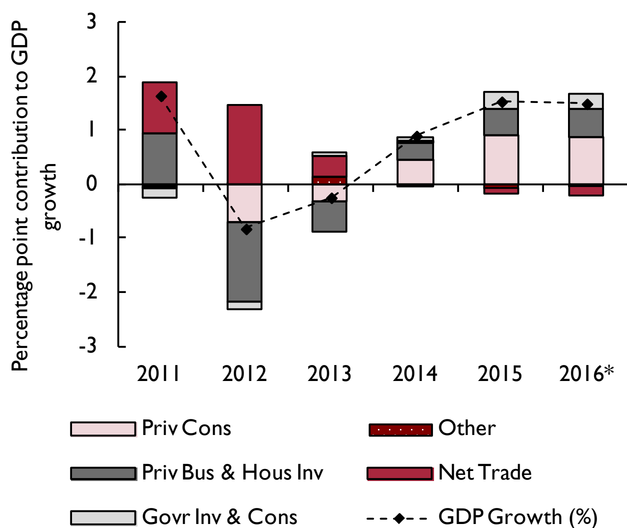
Prospects for individual economies

Euro Area

Output growth has been maintained at moderate rates close to 1.5 per cent a year, and the slow decline in unemployment has continued. Annual consumer price inflation has recently fallen back to about zero, mainly reflecting the further decline in global energy prices between last November and early February, but core inflation has been steady in recent months, at about 1 per cent. On 10 March, the ECB announced wide-ranging measures to ease monetary conditions further in order to promote the return of inflation towards its medium-term objective of 'below, but close to, 2 per cent a year'. We expect the recovery to proceed at moderate rates, of 1.5 per cent in 2016 and 1.7 per cent in 2017, supported by highly accommodative monetary conditions, the general depreciation of the euro in 2014–15, slightly expansionary fiscal policies, and the decline in energy prices over the past two years.

In the fourth quarter of 2015, GDP grew by 0.3 per cent – the same rate as in the third quarter – to a level 1.6 per cent higher than a year earlier. GDP growth in 2015 as a whole was 1.5 per cent. Growth in the fourth quarter, as in the third, was driven by a broad-based expansion of domestic demand, but with fixed investment performing particularly strongly. Net exports again contributed negatively to GDP growth. The expansion has remained uneven across the Area: in the fourth quarter, GDP rose by 0.3 per cent in both Germany and France, but by only 0.1 per cent in Italy and Greece, by 0.8 per cent in Spain, and by 2.7 per cent in Ireland. Preliminary indicators for the first quarter of 2016 suggest continuing moderate growth in the Area. Industrial production in January and February was 1.0 per cent higher than the fourth quarter average and 1.9 per cent higher than a year earlier. Retail trade volume in the Area in January and February was 0.8 per cent higher than the fourth quarter average and 2.3 per cent higher than a year earlier. Recent PMIs have suggested somewhat weaker private-sector growth than have the data for industrial production and retail sales.

Figure 5. Euro Area: Annual GDP growth



Source: NiGEM database and NIESR forecast.
Note: 2016 is forecast.

The growth of bank credit to the private sector has picked up. In the year to March, lending to non-financial corporations rose by 1.1 per cent and loans to households by 1.6 per cent – the largest annual increases since late 2011.

Unemployment fell to 10.3 per cent in February 2016, its lowest since August 2011 and 1.8 percentage points below the peak reached in April 2013. There is still a long way to go to reach the March 2008 trough of 7.2 per cent. There also remain wide differences in unemployment among member countries, with rates ranging from 4.3 per cent in Germany to 10.2 per cent in France, 11.7 per cent in Italy, 20.4 per cent in Spain, and 24.0 per cent in Greece. Employment growth in the Area gathered pace during 2015, rising to 1.2 per cent in the year to the fourth quarter from 0.8 per cent in the year to the first.

Consumer price inflation, on a 12-month basis, has fallen back since January, to zero in March, mainly reflecting declines in energy prices. Core inflation in the year to March was 1.0 per cent, little changed from preceding months. There has been little sign of a significant pick-up in wage growth: hourly labour costs in the Area increased by 1.3 per cent in the year to the fourth quarter, close to the average annual increase since 2013. The increase in labour costs in Germany in the year to the fourth quarter, at 2.1 per cent, was above both the Area's average and those in France (1.3 per cent), Italy (–0.8 per cent) and Spain (1.5 per cent), for example, suggesting continuing slow shifts in international competitiveness broadly

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consistent with warranted adjustments in payments imbalances.

On 10 March, the ECB announced a package of measures "calibrated to further ease financing conditions…and accelerate the return of inflation to levels below, but close to, 2 per cent". This followed a more limited set of measures last December (see *National Institute Economic Review*, February 2016, F16–17) and subsequent developments that appeared to have reduced the likelihood of early achievement of the price stability objective.

First, with effect from 16 March, the ECB's benchmark interest rates were lowered further: the deposit rate, negative since June 2014, was reduced by 10 basis points to –0.4 per cent; the refinancing rate was reduced by 5 basis points to zero; and the marginal lending facility rate was also reduced by 5 basis points to 0.25 per cent.

Second, the 'expanded asset purchase programme' (EAPP), announced in January 2015 and begun in the following March, was expanded further. It originally involved combined purchases of assets amounting to €60 billion a month until at least September 2016, under two programmes introduced in 2014 – the asset-backed securities purchase programme (ABSPP) and the covered bond purchase programme (CBPP3). Last December, the EAPP was extended to at least March 2017. In the latest package, it was announced that, beginning in April 2016, monthly purchases would be increased to €80 billion and again "run until end-March 2017, or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its aim of achieving an inflation rate below, but close to, 2 per cent over the medium term". This means that if the programme ends in March 2017, total asset purchases will have amounted to €1.74 trillion over 25 months (equivalent to about 8 per cent of GDP over a similar period), rather than €1.50 trillion (about 7 per cent of GDP) under the programme as extended last December.

