or other policies under the new administration could affect the economic outlook, but that it was too early to know how these policies would unfold. At her press conference, Chair Yellen noted that some participants in the FOMC had incorporated in their projections some assumption of a change in fiscal policy. The Committee's

Figure 6. Difference between December and September 2016 FOMC projections of midpoint of federal funds rate target range at end-year, 2017–19 and in the long run



Source: FOMC minutes (Dec. and Sep. 2016) and authors calculations.

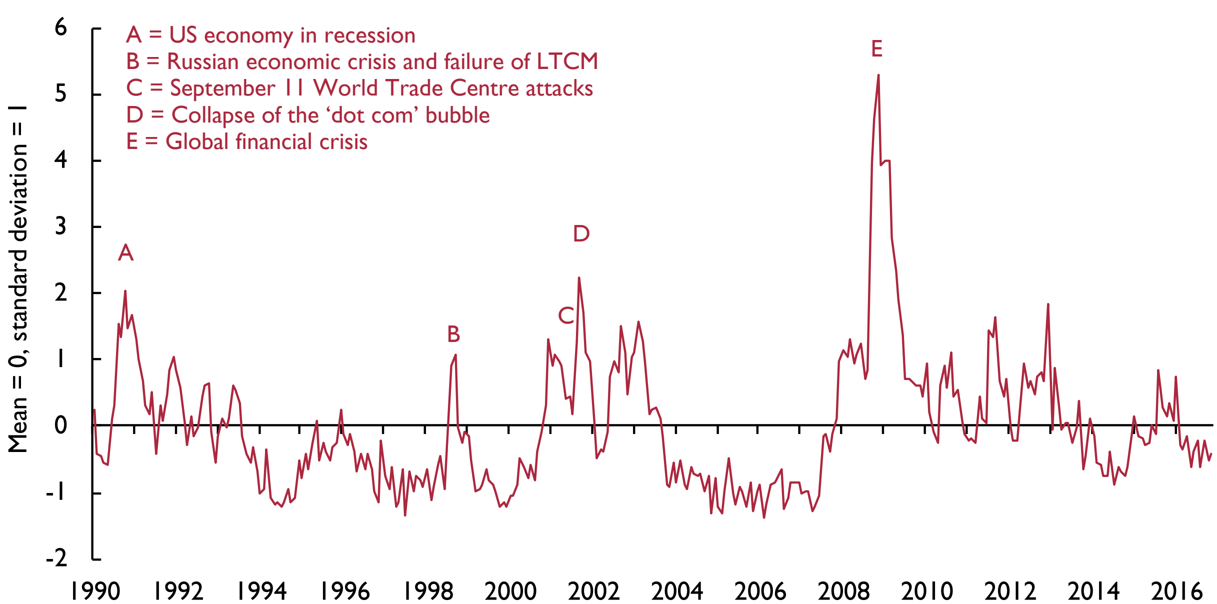
https://doi.org/10.1177/002795011723900105 Published online by Cambridge University Press

Box C. Uncertainty in the US

Following on from our work measuring uncertainty surrounding the UK's referendum on leaving the EU (see the August 2016 *Review)*, we have repeated this exercise for the US economy in the wake of the recent election. Surprisingly, this index – which has mean zero and standard deviation 1 by construction and where values below zero imply that uncertainty is below average – was below its trend level in the eight months preceding the election, averaging –0.35. It fell further in November before rising back towards this pre-election average in December. A negative value implies that uncertainty is below its mean, but not necessarily below 'normal' levels. For example, if we exclude the Great Recession and the recessions of the early 1990s and early 2000s, the mean of this index is –0.22.

This uncertainty series is illustrated in figure C1. Across the sample period there are a number of notable spikes in the series: the early 1990s, corresponding with a short period of contraction in the US economy; a brief period in the late 1990s which appears to coincide with the Russian economic crisis and partial default, and the failure of LTCM causing concern in financial markets; the beginning of the 2000s with the ending of the 'dot com' bubble; the 11 September world trade tower attacks; finally and most notably the global financial crisis. While, during the 'great moderation' period of the mid-2000s the series indicates that uncertainty was consistently low.

Figure C1. Uncertainty index



Source: Authors' calculations.

Similar to our UK uncertainty index, the individual data series underlying our composite index use a number of indicators which may contain information on different manifestations of uncertainty; from perceptions of firms and households, to financial markets and a measure specifically designed to measure economic policy uncertainty.

Financial time series that we have included are the Vixvol, the option implied volatility series based on the S&P 500 stock index; and the spread in yields between the BAA 3-month corporate bond and T-bill. These capture uncertainty within financial markets. The normalised values of these series are plotted in figure C2. It can be seen that both series have trended down gradually since their respective peaks during the Great Recession, and neither series has materially increased during the lead up to or since the election. To account for uncertainty in the real side of the economy we have included the Conference Board consumer confidence index; the Chicago PMI, a survey of general business activity; and the ISM new orders survey for the manufacturing sector. The normalised values of each of these series are plotted in figure C3. Unlike the financial market variables, for these variables a value below 0 would indicate that uncertainty is below, rather than above, the long-term average. The overall picture is the same as that depicted by the financial market variables, which each indicate an overall decline in uncertainty since the end of the Great Recession, with no marked movements surrounding the recent Presidential Election.