Third, the issuer and issue-share limits for the purchase of securities issued by international organisations and multilateral development banks were raised from 33 per cent to 50 per cent.

Fourth, the assets eligible for purchase would be expanded in June 2016 to include investment-grade, euro-denominated, non-bank corporate bonds issued in the Euro Area.

Finally, a new series of four-quarterly targeted long-term refinancing operations (TLTRO II), each with a maturity of four years, would be launched, starting in June 2016, with interest rates as low as on the deposit facility. TLTRO II is intended to give banks additional incentives to lend to the private sector: funds made available to banks under the scheme will depend upon eligible lending.

With regard to forward guidance on interest rates, President Draghi stated on 10 March (and reiterated after the ECB's meeting on 21 April) that "the Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time, and well past the horizon of our net asset purchases". In March, he also stated that "From today's perspective…we don't anticipate that it will be necessary to reduce rates further. Of course, new facts can change the situation and outlook". The ECB's chief economist subsequently confirmed that further cuts in interest rates remained an option.

Germany

GDP grew by 0.3 per cent in the fourth quarter of 2015 and by 1.4 per cent in the year as a whole. GDP growth in the fourth quarter was the same as in the third, but it was driven more by domestic demand. Net exports subtracted from GDP for the second quarter in a row, and to a larger extent, with a slowing down of import growth more than offset by a downturn in exports, which contracted by 0.6 per cent. Domestic demand in the fourth quarter was buoyed mainly by a strong rise in fixed investment, but also by government spending; the growth of private consumption slowed.

More recent indicators suggest that the softening of economic growth between late 2014 – when it was 0.6 per cent in the fourth quarter – and late 2015 was transitory; indeed, the latest 'nowcast' by IfW Kiel estimates GDP growth at 0.6 per cent in the first quarter of 2016, the same as the assumption built into our forecast. We project a modest pick-up in growth to 1.7 per cent in both 2016 and 2017, with robust growth in consumption by both households and the State. Buoyant real income growth and low interest rates should continue to stimulate consumer spending, while the additional government expenditures associated with the large influx of refugees has been estimated at €14–17 billion in 2016, or around ½ per cent of GDP.[2] Apart from these domestic factors, we expect a gradual strengthening of demand from German export markets.

The overall government budget was in significant surplus in 2015, amounting to 0.6 per cent of GDP. The

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additional expenditure associated with refugees will weigh on the fiscal balance in 2016, but perhaps not as much as we had previously assumed. The government has stated that it will aim to fund this expenditure through a reallocation of resources from other parts of the budget, and thus make it fiscally neutral. Our forecast is now for a marginally larger surplus this year than we projected previously – 0.5 per cent of GDP compared with 0.3 per cent in February's forecast. We still expect the government to run significant surpluses through the forecast period, with the ratio of debt to GDP falling from just under 70 per cent at end-2015 to just over 50 per cent by end-2022.

As 2016 progresses, refugees will increasingly find their way into the labour market. With unemployment having reached another new post-unification low of 4.3 per cent in January and February, and given the trend decline of the working population, this increased supply of labour will relieve labour market pressures as well as boosting potential output growth and supporting the GDP growth that we are projecting. We expect unemployment to remain broadly unchanged in the coming year but to rise slightly to around 5 per cent by 2022.

Despite low unemployment, wage growth has remained subdued. Thus the four-quarter growth rate of hourly labour costs (as monitored by Eurostat) declined in the second half of last year, from 3.0 to 2.1 per cent. This is likely, at least in part, to reflect low actual and expected inflation. Consumer price inflation, on a 12-month basis, has in recent months remained close to zero: in March it was 0.1 per cent, only marginally above the Euro Area average. Recent work by IfW Kiel suggests that the economy's long-run potential rate of growth is around 1½ per cent, and with the economy forecast to grow at a rate slightly above this in 2016–17, we expect inflation to pick up to a rate slightly higher than the Euro Area average but to remain below 2 per cent.

France

GDP grew by 0.3 per cent in the final quarter of 2015 and by 1.2 per cent in the year as a whole, marginally higher than we estimated in February. More recent indicators suggest that growth continued at a similar pace in the first quarter of 2016, and our projection for this year as a whole is unchanged from February, at 1.3 per cent. The expansion is expected to continue to be driven largely by private consumption, supported by the growth of real disposable incomes. Exports in 2016 should maintain their strong fourth quarter performance, despite a slight weakening of global demand, as a result of the delivery of aeronautical and shipping equipment under a number of major contracts. In 2017, a reduction in such exports is expected to be offset by the moderate acceleration of world demand, with trade again contributing positively to growth. GDP growth is thus again expected to pick up in 2017, but by less than we projected in February – to 1.4 per cent rather than 1.8 per cent.

Unemployment, having reached a post-crisis peak of 10.6 per cent last August, fell to 10.2 per cent over the following three months – its lowest level since June 2014 – but between November and February there was no further decline. The pace of economic growth we project seems unlikely to be sufficient to reduce unemployment materially further, even taking into account the special measure to promote employment introduced by the government last January (see February 2016 *National Institute Economic Review*, F22), in the absence of more substantial labour market reforms.

Although wage growth seems to have picked up slightly in 2015, hourly labour costs (as measured by Eurostat) in the fourth quarter were still only 1.3 per cent higher than a year earlier. The broad stability of prices implies a similar rate of growth of real wages. January's minimum wage increase was marginally smaller than that of 2015 and inflation expectations one year ahead have softened; both of these factors lead us to forecast a slight slowing of nominal wage growth this year. Consumer price inflation remains subdued: in February, the 12-month change in the harmonised index fell back below zero, to –0.1 per cent, from 0.3 per cent in the preceding two months. We expect average inflation to be marginally negative in 2016 before picking up to 1.1 per cent next year.