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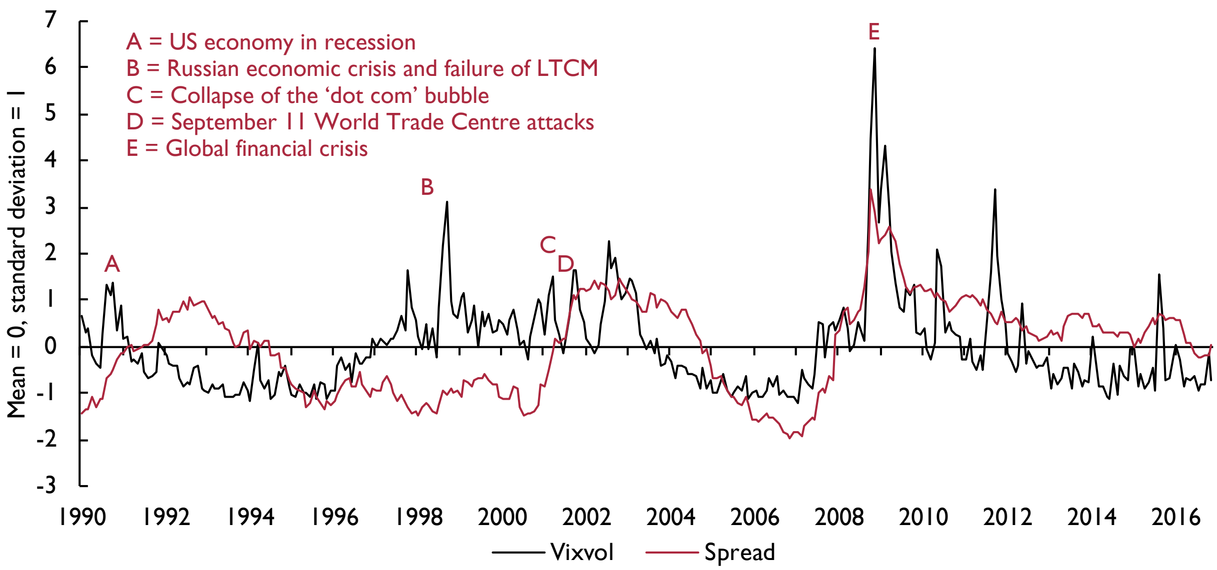
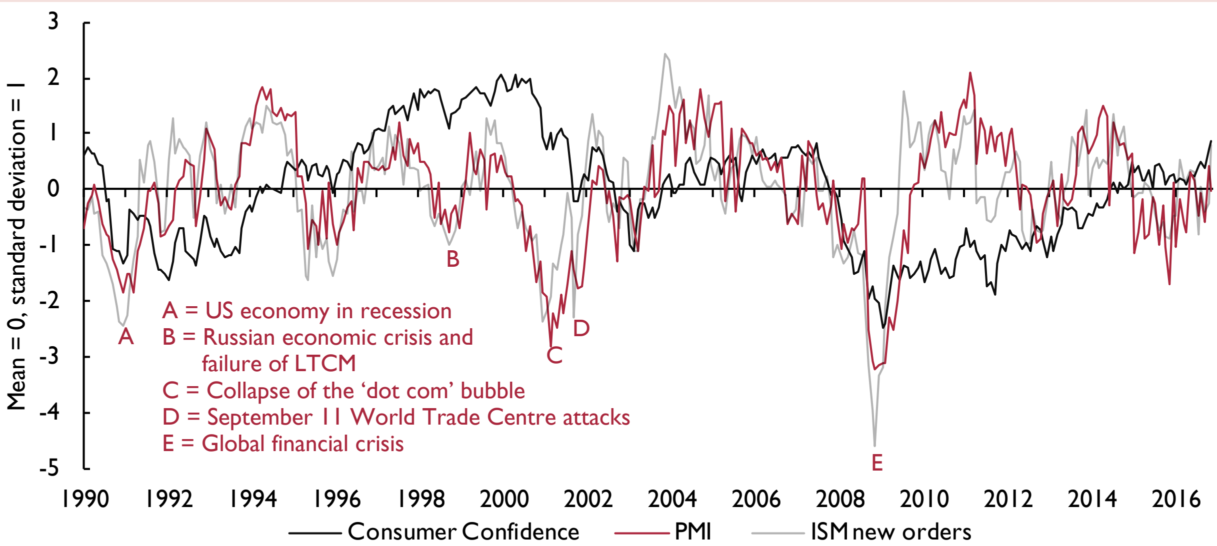
Box C. (continued)

Figure C2. Measures of uncertainty in financial markets



Source: Datastream and authors' calculations.

Figure C3. Measures of uncertainty in the real economy



Source: Thomson Reuters Datastream and authors' calculations.

Our final measure is the Economic Policy Uncertainty index, created by Baker *et al.* (2015) and constructed by counting the number of times a certain set of words appear in ten large national newspapers; the normalised series is plotted in figure C4. As can be seen, this is the most volatile of the series and at the monthly frequency has the least persistent changes in uncertainty. Interestingly, the largest spike in this series does not correspond to the financial crisis but rather with the government shut-down

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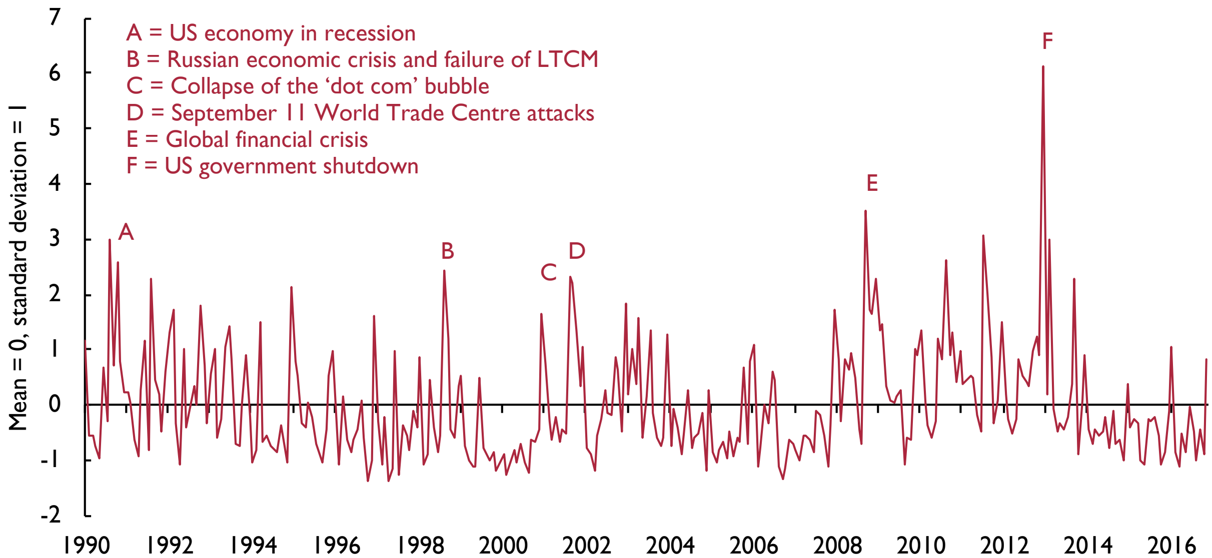
Box C. (continued)

Figure C4. Policy uncertainty index



Source: http://www.policyuncertainty.com/.

period in October 2013. While in the final month of our period this index has increased somewhat, it remains within historically normal levels, suggesting that overall economic policy uncertainty also currently remains subdued.

It must be noted that media based measures such as this one have been criticised on the grounds that they may be capturing fear or pessimism in addition to uncertainty. In a recent speech, Forbes (2016) claimed that the UK economic policy index was poorly correlated with economic variables such as GDP.

Our index currently suggests the uncertainty in the US economy has not increased, on aggregate. This is also the case when we look across the indicators from which we have extracted this common factor. There is currently scant evidence that a surprise political outcome has led to increased uncertainty.

Ironically, there is a lack of clarity over policies that the President will actually implement. Perhaps we are in the perverse situation where clarity over policy may well illicit an increase in uncertainty in US economic firms and households over the future path of the economy.