The fiscal deficit narrowed further in 2015, to 3.7 per cent of GDP. Low inflation and weak growth are among the factors complicating the government's task – agreed with the EU – of reducing the deficit below 3 per cent of GDP by 2017, because they reduce both the tax base and the denominator against which the deficit is judged. Our projections in recent *Reviews* have fluctuated between the government achieving and missing its target by marginal amounts. In our current central projection they exactly achieve their target in 2017, however as we have highlighted previously there remains a large amount of uncertainty around this central forecast. The pursuit of this target under EU rules is likely to require them to tighten fiscal policy further, which would be likely to have a counterproductive, contractionary effect on economic activity. Otherwise, a further period of leniency may be required.

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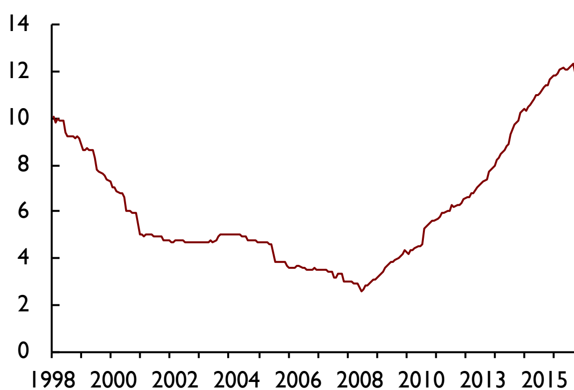
Italy

Italy's economic recovery slowed further in the fourth quarter of 2015, with GDP growth of 0.1 per cent, its lowest quarterly growth rate of the year. In 2015 as a whole, after three years of contraction, GDP expanded by 0.6 per cent, with the first, albeit modest, increase in fixed investment in six years.

Although quarterly GDP growth weakened in the course of last year, the expansion of final domestic demand was relatively robust; with net exports broadly flat, slowing GDP growth largely reflected the contractionary influence of changes in inventory accumulation. Although this suggests that stockbuilding may provide a short-term boost to GDP growth in 2016, and although economic activity is supported by expansionary monetary conditions, lower oil prices, and the improvement in international competitiveness allowed by the euro's depreciation since 2013, the outlook remains clouded by a number of factors. These include a banking sector struggling under the weight of non-performing loans (NPLs), high unemployment, and a government with very little room for fiscal manoeuvre. Accordingly, our growth forecast has been revised down from the February *Review*, with GDP now projected to rise by 0.7 per cent in 2016 and 1.0 per cent in 2017.

The large volume of non-performing loans in the banking system, which has risen substantially in the wake of the financial crisis, although it has recently fallen back slightly – see figure 6 – remains a significant concern. It disrupts the normal flow of credit, weighs down on private demand, and reduces the chances of vigorous economic recovery. NPLs have also been a concern for investors in Italian banks, as indicated by a substantial decline in their share prices in early 2016. On 12 April, the government announced a new step to help deal with the problem: agreement was reached with domestic banks, insurers, and asset managers that they would contribute to a €5 billion fund (named 'Atlante') to be set up to 'backstop' capital raisings by weak banks and to buy junior tranches in securitised assets backed by NPLs. The state-owned Cassa Depositi e Prestiti is to have a stake in the fund, but its role will by limited by EU rules on state aid. Establishment of the fund is to be accompanied by changes in bankruptcy rules aimed at accelerating the recovery of loans by creditors. Some analysts have estimated that the fund could be leveraged to allow the purchase of €70 billion of gross NPLs.

Figure 6. Italy: share of non-performing loans in total loans (in per cent)



Source: Thomson, Reuters, Datastream.

Unemployment, at 11.7 per cent in February, has remained high; it is broadly unchanged since last July, despite a number of measures introduced by the government, including the Jobs Act of December 2014, which aimed to reduce the duality of the labour market, and tax deductions for hiring. Lack of significant employment growth weighs on prospects for demand growth as well as increasing the risk of labour market hysteresis. The weakness of the labour market has been reflected in declines in wages; hourly labour costs in the fourth quarter of 2015 were 0.8 per cent lower than a year earlier. Annual consumer price inflation also fell back into negative territory in February and March, partly reflecting the recent decline in oil prices: prices in the twelve months to March fell by 0.2 per cent. However, core inflation in the same period remained positive, at 0.6 per cent.

The government budget deficit last year was 2.6 per cent of GDP, 0.4 percentage point smaller than in 2014. The draft budgetary plan sent to the European Commission last October forecast a 2.2 per cent budget deficit for 2016. However, measures approved late last year, such as the Stability Law, which includes reductions in corporate tax rates as well as delays in planned tax rate hikes, will most likely increase the deficit to around 2.5 per cent.

Spain

Spain remained the fastest growing major economy in the Euro Area in the fourth quarter of 2015, with GDP growth of 0.8 per cent, the same as in the third quarter. But despite associated strong growth in employment, unemployment in Spain remains by far the highest in the Area except for Greece. Against this background, political uncertainty has increased with the political

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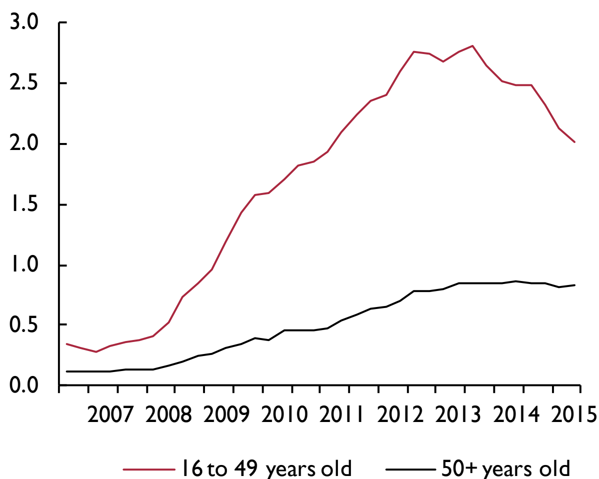
parties having failed to agree on forming a government since last November's elections, and with new elections scheduled for late June. We forecast robust, though somewhat slower, GDP growth in 2016 and 2017, at 2.7 and 2.6 per cent, respectively, little changed from our February projection.

Growth in the last quarter of 2015 was driven by domestic demand, particularly private consumption and investment, fuelled by lower oil prices, employment growth, and favourable financial conditions promoted by the ECB's loose monetary policy. The contribution of net exports was neutral, which we assume will continue to be the case in 2016 and 2017.

Unemployment has fallen significantly from its early 2013 peak of 26.3 per cent, to reach 20.4 per cent in March 2016. In the year to this March, the rate fell by 2.8 percentage points. More than half a million jobs were created in the year to the fourth quarter of 2015, representing employment growth of 3.0 per cent. Nonetheless, joblessness remains extremely high, with around 4.8 million people unemployed, and assuming that progress in reducing the unemployment rate continues at the pace of the past three years, it will take another six years to reach the pre-crisis unemployment rate of about 8 per cent. This indicates that there is significant risk of hysteresis, particularly among those unemployed for more than a year, who have recently accounted for 60 per cent of the unemployed, up from a low of 20 per cent in 2008. The risk is even higher for those aged 50 or older. In fact, since unemployment started falling in late 2013, 0.8 million people aged 49 or less who were unemployed for more than a year found a job, while for those aged 50 years or more the figure is just 25,000 (figure 7).

Figure 7. Spain: Number of people unemployed for one year or more (millions)



Source: INE.

In the twelve months to March 2016, consumer prices fell by 1.0 per cent, dragged down by the decline in oil prices. However, core inflation increased by 0.1 percentage point in March from the previous month, to stand at 1.1 per cent. There have been signs of a pick-up in wage increases, with hourly labour costs, as measured by Eurostat, rising by 1.5 per cent in the year to the fourth quarter of last year. We expect inflation to rise back into positive territory by the end of 2016.

The government's budget deficit in 2015 was initially estimated to be 5.2 per cent of GDP and subsequently revised to 5.1 per cent, a much larger figure than the 4.2 per cent target set by the European Commission. Significant further reductions in the deficit are likely to prove difficult in the short term, given the political situation. In the meantime, the debt-to-GDP ratio has continued to increase, reaching 98 per cent at the beginning of 2015, the highest level shown in data available since 1981.

United States

The expansion of output and employment has weakened in recent months from the average pace of growth in 2014 and 2015. The appreciation of the dollar in recent years has weighed on net exports, fixed investment in the energy sector has been depressed by the decline in oil prices, and an increase in household saving has limited the growth of consumption. Core consumer price inflation has risen close to the Fed's medium-term objective of about 2 per cent, but all-items inflation has recently fallen back to about 1 per cent and increases in labour earnings have remained subdued. The Fed, after raising its target range for the federal funds rate last December from near zero, where it had been maintained for seven years, has left rates unchanged, indicating in March that the path of future increases was likely to be less steep than envisaged three months earlier.

In the fourth quarter of 2015, GDP growth weakened to 1.4 per cent at an annual rate from 2.0 per cent in the third quarter. Growth in the second half of last year was thus significantly weaker than the 2.4 per cent average growth rate of both 2014 and 2015. Growth in the fourth quarter was more than fully accounted for by household consumption; the growth of fixed

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investment was the slowest for more than three years, and the contributions of both net exports and inventory accumulation were negative. Recent, partial data for the first quarter of 2016 suggest that the expansion weakened further, likely to below 1 per cent at an annual rate.[3] Thus industrial production contracted by 0.6 per cent in the first quarter, with manufacturing output up only slightly. Moreover, the growth of real consumer spending in the first two months of the year was sluggish, with consumers saving a higher proportion of their disposable incomes. Also recent trade data indicate a further negative contribution from net exports.

Taking into account these developments, we have revised down our projection of GDP growth in 2016 as a whole to 2.0 per cent from 2.5 per cent three months ago, with a pick-up to 2.5 per cent growth projected for 2017.

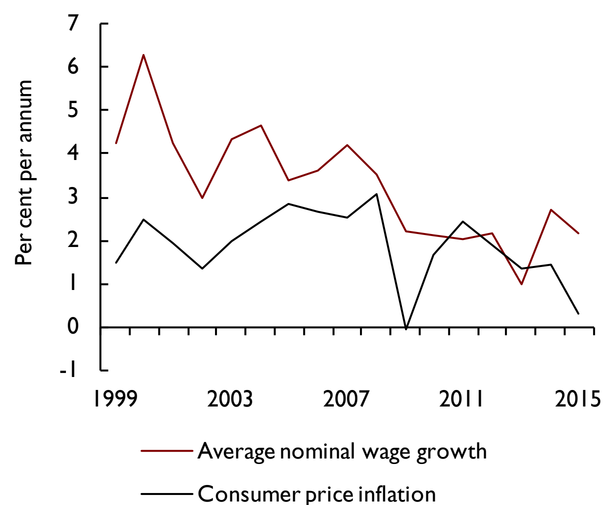
The growth of employment has remained more solid than the growth of output but has also slowed somewhat since 2014. Non-farm payrolls increased by 209,000 a month, on average, in the first quarter, compared with 229,000 in 2015 and 251,250 in 2014. The annual growth rate of non-farm jobs, which peaked at 2.3 per cent early last year, was 1.9 per cent in the first quarter of 2016. The slowing growth of employment has been associated with further declines in unemployment, to 4.9 per cent in January and February, its lowest level since early 2008, although it ticked up to 5.0 per cent in March. This is the top end of the Fed's range estimate of the longer-term unemployment level, which it revised down slightly further in March to 4.7–5.0 per cent. The labour force participation rate has risen from the 38-year low of 62.4 per cent reached last September, to 63.0 per cent in March, but it remains historically low – one indication that labour market slack may be greater than suggested by the unemployment rate. Another indication is the continuing subdued growth of labour earnings. Thus average hourly earnings in the private sector were 2.3 per cent higher in February and March than a year earlier – the smallest 12-month increase since last August. The employment cost index, which takes account of benefits as well as pay, rose by only 2.0 per cent in the year to last December.