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This box was prepared by Rebecca Piggott and James Warren.

https://doi.org/10.1177/002795011723900105 Published online by Cambridge University Press

forecast of GDP growth and inflation remained largely unchanged.

Market expectations, which measure means rather than medians of projections, show smaller increases in the federal funds rate in 2017–19 than projected by the Fed, as illustrated in figure 6. The market-implied probability of a first rate hike for 2017 in June, as of early January, is about 70 per cent, with 70 per cent probability attached to a total of two rate hikes by the Fed in 2017 and about 40 per cent probability attached to three.

Canada

Output growth has picked up from the energy-related slowdown of 2015, but excess capacity has continued to weigh on inflation. The economy faces significant risks, upside and downside, from policy changes by the new US administration.

GDP grew by 0.9 per cent in the third quarter of 2016, the highest quarterly growth rate since the second quarter of 2014, following a contraction of 0.3 per cent in the previous quarter when wildfires disrupted oil production. Growth in the third quarter was boosted by rising energy exports, while domestic demand growth slowed, with declines in both government consumption and business fixed investment. The introduction of child benefit in July spurred household consumption in the third quarter, while the new federal infrastructure programme is expected to boost growth in the period ahead. We forecast GDP growth of 1.7 per cent this year, rising to 2.2 per cent in 2018.

The Comprehensive Economic and Trade Agreement (CETA), a free trade agreement eliminating 98 per cent of tariffs between Canada and the EU, was signed in October 2016. The Canadian government estimates that this could increase bilateral trade with the EU by 20 per cent and boost GDP by up to C$12 billion, or around 2½ per cent of GDP, per year. The European Parliament and EU national parliaments need to approve CETA before it can take effect, so we have not incorporated any assumption about the effects of the agreement in our forecast.

One of the risks associated with prospective policy changes in the US is that of renegotiation or cancellation of the NAFTA. Uncertainty about this may well weigh on investment in the near term.

The unemployment rate was 6.9 per cent in December, up from 6.8 per cent in November, partly reflecting an increase in labour force participation: employment rose by 0.3 per cent in the month. We expect unemployment to average 6.7 per cent this year, slightly lower than in 2016.

Consumer price inflation, on a 12-month basis, began 2016 at the Bank of Canada's target rate of 2 per cent but it declined during the year, weighed down by excess capacity in the economy. It was 1.5 per cent in the year to December. The Bank recently introduced, for monitoring purposes, three measures of core inflation; the latest data for them are all below 2 per cent. We expect inflation to pick up in the near term in the wake of the recent upturn in oil and other commodity prices and as excess capacity is reduced. We expect it to average 1.8 per cent this year.

Concerns remain about overheating in housing markets, particularly in Toronto and Vancouver. Rapid growth in mortgage and consumer credit led to a rise in the ratio of household debt to disposable income to a record high of 167.6 per cent in the second quarter of 2016. The provincial government in British Columbia has introduced a stamp duty on house purchases by non-residents and Vancouver has implemented a tax on vacant homes. More stringent federal prudential requirements for mortgage borrowing are also designed to restore stability to the market.

Euro Area

GDP growth has continued at a relatively steady annual rate of about 1½ per cent, bringing further progress in reducing unemployment, which in October and November reached 9.8 per cent, its lowest level in more than seven years. However, unemployment remains high by pre-2009 standards, and, like output growth, it remains very uneven among member countries. Annual consumer price inflation has risen in recent months from close to zero to slightly above the core rate of about 0.9 per cent, reflecting the stabilisation and partial recovery of global energy prices since 2015. There has been little indication of any significant rise in underlying inflation. Thus inflation remains well below the ECB's objective of "below, but close to, 2 per cent". On 8 December, the ECB announced that its asset purchase programme would be extended from March to at least December 2017, but that starting in April monthly purchases would revert to €60 billion from the stepped-up rate of €80 billion a month introduced last April.

In the third quarter of 2016, GDP increased by 0.3 per cent, to a level 1.7 per cent higher than a year earlier. Growth in the third quarter was driven mainly

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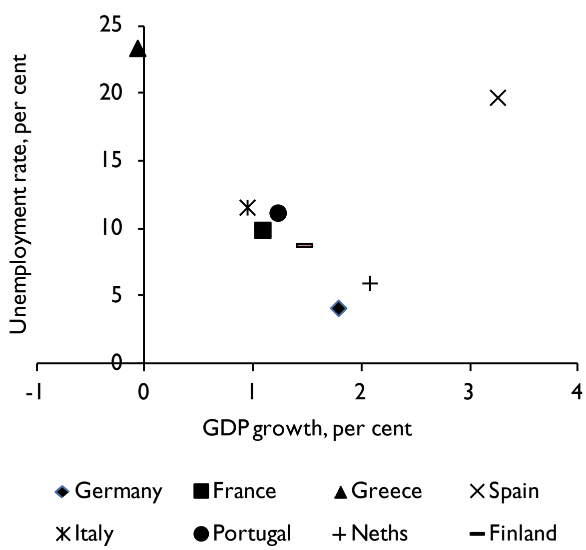
by consumer spending, with net exports contributing negatively. More recent, higher-frequency data point to continued moderate growth in the fourth quarter, with some indicators, including industrial production and the volume of retail trade, suggesting a strengthening of the expansion.

Unemployment fell to 9.8 per cent in October and November, its lowest level since July 2009. This is 2.3 percentage points below the peak reached in March 2013 and 2.5 percentage points above the March 2008 trough: in the past 3½ years, a little less than half of the rise in unemployment that occurred during the recession has therefore been reversed. Differences in unemployment rates among countries have remained extremely large. In November, unemployment was 4.1 per cent in Germany, a post-unification low, but 9.5 per cent in France, 11.9 per cent in Italy, 19.2 per cent in Spain, and 23.1 per cent in Greece. Wage increases have remained moderate. Thus in the year to the third quarter of 2016, hourly labour costs rose by 1.5 per cent in the Area as a whole, and by somewhat more in Germany (2.5 per cent) than in countries where unemployment has been higher (such as France at 1.4 per cent, Italy at –0.5 per cent and Spain at 0.4 per cent).

Consumer price inflation, on a 12-month basis, rose to 1.1 per cent in December, the highest rate since September 2013. This measure of annual inflation has risen steadily

Figure 7. GDP growth and unemployment for selected Euro Area economies



Source: NiGEM database and NIESR forecast.
Note: Figures refer to 2016.

from the trough of –0.2 per cent reached last April. Core inflation in the same period has been steady at 0.8–0.9 per cent. The rise in the all-items inflation rate towards and above the core rate mainly reflects the stabilisation and partial recovery of energy prices after the declines that occurred in 2014–15. There has been little sign of a pick-up in underlying inflation. Thus inflation has remained well below the ECB's medium-term objective of "below, but close to, 2 per cent".

In light of developments and ECB staff projections for GDP growth and inflation that had changed only marginally since September, the ECB announced on 8 December that it would extend the duration of the purchases under its asset purchase programme (APP) from end-March to end-December 2017 "or beyond, if necessary, and in any case until the Governing Council sees a sustainable adjustment in the path of inflation consistent with its inflation aim". However, beginning in April, monthly purchases will revert to €60 billion from €80 billion, the level to which they were raised last April. President Draghi explained that this change was motivated by the fact that the threat of deflation that had been apparent when purchases were increased early this year had significantly diminished. He emphasised that the change was not to be viewed as a step in "tapering" the purchases toward zero, that the Governing Council had not discussed such tapering, and that if necessary the purchases could again be scaled up or extended in duration.

With regard to the constraints that it had placed on the APP, the ECB announced that following the evaluation foreshadowed in September (see November 2016 *Review*, F19 and Box B), it would make two parameter adjustments in January 2017: first, the maturity range of eligible public sector securities would be broadened by reducing the minimum remaining maturity to one from two years; and second, purchases of securities with a yield below the interest rate on the ECB's deposit facility (–0.4 per cent since last March) would be permitted, to the extent necessary. Mr. Draghi explained that these options had been chosen partly because of legal and institutional constraints on raising the issuer and issue-share limits attached to the APP.

Even with the ECB's latest policy measures, the ECB staff's forecast of consumer price inflation in 2019 is 1.7 per cent, which Mr. Draghi acknowledged did "not really" meet its inflation objective.

With regard to fiscal policy, the European Commission argued in November that "In light of the slow recovery and risks in the macroeconomic environment, there is a

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case for a moderately expansionary fiscal stance for the euro area", more specifically a fiscal expansion of up to 0.5 per cent of GDP at the level of the Euro Area as a whole for 2017.[6] In early December, the Eurogroup of Euro Area finance ministers rejected the Commission's recommendation, approving instead a neutral fiscal stance for the Area this year.

Germany

Output growth slowed to 0.2 per cent in the third quarter of 2016 from 0.4 per cent in the previous quarter. This was the weakest quarterly expansion in a year, with a decline in net exports partly offsetting continued robust growth of private and government consumption; fixed investment was flat. More recent data suggest that growth picked up in the fourth quarter, and the preliminary official estimate of GDP growth in 2016 as a whole is 1.9 per cent, slightly higher than growth in 2015 and Germany's highest growth rate since 2011. Limited fiscal stimulus, as well as the ECB's accommodative monetary policy, has recently supported growth. We forecast output to grow by 1.7 per cent this year and 1.3 per cent in 2018.

Household incomes and consumption have continued to be boosted by a strong labour market, with unemployment at 4.1 per cent in the three months to November, its lowest level since German unification. However, there has been little sign of any significant increase in wage growth: Eurostat data show that hourly labour costs (including benefits) rose by 2.5 per cent in the year to the third quarter of 2016, unchanged from the four-quarter increase a year earlier. Wages have continued to rise somewhat faster in Germany than in the Euro Area as a whole – by about 1 percentage point a year in 2015–16 – thus helping other member countries to improve, albeit slowly, their international competitive positions relative to Germany.

Germany's external current account surplus remains the largest in the world, by far, in US dollar terms, although we expect it to narrow somewhat this year, to 8.1 per cent of GDP, and again in 2018, to 7.4 per cent, from 9.1 per cent in 2016. The UK is currently Germany's main trading partner and we expect Germany's exports to be damped by the UK's exit from the EU, and indeed in advance of the event, as the UK economy weakens.

Labour market pressures are being eased by immigration, including the large influx of refugees in 2015, and on a smaller scale in 2016, resulting from conflicts in the Middle East. This has boosted Germany's population by around ½ per cent. Most refugees have not yet entered the labour market but many are expected to do so over the next two years. Poor German language skills and a lack of formal or recognised qualifications mean that most refugees are unlikely to be able to find jobs quickly, so that the unemployment rate is expected to rise in the near term, to 4.3 per cent on average this year and 4.7 per cent in 2018. This would still be low by most historical standards and compared to other major European economies.

Consumer price inflation, on a 12-month basis, jumped to 1.7 per cent in December from 0.8 per cent in November. This is the highest 12-month rate of inflation since July 2013, the increase being accounted for mainly by a rebound in energy prices. We expect inflation to average 1.5 per cent this year before falling to 1.2 per cent in 2018.

France

Economic growth has continued at an underlying annual rate of 1–1¼ per cent. After an erratic, weather-affected, first half of 2016, with strong GDP growth of 0.6 per cent in the first quarter followed by a slight contraction of 0.1 per cent in the second, growth resumed in the third quarter with a modest expansion of 0.2 per cent. In the third quarter, final domestic demand contributed 0.2 percentage point to GDP growth, thanks mainly to housing investment and government spending; private consumption and business fixed investment remained stagnant. Stockbuilding made a significant positive contribution to growth of 0.6 percentage point, offset by a similar negative contribution by net trade. Indeed, the increase in stockbuilding seems to have been related to imports of hydrocarbons and transport equipment. The Banque de France has projected a pick-up in growth to 0.4 per cent in the fourth quarter. The lacklustre mid-year performance has led us to revise our estimate of GDP growth in 2016 downwards slightly to 1.1 per cent. Given the weakness of growth in France's main trading partners, we expect net trade to continue making neutral or negative contributions to growth in the short term.

Unemployment has recently surprised on the downside. After fluctuating at around 10¼ per cent since the end of 2012, it declined to 9.5 per cent in the three months to November. Wage growth has remained subdued, at 1.5 per cent in the year to the third quarter of 2016, close to the Euro Area average.

Consumer price inflation has risen further in recent months but remains low, at 0.8 per cent in the twelve months to December. The recent rise in inflation is accounted for largely by energy and food prices, and core inflation has edged down to 0.4 per cent. Given the continuing output and employment gaps, the inflation outlook remains weak.

With the second round of the French presidential election due this May, the future path of fiscal policy is uncertain. We estimate that the government deficit was equivalent to 3.3 per cent of GDP in 2016, and on the assumption of current policies we project a decline to 3.0 per cent in 2017. The limited reduction projected for this year is partly a reflection of our projection of weak economic growth.

Italy

By the country's recent standards, the 0.3 per cent growth of GDP in the third quarter of 2016 was relatively strong; and growth in the year to the third quarter was 1.0 per cent, somewhat higher than the 0.6 per cent average growth of 2015. But this limited improvement in growth performance has not brought further progress in reducing unemployment, which remains high: indeed, it has turned up in recent months. The country also faces other significant challenges. Renewed turmoil in the banking sector, with Monte dei Paschi di Siena (MPS) failing to raise the private capital required to comply with EU regulatory requirements, led to the announcement just before Christmas of a government bail-out of Italy's oldest bank under the EU's "precautionary recapitalisation" rules, using part of a fund newly approved by parliament for the recapitalisation of banks. Moreover, political uncertainty is elevated, with a new caretaker government having been appointed following the resignation on 7 December of Prime Minister Renzi, a few days after he lost a referendum on constitutional change. Early elections are a possibility.