Consumer price inflation, by the Fed's preferred measure – based on the price index for personal consumption expenditure – was 1.0 per cent in the year to February, down from 1.2 per cent in the year to January but higher than the 0.2–0.7 per cent range observed in the second half of last year. The core 12-month rate rose to 1.7 per cent in January and February from the 1.3–1.4 per cent range seen late last year. In terms of

Figure 8. US: unemployment and employment rates

Source: NiGEM database and NIESR forecast.

Figure 9. US: nominal wage growth and consumer price inflation



Source: NiGEM database.
Note: Inflation is defined as change in consumer expenditure deflator.

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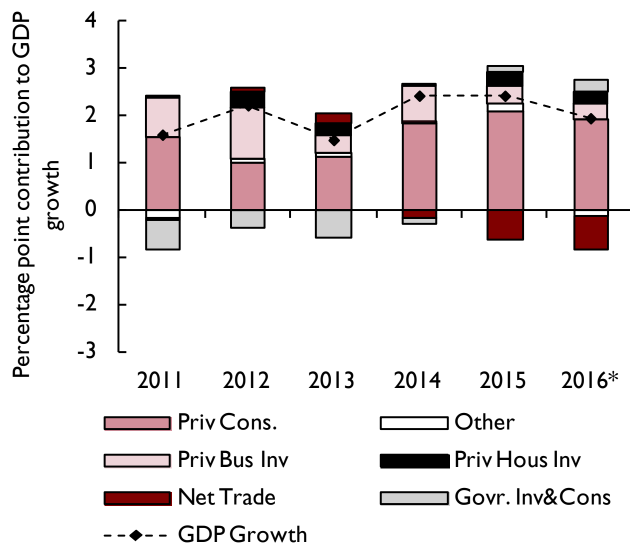
Figure 10. US: contribution to year-on-year GDP growth



Source: NiGEM database and NIESR forecast.
Note: 2016 includes forecast projections.

the narrower consumer price index, core inflation in the year to March was 2.2 per cent, with the all-items inflation rate at 0.9 per cent. Expected future inflation appears to have rebounded significantly since early February. Thus the five-year breakeven inflation rate, which fell to 0.9 per cent in early February – its lowest level since mid-2009 – had risen to 1.5 per cent by late April.

At its mid-March meeting, the Federal Open Market Committee (FOMC) decided to maintain its target range for the federal funds rate at 0.25–0.50 per cent, as set last December, when it had indicated that the median expectation of the Committee's participants was that the range would be raised by 1 percentage point in 2016. The March meeting lowered this median to 0.5 percentage point, at the same time as participants lowered slightly their projections for GDP growth in 2016 and 2017, as well as their projection of inflation in 2016. Chairman Yellen indicated that the decision to hold rates unchanged reflected both a downward revision since last December of global economic growth projections and the recent tightening of financial conditions, including a widening of corporate bond spreads. Since the FOMC's March meeting, indicators of demand and activity in the US economy itself have weakened, and many analysts' growth projections have been revised down.

Canada

GDP growth slowed to 0.2 per cent in the fourth quarter of 2015 from 0.6 per cent in the third, depressed both by falling fixed investment in the energy sector and by a switch from positive to negative inventory accumulation. Net exports made a positive contribution to growth in the fourth quarter, thanks to a drop in imports that exceeded a decline in exports. In 2015 as a whole, GDP grew by 1.2 per cent, the weakest performance since 2009 and marginally below our February estimate. More recent data, including a 0.6 per cent increase in monthly GDP in January, have been more positive, but the process of adjustment to an economy that is less dependent on the resource sector, particularly energy production, is expected to continue to weigh on growth over the next few years.

Unemployment fell to 7.1 per cent in March from 7.3 per cent in February but remains above the 6.6 per cent trough reached at the beginning of 2015 as well as the pre-crisis lows of around 6.0 per cent. Lack of wage pressures and the persistence of involuntary part-time employment and long-term unemployment indicate that there is significant slack in the labour market.

Consumer price inflation, on a 12-month basis, slowed to 1.4 per cent in February from a 14-month high of 2.0 per cent in January. Falling gasoline prices dragged inflation down while core inflation was at 1.9 per cent, down from 2.0 per cent in the previous month.

The new government elected last October, reversing the policies of the previous administration, introduced an expansionary budget in March including around C$11 billion of additional spending on infrastructure and C$12 billion worth of measures benefitting households. The budget was designed to raise GDP by 0.5 per cent in 2016 and 1 per cent in each of the next two years. Canada's fiscal position remains healthy: we now forecast a government deficit of 2.0 per cent of GDP in 2016, 0.3 percentage point larger than our February forecast, but our forecast deficit for 2017 is unchanged, also at 2.0 per cent. The government's net debt position, about 27 per cent of GDP at the end of 2015, is the lowest among the major advanced economies.

The Bank of Canada has maintained its key interest rate at 0.5 per cent since lowering it to this level in July last year. Market expectations of a rate cut this year have dropped sharply, partly on account of the expansionary budget, and this has been reflected in a significant rise in longer-term interest rates since mid-January, with 10-year government bond yields up by

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about 25 basis points – the only significant increase in long rates among the major economies in this period. Combined with positive economic data for the start of the year and the upturn in global oil prices since early February, this has contributed to a 16 per cent appreciation of the Canadian dollar against the US dollar from the 12-year low reached in January.

Taking into account these developments, we have lowered our growth projections for 2016 and 2017 slightly, to 1.7 per cent and 2.1 per cent, respectively. We expect inflation to remain below the Bank of Canada's 2 per cent target until the second half of 2017 as the disinflationary effects of lower energy prices and excess capacity in the economy more than offset exchange rate pass-through effects.

Japan

Economic growth has remained weak and erratic, and inflation has remained well below target despite low unemployment. The Bank of Japan has taken further action to ease monetary conditions, by lowering the interest rate paid on some bank reserves below zero, but its efforts to raise inflation have been complicated by the recent appreciation of the yen. Recent developments have led us to revise our growth forecast down, with a slight contraction in GDP now projected for next year in the wake of the increase in the consumption tax, from 8 to 10 per cent, scheduled for next April.