GDP growth in the third quarter of 2016 was driven entirely by domestic demand, with small but positive contributions from private consumption and investment outweighing a small negative contribution from net trade. Growth of private fixed investment, having been positive in 2015 for the first time since 2008, has continued: we estimate that it rose by 1.7 per cent in 2016 as a whole, after an increase of 1.4 per cent in 2015. However, given its cumulative decline of close to 30 per cent between 2007 and 2014, these increases signal only a limited recovery in investment. This may partly reflect constraints on the supply of credit associated with the difficulties of the banking system, as well as weak domestic demand and international competitiveness. We estimate that GDP growth averaged 0.9 per cent in 2016, and we forecast continued subdued growth of 1.0 per cent in 2017, followed by a moderate pick-up to 1.3 per cent in 2018.

Consumer price inflation, on a 12-month basis, has picked up from negative rates early last year to 0.5 per cent in December, mainly owing to an upturn in energy prices. Core inflation has been more stable, at 0.6 per cent in the twelve months to December. Weighing down on inflation has been the weakness of wages, which were unchanged in the third quarter of 2016 from a year earlier, after more than a year of decline.

After reaching a peak of 13.1 per cent in late 2014, unemployment fell to a plateau of about 11.6 per cent in August 2015, at which it remained for a year. In the three months from August 2016, however, unemployment turned up again, reaching 11.9 per cent in November, its highest level since June 2015. Part of the recent rise may be attributed to declines in the labour-force inactivity rate, which declined by 1.2 percentage points between August and November 2016. However, in a context of declining wages and after a series of policy measures designed to increase job creation (including the 2014 Jobs Act and the introduction of tax deductions for hiring), lacklustre job creation and high unemployment remain major concerns.

Problems in the banking sector continued in the second half of 2016. The ratio of bad debts to total bank loans has stabilised at about 12¼ per cent following the introduction of the Atlante fund in April 2016. However, in December the MPS bank failed to secure a €5bn injection of private capital, which was thought at the time to be what was required and sufficient for MPS to comply with EU bank capital regulations. In response, the government prepared a €20bn package for the recapitalisation of several weak banks, including MPS, and this was approved by parliament on 22 December. This could add 1.2 percentage points to Italy's government debt-to-GDP ratio, which, by the third quarter of 2016, was about 135 per cent of GDP. The package will not, however, be included in the government's deficit figures. In order to comply with EU bank bail-out and state aid regulations, the government's "precautionary recapitalisation" of MPS will have to bail in junior bondholders, a large number of which are households. About €6.5 billion of the €20 billion fund is now expected to have to be used for MPS, with plans for restructuring the bank expected to be submitted by the government and the bank to European authorities by end-January. Even after this capital injection for MPS, the sector remains saddled with a large burden of non-performing loans, and while a bail-out was possible for

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MPS, as a large systemic bank, EU rules may prevent the government bailing out other, smaller, banks.

In December the parliament approved the budget for 2017. The new budget plans a deficit of 2.3 per cent of GDP for 2017, which is higher than the 1.8 per cent target agreed with the European Commission. Among other things, the budget envisages a reduction of the corporate tax rate from 27.5 to 24.0 per cent and additional support for early retirements.

Spain

Spain has remained the fastest growing major economy in the Euro Area. Growth in the third quarter of 2016 slowed only marginally to 0.7 per cent from 0.8 per cent in each of the preceding three quarters. Preliminary estimates by the Bank of Spain suggest that growth in the fourth quarter continued at the rate of 0.7 per cent. This implies that growth in the year as a whole was 3.3 per cent, marginally higher than in 2015. We expect the expansion to moderate in 2017 and 2018, to 2.5 and 2.3 per cent, respectively, as economic slack diminishes.

GDP growth in the third quarter was driven mainly by domestic demand, which contributed 0.6 percentage point, with expansion shared among the main spending categories except fixed investment, which was virtually flat. The dip in government consumption in the second quarter proved transient, as expected. Fuelling the growth of private consumption have been favourable credit conditions and significant employment growth, at 2.8 per cent in the year to the third quarter of 2016 on Eurostat data.

Unemployment has continued to decline but, at 19.2 per cent last November, it has remained the second highest in the Euro Area, after Greece, and an issue of major concern. Most of the rise in unemployment that occurred between the mid-2007 low of 8 per cent and the early 2013 peak of 27 per cent has yet to be reversed. Not surprisingly, wage increases have remained moderate, at 0.8 per cent in the year to the third quarter of 2016, half the average increase in the Euro Area.

Consumer price inflation, on a 12-month basis, has recently surprised on the upside, at 1.4 per cent in December 2016, up from 0.5 per cent in November, which was the first positive reading since May 2014. This upturn in inflation has been driven mainly by energy prices. Changes in core inflation, which was 1.0 per cent in the year to December, have been much more muted.

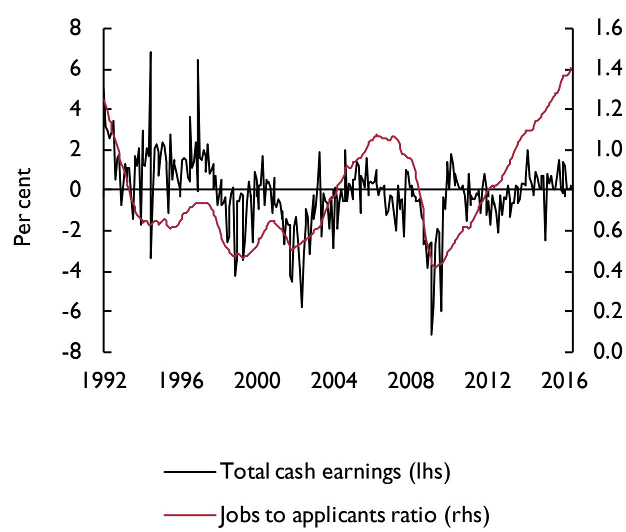
A new government was elected at the end of October 2016, putting an end to a year-long caretaker government. As a result, a new draft budget was sent to the European Commission, targeting deficits of 3.1 and 2.2 per cent of GDP, respectively, for 2017 and 2018. These goals are to be achieved by freezing government spending at the 2016 level together with revenue measures relating to corporate taxes and VAT. The budget is expected to be ratified by parliament during the first quarter.

Japan

There has recently been some improvement in Japan's economic performance and prospects. The economy grew in each of the first three quarters of 2016 – the first occurrence of positive growth in three consecutive quarters since 2013. Output rose by 0.3 per cent in the third quarter, compared with 0.5 per cent in the second and 0.7 per cent in the first. Both private and government consumption grew by 0.3 per cent in the third quarter, and the strong growth of housing investment continued, at a rate of 2.6 per cent, down from the even faster rate of 3.5 per cent in the second quarter. Business fixed investment contracted slightly after rising strongly in the second quarter. The external sector also contributed positively to GDP growth in the third quarter, with exports growing by 1.6 per cent, while imports contracted for the fourth consecutive quarter.

The third-quarter national accounts data incorporated for the first time the 2008 System of National Accounts

Figure 8. Japan: nominal wage growth and the jobs-to-applicants ratio



Source: Datastream.

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alongside the standard revision process including the incorporation of new input-output tables. As a result, real GDP estimates for 2013–16 were revised up, indicating that the economy was in better health leading into the April 2014 consumption tax hike than previously thought. The GDP growth rate for 2015, at 1.2 per cent, is now double the previous estimate. This upgrade was largely accounted for by upward revisions to private consumption and housing investment, which suggests that the recovery of household demand apparent in 2016 began earlier than previously thought. This is consistent with movements in the consumer confidence index, which rose significantly in 2014–15; in December 2016 it reached its highest level in more than three years. This is one factor leading us to revise upwards our projected growth rates for consumption this year and next, to 1.0 and 0.9 per cent, respectively, from 0.4 per cent for both years in our November forecast.

The outlook for business fixed investment is broadly unchanged from our November forecast, with growth of 2.6 per cent projected for both 2017 and 2018. The Bank of Japan's December Tankan survey indicated an improvement in sentiment in the final quarter of last year among large manufacturers – the first such improvement in 18 months – but sentiment among small and medium-sized manufacturers remained weak.

In our forecast for the external sector, export growth has been revised up slightly owing to the recent depreciation of the yen – by 4 per cent in trade-weighted terms in the fourth quarter of 2016. Import growth is expected to pick up with private consumption. We expect the contribution of net trade to GDP growth to be broadly neutral in 2017 and 2018, little changed from our November forecast.

Taking account of recent data, our forecast of GDP growth in 2017 and 2018 has been revised up to 0.7 and 0.8 per cent, respectively, from 0.4 and 0.6 per cent in our November forecast. For the medium term, we project annual GDP growth of 0.3 per cent, in line with estimates of Japan's potential growth rate.

After six consecutive months of negative price inflation, in terms of the 12-month change in the all-items consumer price index, inflation turned positive in October 2016 and rose further, to 0.5 per cent, in November. This upturn can be attributed largely to a rise in the prices of energy and fresh food. Excluding energy and fresh food, 'core core' inflation in the year to November was 0.1 per cent. The expected improvement in domestic demand conditions, the recent depreciation of the yen and the upturn in global commodity prices should support inflation in the period ahead.

However, the stagnation of nominal wages remains a concern. Key indicators of labour market conditions suggest that the economy is close to full employment, yet wage growth has remained very weak. Unemployment increased slightly in November to 3.1 per cent, from 3.0 per cent in October, which was a 22-year low. Moreover, the ratio of job offers to applicants has climbed steadily from its nadir of 0.44 in December 2009 to 1.41 in November 2016, its highest level since August 1991. However, total cash earnings rose by only 0.2 per cent in the year to November; in fact, annual wage growth has averaged 0.1 per cent since early 2010. As figure 8 illustrates, since the great recession the transmission from labour demand to nominal wages appears to have been absent or exceptionally muted. Prime Minister Abe's attempts to encourage wage growth have clearly not been successful. A prolongation of this situation presents a significant downside risk to the economy. Given the expected uptick in price inflation in the short term, if wages remain stagnant households' real incomes will suffer significant erosion, depressing consumer demand and price growth. Our forecast assumes that the labour demand mechanism will again become functional, and we forecast price inflation of 0.5 per cent in 2017, rising to 0.8 in 2018, with unemployment relatively stable, at 3.0 per cent in both years.

In light of the continued weak outturns for wage and price inflation, alongside indications of persistently low inflation expectations, it is unsurprising that the December monetary policy meeting of the Bank of Japan chose to keep monetary policy parameters unchanged, with the interest rate on some excess reserves at –0.1 per cent and the target for the long-term interest rate at zero per cent. We expect monetary policy to remain loose throughout our forecast period.

China

With the support of fiscal stimulus and accommodative monetary policy, GDP in 2016 grew by 6.7 per cent, down from 6.9 per cent in 2015 and close to the middle of the government's target range of 6.5–7.0 per cent. However, this on-target expansion continued to mask substantial problems facing China's economy.

China's debt-to-GDP ratio has continued to rise, reaching 255 per cent at the end of June 2016, up from around 140 per cent at the end of 2008. This steep increase in debt,

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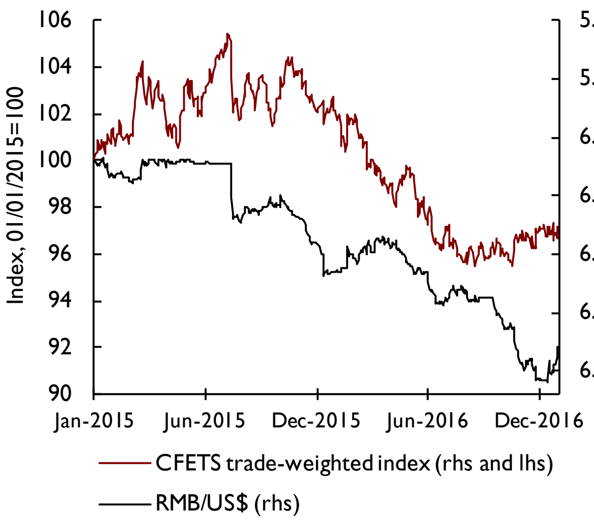
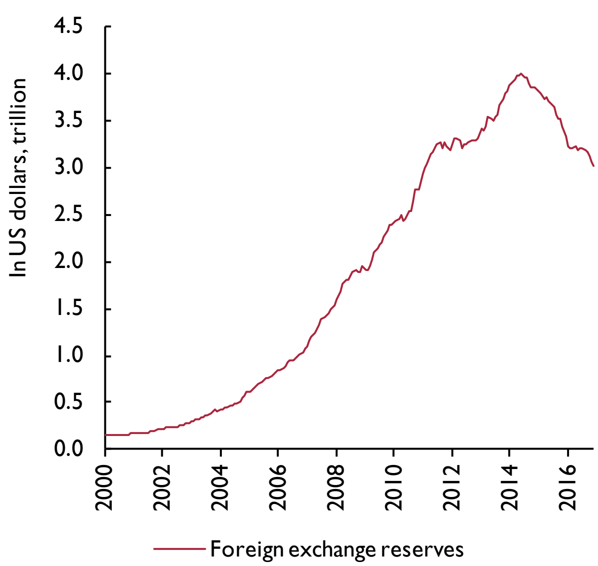
Figure 9. China: trade-weighted and US dollar exchange rate



Source: Datastream and authors' calculations.