The economy contracted by 0.3 per cent in the final quarter of 2015, almost entirely on account of a 0.9 per cent drop in private consumption; private fixed investment and net exports both made modest positive contributions to growth. In 2015 as a whole, GDP increased by 0.5 per cent, compared with our February estimate of 0.9 per cent. More recent indicators suggest that if growth returned in the first quarter, it was weak. Consumer spending has remained subdued in recent months, industrial production has been on a declining trend, and PMIs have indicated weak growth at best. The recent appreciation of the yen – by about 8 per cent, in trade-weighted terms (see note 1), between December 2015 and late April, has dented business confidence. The Tankan survey for March reported the weakest levels of business sentiment since mid-2013, suggesting a weaker outlook for investment than in our February forecast. The appreciation of the yen is also likely to weigh down on net exports this year. The earthquake in April in Kyushu is likely to depress growth in the second quarter; a number of factories have had to cease production. Taking into account recent developments, we have revised down our growth projection for 2016 to 0.2 per cent from 1.0 per cent in February, while for 2017, assuming implementation of the planned increase in the consumption tax, we now forecast a marginal decline in GDP.

Inflation remains subdued and significantly below the Bank of Japan's 2 per cent target. Consumer price inflation in the year to February was 0.3 per cent, close to the average for recent months, and the variant that excludes food and energy was also little changed, at 0.8 per cent. The March Tankan survey showed a significant decline since December in producers' inflation expectations. While the labour market remains tight, with unemployment recently stable at 20-year lows of about 3.3 per cent, there is little evidence of any acceleration in wages: in fact, the spring round of wage negotiations seems to be delivering smaller increases than last year, despite government pressure for larger pay rises. Taking into account the recent appreciation of the yen, we expect average inflation to be zero this year before picking up to 1.0 per cent in 2017, largely as a result of the sales tax increase.

The Bank of Japan, in an effort to provide extra stimulus, announced in late January that it would reduce in mid-February the interest rate paid on a portion of banks' reserves to –0.1 per cent from 0.1 per cent. This led to a general decline in Japanese interest rates over the following weeks, with even the 10-year government bond yield below zero from late February. However, the yen, after a short-lived depreciation following the announcement, rose in value over the following weeks. By late April, it was about 7 per cent higher against the US dollar than just before the announcement, and 5 per cent higher in trade-weighted terms. This appreciation may, perhaps, be attributed partly to a relative decline in inflation expectations in Japan, partly to a downward shift in expectations about US monetary tightening, and partly to the substantial easing action by the ECB. In any event, the exchange-rate response that might have been expected did not occur. The negative interest rate has also led to concerns about bank profitability, which is being affected by the narrowing of interest margins and also by a decline in interbank lending, which has fallen to its lowest level since 1988. Concerns have arisen that impairment of this market may mean that when the normalisation of monetary policy occurs, excess market volatility may arise, with banks unable to use this market to smooth funding. Nevertheless, Bank of Japan officials have indicated their readiness to lower interest rates further into negative territory if necessary, and market indications are that further reductions are expected, possibly as early as late April.

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Our forecast for 2017 onwards assumes implementation in April 2017 of the previously announced consumption tax increase from 8 to 10 per cent. We expect that the economy's response will be similar to that which followed the April 2014 increase in the tax from 5 to 8 per cent. Households will bring forward consumption expenditures to the first quarter of 2017, with a sharp subsequent contraction in spending followed by a slow recovery. Our forecast for 2017 is therefore a small decline in GDP, with the external sector partly offsetting a larger contraction in domestic demand. While this is our modal forecast, the risks seem tilted to the downside, especially given the limited space for further monetary stimulus and the seemingly limited effectiveness of recent measures. While there remains a valid case for the tax increase to help the government secure fiscal sustainability and achieve its target of primary budget balance by 2020, temporary fiscal measures may be necessary to offset its short-term contractionary effect. Indeed, without an improvement in the economy in the coming year the tax hike could, justifiably, be further postponed.

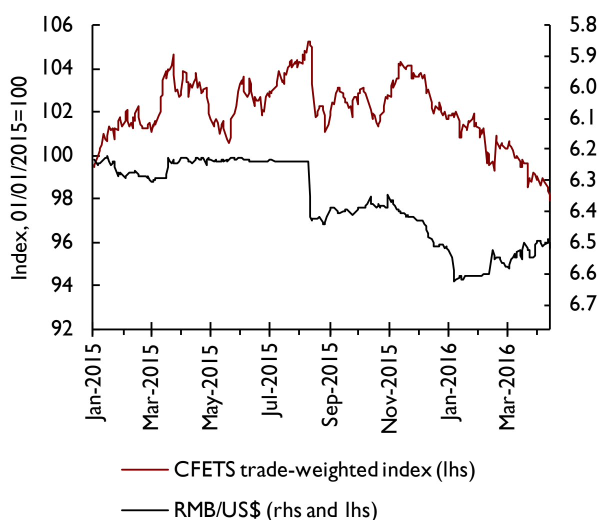
China

Concerns that were apparent in global financial markets in late 2015 and early this year, about slowing growth in China and a possible resort by the authorities to currency depreciation, have been eased in recent months by stabilisation of the renminbi's exchange rate in terms of the US dollar, expansionary measures taken by the fiscal and monetary authorities, and more positive economic data. GDP growth in the year to the first quarter of 2016 was 6.7 per cent, marginally slower than in the year to the fourth quarter of 2015 and within the target range of 6.5–7.0 per cent set by the government in early March for 2016. Other recent data, for the year ending in March, have shown a resumption of growth in international trade and the fastest expansion in industrial production and fixed-asset investment since mid-2015, as well as a marked upturn in property sales.

Recent data have, however, shown less progress in the planned transition from an economy based mainly on investment, exports, manufacturing and construction to one based more on household consumption and the production of services, and this rebalancing seems unlikely to be promoted by recent expansionary measures. Our view concerning the challenges facing the economy in the medium- to long-run therefore remains unchanged. We continue to forecast a continuing slowing of output growth next year and in the medium term, Our forecast of output growth in 2016 and 2017 is largely unchanged from our projections three months ago, at 6.5 and 6.2 per cent, respectively.