Figure 10. China: foreign exchange reserves



Source: Datastream.

to levels that are high by most international standards, is largely accounted for by lending by state-owned banks to state-owned enterprises, many of which are loss-making and operating in heavy industries suffering from overcapacity. The government has taken steps to reduce overcapacity in key industries, including coal and steel. Thus annual production quotas were introduced in 2016, which seem to have become stricter this year. Restructuring is thus underway but there is much to be done in this area as well as in the recapitalisation of banks.

The threat of deflation in China has receded, which is good news for the indebted. Partly owing to increases in the prices of coal as well as other commodities, producer price inflation, on a 12-month basis, moved into positive territory in September 2016, after 54 months of decline. It rose to 5.5 per cent in December, outpacing consumer price inflation at 2.1 per cent. This was the second consecutive month – and also only the second month since 2011 – for annual producer price inflation to exceed consumer price inflation, which has been trending slowly upwards over the past two years towards the authorities' target of 3 per cent.

The renminbi has continued to depreciate against the US dollar, reaching at the beginning of January 2017 its lowest value since December 2008. The depreciation has slowed, however, since mid-December. The renminbi lost about 4 per cent of its value in the three months to early January, and about 14 per cent in the three years from the start of 2014, when its value in terms of the US dollar reached a peak. In terms of China's official basket of currencies, as illustrated in figure 9, the renminbi's value was relatively stable over the past six months.

China's official foreign exchange reserves have been on a declining trend since mid-2014, falling by about a quarter in this period (figure 10), but the speed of decline has varied. After relative stability in the first half of 2016, the pace of decline increased towards the end of the year, reaching almost US$70bn in November 2016. Roughly half of this decline has been estimated to be due to valuation changes arising from appreciation of the US dollar. The fall in reserves in the past 2½ years, however, has been mainly a result of central bank sales of foreign currency assets to slow the renminbi's decline. Expectations of increases in interest rates in the US, coupled with slowing economic growth in China, repayments of foreign debt, and attempts by the private sector to diversify financial portfolios internationally are all thought to have contributed to increased capital outflows in this period.

Concern about capital outflows recently prompted the authorities to introduce new rules for certain foreign exchange transactions. Thus in late November, they informed banks that the threshold above which official approval was required for certain foreign payments, including repayments of loans and payments of

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dividends, was being lowered from US$50 million to US$ 5 million. Also, in late December, the authorities introduced additional reporting requirements for individuals wishing to use their annual $50,000 quota of foreign exchange. The new measures may have contributed to the stabilisation of the renminbi since mid-December and the slowing of the pace of reserve losses in December relative to the two preceding months.

India

Economic activity has been disrupted since early November 2016, to an extent that is as yet difficult to gauge because of lack of data, by government action to demonetise certain currency notes with the aim of reducing tax evasion and other crimes. Before then, robust growth of the economy continued, with 7.3 per cent GDP growth in the year to the third quarter. Household and government consumption remained the main drivers of growth, increasing by 7.6 and 15.2 per cent, respectively, in this period. Investment, meanwhile, contracted by 5.6 per cent. The external sector made a positive contribution to GDP growth in the four-quarter period, with imports contracting by 9 per cent while exports were flat.

On 8 November, the government announced that the two currency notes that were the most commonly used in terms of the value of transactions, together accounting for 86 per cent of transactions in the economy, would not be legal tender from midnight that day (see table 2). The notes could be exchanged for new notes, or deposited, at banks up to the end of 2016, but exchanges or deposits in excess of a certain amount would be scrutinised, with penalties imposed on those who could not account for the source of their cash. The government explained that the policy was aimed largely at fighting corruption, both by making forgeries of the notes obsolete and by cracking down on revenues and income not taxed in the shadow economy, which estimates suggest could be as large as 25 per cent of GDP (Schneider, 2006).

However, the implementation of the policy suffered from poor planning and communication, which led to cash shortages, with large queues at banks of people wanting to exchange the old notes. Inadequate supplies of replacement notes and incompatibility of the new notes with automatic teller machines have been other problems. Moreover, several subsequent adjustments to the rules governing the deposit and exchange of old notes further reduced clarity around the policy. The result was a significant disruption of cash transactions. The policy is also likely to have disadvantaged poorer rural households, with more affluent households likely to hold a smaller proportion of their gains from the informal economy in cash, and to have more ready access to the new notes.

How well targeted the policy was has also been called into question by estimates that by end-December about Rs 14 trillion out of the Rs 15.5 trillion of notes demonetised had been returned to the banks. This contrasts with the government's prediction of Rs 10 trillion, which seems to have been based on an assumption that criminal holdings were larger than was actually the case.

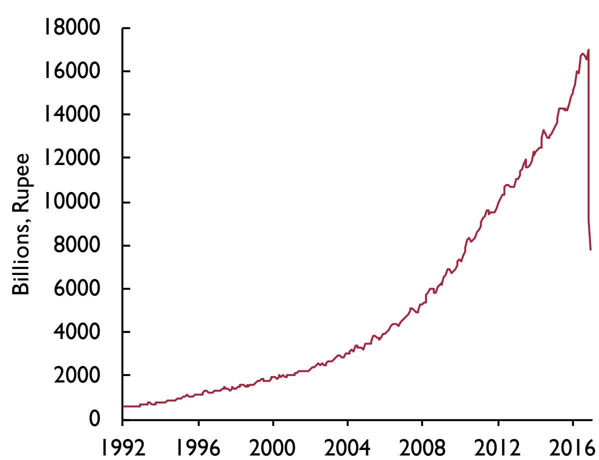
In light of the policy's aim of making it more difficult to engage in the informal economy, the choice of denominations for the new notes may also be considered odd. The usual practice when withdrawing currency to combat money laundering and corruption is to replace

Table 2. India: notes in circulation prior to demonetarisation

	Volume mn rupees		Value bn rupees	
	March 2015	March 2016	March 2015	March 2016
500	13,128 (15.7%)	15,707 (17.4%)	6,564 (46%)	7,854 (47.8%)
1000	5,612 (6.7%)	6,326 (7%)	5,612 (39.3%)	6,326 (38.6%)
Total	83, 579	90, 266	14, 289	16, 415

Source: RBI.
Note: Figures in parenthesis denote the percentage share within the total.

Figure 11. India: money supply – notes and coins in circulation (excluding currency held by banks)



Source: Datastream.

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high with lower denominations, thus making it more inconvenient to transport large amounts of cash. But this was not done in this case.