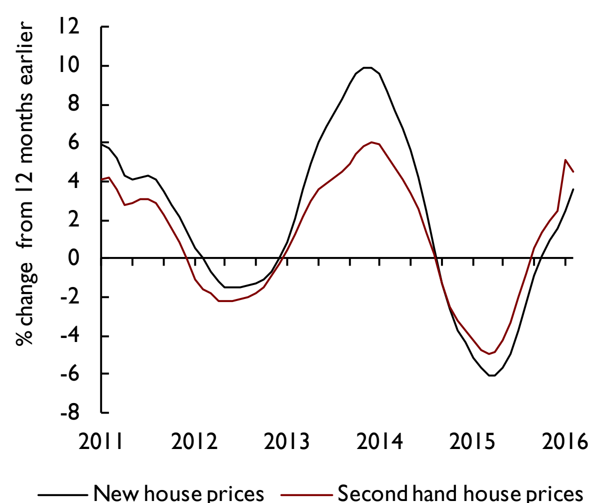
In February, the People's Bank reduced minimum down payments for home purchases financed by mortgages, and also increased the frequency of its open-market operations, from bi-weekly to daily, to help ensure adequate liquidity in the banking system. Also, on 1 March, it reduced the

Figure 11. China: exchange rates



Source: Datastream and authors' calculations.

Figure 12. China: house prices (70 large and medium-sized cities)



Source: Datastream.

https://doi.org/10.1177/002795011623600110 Published online by Cambridge University Press

required reserve ratio for banks by 0.5 percentage point to 17 per cent, the fifth reduction in the past year.

Recent announcements of expansionary fiscal measures, including spending on infrastructure, signify the government's policy of using fiscal space to support growth while the economy rebalances and investment weakens. The government indicated in early March that it would allow the fiscal deficit to widen to 3.0 per cent of GDP in 2016 from 2.4 per cent last year. However, given that fiscal spending includes significant off-budget items, it is difficult to evaluate precisely the size and stimulative effect of proposed easing measures.

With regard to economic restructuring, the authorities in late February acknowledged the existence of overcapacity in the industrial sector by announcing that 1.8 million workers are expected to be laid off in the steel and coal sectors – a number representing roughly 0.5 per cent of the non-agricultural labour force – and that a fund of $15.3 billion would be set aside to support the affected workers and areas.

House prices for both newly built and second-hand houses in 70 medium-sized and large cities fell between mid-2014 and mid-2015 but have been recovering since last September. In the year to February 2016, they rose by 3.6 and 4.5 per cent respectively, as illustrated in figure 12. The pick-up in house prices has accompanied increased housing sales and faster growth in housing investment and construction. The rise in sales seems to have occurred mainly in large cities, where supply is limited, which points to the difficulty of supporting the housing market in the smaller cities, where there has been an oversupply of housing, without generating excessive price rises in the largest ones.

Consumer price inflation has picked up in recent months, reaching 2.3 per cent in February and March 2016 on a 12-month basis, still below the government's 3 per cent target for the year. Much of the increase is attributed to a jump in food prices. Core inflation has remained at around half the government's target. Meanwhile, the producer price index has continued to decline, but at a slower rate, falling by 4.3 per cent in the year to March 2016. This was the 49th consecutive 12-monthly decline.

One factor putting upward pressure on prices since mid-2015 has been a depreciation of the renminbi, by about 7 per cent in trade-weighted terms. As shown in figure 11, this depreciation has continued since early February even though the currency has appreciated by about 2 per cent in terms of the US dollar in this period.

India

India remains the fastest growing major economy. GDP increased by 7.3 per cent both in the year to the final quarter of 2015 and in 2015 as a whole. The main driver of growth has remained private consumption, which increased by 6.4 per cent in the year to the fourth quarter. GDP growth, measured on a four-quarter basis, softened in the latter part of 2015 largely on account of slowing expansion of fixed investment, which grew by 2.8 per cent in the year to the final quarter. The external sector contributed positively to GDP growth in the same period, despite a 9.4 per cent contraction in exports. Data available for early 2016 suggest, on balance, that GDP growth has remained close to its recent pace. Data for industrial production show growth of only 2.0 per cent in the year to February after three 12-month declines, but recent PMIs have indicated more healthy growth, with the composite index reaching a 37-month high in March. Our growth projections for 2016 and 2017 have been revised slightly upwards, to 7.5 and 8.0 per cent, respectively.

After rising from 3.7 per cent in July 2015 to 5.7 per cent in January this year, consumer price inflation, on a 12-month basis, has more recently fallen back, to 4.8 per cent in March. This partly reflects subdued prices of energy and other commodities, but the core rate has also fallen, to 4.5 per cent. With inflation thus within the Reserve Bank's new target range of 4, plus or minus 2, per cent, for the current fiscal year and beyond, the Bank lowered its benchmark interest rate in early April by a further 25 basis points, to 6.5 per cent, its lowest level since 2011. We expect inflation to average 5.2 and 5.0 per cent, respectively, in 2016 and 2017.

With regard to fiscal policy, the budget announced in February confirmed the deficit targets of 3.5 per cent of GDP for the fiscal year 2016/17 and 3.0 per cent in the following two years, down from 3.9 per cent in 2015/16. There has been little progress with structural reforms.

A key risk to the economy is posed by the increased scale of the non-performing loans of the banks, especially those that are state-owned, where stressed assets accounted for about 17 per cent of total assets last September. A review of asset quality undertaken by the Reserve Bank last year led it both to demand that all banks make full provision for troubled loans by end-March 2017, and to put pressure on corporate debtors to repay overdue loans. The government has meanwhile introduced new bankruptcy legislation in parliament that would strengthen banks' leverage over delinquent borrowers. Also, in the budget for the fiscal year 2016–

https://doi.org/10.1177/002795011623600110 Published online by Cambridge University Press

17 published in February, the government announced that nine of the state-owned banks were not expected to pay dividends to the government. This signalled that the government is taking the issue of non-performing loans seriously; it should make it easier for these banks to repair their balance sheets. It also, however, indicates the risk of strains on the public finances that may arise from the difficulties of the banks and the possibility that the government may be forced to inject capital.

Brazil

Brazil's economic and political difficulties have continued. In the last quarter of 2015, GDP fell by 1.4 per cent, to a level 5.9 per cent lower than a year earlier. In 2015 as a whole, output fell by 3.9 per cent, the worst annual performance since 1991. Inflation remains high and unemployment is rising. Political gridlock continues, with a government unable to enact measures to contain a rising budget deficit, which reached 10.4 per cent of GDP in 2015, with a primary deficit of 1.9 per cent of GDP, the largest in eighteen years. On 17 April, the lower house of Congress voted to open impeachment proceedings against President Rousseff on charges that she obscured the scale of the country's fiscal deficit in the period before the 2014 elections; the motion was thus advanced to the Senate. This process is taking place in the midst of a corruption scandal surrounding the state oil company and involving a wide range of politicians and officials.

Meanwhile financial markets have risen significantly since late January, reportedly driven by growing expectations of the installation of a more business-friendly government. Thus between late January and late April, 10-year government bond yields fell by about 350 basis points, the real appreciated by about 15 per cent against the US dollar – more than any other major currency – to levels last seen in August 2015, and the stock market rose by about 40 per cent in domestic currency terms.

In the fourth quarter of last year, all major components of demand fell, including exports, despite a currency depreciation of more than 40 per cent against the US dollar between mid-2014 and late 2015. With imports falling by more than exports, reflecting the weakness of domestic demand, the trade deficit has narrowed and has recently been close to balance. Household consumption has been depressed by falling real incomes and rising unemployment, which reached 8.2 per cent in February, almost double the low reached in late 2014.

In light of recent developments, and assuming no change in policy regime, we have revised our growth projections downwards. We expect the recession to continue this year with a GDP contraction of 3.4 per cent, and growth to resume in 2017, at a modest rate of 0.9 per cent.

Consumer price inflation, on a 12-month basis, peaked at 10.7 per cent in January 2016 and eased off to 9.4 per cent in March, partly because increases in administered prices implemented early last year dropped out of the 12-month comparison. The recent appreciation of the real has also reduced upward pressure on prices. Nevertheless, inflation remains significantly above both the Central Bank's target of 4.5 per cent and the upper limit of its tolerance range, which has been lowered for 2017 to 6.0 from 6.5 per cent. The Central Bank has maintained its benchmark, Selic, interest rate at 14.25 per cent since July 2015. It forecast in March that inflation will fall to 6.6 per cent by the end of 2016 and meet its 4.5 per cent target in early 2018. We forecast a somewhat slower path of disinflation, with inflation falling to 5.0 per cent, on average, next year.

Russia

The decline in economic activity appears to be moderating. GDP fell by 3.9 per cent in the year to the fourth quarter of 2015, the fourth successive four-quarter contraction. Declining incomes curtailed household spending (which fell by 12.4 per cent in the year to the fourth quarter) while government budget cuts reduced public consumption (–1.7 per cent). Gross fixed capital formation continued to decline (–6.0 per cent) but net exports rose, with exports increasing by 9.8 per cent and imports falling by 25.4 per cent, reflecting both the fall in domestic demand and the improvement in Russia's international competitiveness associated with the large depreciation of the rouble in recent years. In 2015 as a whole, GDP fell by 3.7 per cent, slightly more than estimated in our February *Review*. Indicators for early 2016 point to a slowing of the contraction, with industrial production in February and March little changed from early 2015, and PMIs for the services sector suggesting a resumption of growth in parts of the economy.

Increases in global oil prices since early February 2016 will promote the stabilisation of activity. On the other hand, international sanctions continue to weigh on the economy. The EU and the US extended their sanctions in March for six months and one year respectively. These sanctions limit access to foreign finance, and also include asset freezes and travel bans, targeting senior Russian

https://doi.org/10.1177/002795011623600110 Published online by Cambridge University Press

officials, businessmen and state-owned companies, and generally adding to the difficulties of doing business in Russia. The duration of sanctions will depend on implementation of the Minsk peace agreements relating to Ukraine.

Unemployment has risen significantly from the 20-year low of 4.8 per cent reached in mid-2014, to 6.0 per cent in March. Real pay fell by 3.0 per cent and real disposable income by 1.8 per cent in the year to March. Another indication of increased economic hardship is the share of the population living under the poverty line, which rose to 13.4 per cent in 2015, the highest level since 2008.

Consumer price inflation, on a 12-month basis, having peaked at 16.9 per cent in March 2015, has slowed significantly in recent months, reaching 7.3 per cent in March 2016, the lowest rate in almost two years. Despite the slowdown of inflation and the appreciation of the rouble in recent months, which has contributed to it, the Central Bank has kept its benchmark rate at 11 per cent since last August, citing in March inflationary risks arising from developments in the oil market, persistently high inflation expectations and budget uncertainties. The Central Bank also indicated that monetary policy might need to remain moderately tight for longer than previously planned to ensure achievement of its inflation target of 4 per cent for 2017 and subsequent years under its new monetary policy regime introduced in 2015.

Taking into account recent developments, we now project a somewhat larger decline in GDP in 2016 than we forecast in February – a fall of 1.9 per cent, rather than 1.1 per cent – followed by a slower recovery in 2017, with growth of 0.5 rather than 2.5 per cent. Our inflation projections have also been lowered, but they still remain somewhat above the Central Bank's target throughout the forecast period.

NOTES

1 This is in terms of the effective exchange rate index calculated by the Bank of England.
2 See IfW Kiel, DiW and German Economic Council.
3 After our forecast was finalised, the advance estimate of first-quarter GDP growth was released, as 0.5 per cent, annualised, below our assumption of 0.8 per cent. This is the slowest quarterly growth for two years.

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