The Indian economy remains heavily dependent on cash-based transactions. The World Bank's Global Financial Inclusion database reports that in 2014, 53 per cent of the population had access to a financial account, while access to debit and credit remained low, at 4.2 and 22.1 per cent respectively. Moreover, the Reserve Bank of India (2015)[7] reported that in 2014 just under half of bank accounts had remained dormant for over a year.

We expect that when data become available the policy's effect of bringing about a severe, though temporary, reduction in the supply of cash, and thus the total money stock (see figure 11) will be seen to have caused significant, though temporary, declines in economic growth and inflation, which should begin to dissipate towards the end of the first quarter, after which the economy will rebound. Our estimate of GDP growth in 2016 has been lowered slightly, to 7.2 per cent, and we now expect GDP growth of 6.0 and 7.9 per cent, and inflation of 2.7 and 3.1 per cent, in 2017 and 2018 respectively.

Brazil

Hopes of signs of an end to the country's deep recession have so far been dashed. GDP fell by 0.8 per cent in the third quarter of 2016, the seventh consecutive quarterly drop and the largest since late 2015. All the main components of domestic demand contracted in the third quarter, most notably private fixed investment, with a decline of 3.1 per cent; an increase in net exports provided a small offset but only because of a drop in imports, as exports fell. High unemployment, persistently large fiscal deficits and renewed political uncertainties stemming from the '*lava jato*' corruption investigation process add to the challenges facing the country. A rare bright spot has been the recent reductions in official interest rates, allowed by the decline of inflation to within the Central Bank's target range.

Rising unemployment has become a major concern. The unemployment rate reached 11.9 per cent in November 2016, far above the 6.4 per cent low reached only two years earlier.

The government's budget deficit declined from a peak of 10.2 per cent of GDP in 2015 to 9.3 per cent in the twelve months to November 2016, 6.8 percentage points of which is accounted for by interest payments. This improvement in the overall deficit, however, is more than accounted for by a decline in interest payments resulting from a favourable financial market reaction to the appointment last May of the new Temer government; the primary deficit worsened last year. To combat the elevated deficit, the government managed to enact in December a constitutional amendment freezing government spending in real terms for 20 years. It is now working to overhaul the social security system, including by raising the state pension age. Progress in reducing the fiscal deficit will take time, and we expect it to continue acting as a drag on the economy in the near term.

Consumer price inflation fell more quickly last year than expected, from a peak of 10.7 per cent in the twelve months to January 2016 to 6.3 per cent in the year to December – the first time in two years for inflation to be below the 6.5 per cent ceiling of the Central Bank's 2.5–6.5 per cent target range. The decline in inflation last year can be attributed partly to the fact that increases in administered prices implemented at the beginning of 2015 dropped out of 12-month price comparisons, partly to falls in food prices, and partly to a recovery in the exchange value of the real in the course of the year. Also, however, it reflects the weakness of domestic demand and the increasing output and employment gaps in the economy.

The rapid decline in consumer price inflation, coupled with the worsening of the economic outlook, has prompted the Central Bank to lower its benchmark Selic rate, which had been maintained at 14.25 per cent between July 2015 and September 2016, by 25 basis points in both October and November and by 75 basis points in December, to 13 per cent. For 2017, the Central Bank's target range for inflation, unchanged for the past ten years, has been narrowed to 3.0–6.0 per cent, with an unchanged mid-point.

In light of recent data, we have revised our projections of output growth downwards. We now expect the economy to contract by a further 1.3 per cent in 2017, following the 3.5 per cent decline estimated for 2016, and a tepid recovery to begin in 2018 with growth of 0.9 per cent.

Russia

GDP shrank by 0.4 per cent in the year to the third quarter of 2016, the smallest of seven consecutive four-quarter declines. The recession, attributable mainly to the collapse of global oil prices in 2014–15 and the international economic sanctions imposed following Russia's intervention in Ukraine in early 2014, appears

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to be close to its nadir. In fact, the Central Bank has estimated that growth was slightly positive in the fourth quarter. The partial recovery of global oil prices since early 2016 has boosted Russia's economic prospects, and the rouble's exchange value has continued to recover from the lows reached early last year.

In an unprecedented agreement with OPEC, Russia agreed in December to cut oil output by 300,000 barrels a day in the first half of 2017. Oil prices are expected to increase further in 2017, assuming that the agreements by OPEC and other producers hold. However, international sanctions seem likely to persist for some time. The EU has extended sanctions for a further six months, until July 2017.

Declining oil revenue and increases in the domestic currency costs of foreign spending have increased the budget deficit, to an estimated 3.7 per cent of GDP in 2016. Plans to reduce the fiscal deficit by 1 percentage point of GDP over the next three years may slow the economic recovery. We forecast a return to positive growth in 2017, albeit at a modest rate, before a further pick-up in 2018.

Consumer price inflation, on a 12-month basis, fell to 5.4 per cent in December 2016, down from the peak of 16.9 per cent reached in March 2015 and the lowest inflation rate since June 2012. The decline of inflation has been helped by the Central Bank's firm monetary policy, focused on its 4 per cent inflation target for 2017, and by the appreciation of the rouble since early 2016. The Central Bank kept its benchmark rate unchanged at 10 per cent in December, but signalled the possibility of further cuts in 2017. Moderately tight monetary conditions need to be maintained to achieve the inflation target. We expect inflation to average 4.1 per cent in 2017.

NOTES

1 See, for example, Fact Sheet: 'Donald J. Trump's pro-growth economic policy will create 25 million Jobs, 15 September, 2016': https://www.donaldjtrump.com/press-releases/fact-sheet-donald-j.-trumps-pro-growth-economic-policy-will-create-25-million-jobs.
2 See Wilbur Ross and Peter Navarro, 'Trump versus Clinton on infrastructure', 27 October, 2016, http://peternavarro.com/sitebuildercontent/sitebuilderfiles/infrastructurereport.pdf.
3 See November 2016 *National Institute Economic Review*, F14.
4 See, for example, Martin Feldstein, 'The house GOP's good tax trade-off', *Wall St. Journal*, 6 January, 2017.
5 See G. Gopinath, E. Farhi and O. Itskhoki, 'Trump's tax plan and the dollar', Project Syndicate, 3 January, 2017, https://www.project-syndicate.org/commentary/trump-tax-plan-hurts-competitiveness-by-emmanuel-farhi-et-al-2017-01.
6 *Towards a Positive Fiscal Stance for the Euro Area*, Communication to the European Parliament, The Council, the European Economic and Social Committee and the Committee of the Regions, 16 November, 2016, https://ec.europa.eu/info/sites/info/files/2017-european-semester-communication-fiscal-stance_en_1.pdf.
7 https://rbi.org.in/scripts/PublicationReportDetails.aspx?ID=836.

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