

Prospects for individual economies

United States

While GDP growth has remained erratic from quarter to quarter, its underlying rate has recently been steady at an annual rate of about 2.0 per cent. Growth slowed to 1.4 per cent, annualised, in the first quarter of 2017, with weakened growth of consumer spending and a downturn in stockbuilding outweighing a major pick-up in private fixed investment and an upturn in net exports. GDP in the first quarter was 2.1 per cent higher than a year earlier. More recent indicators point to a moderate acceleration of activity in the second quarter, with growth roughly 2.5 per cent at an annual rate, which would imply growth in the first half of 2017 close to 2.0 per cent. Our forecast for 2017 and 2018 is unchanged from May.

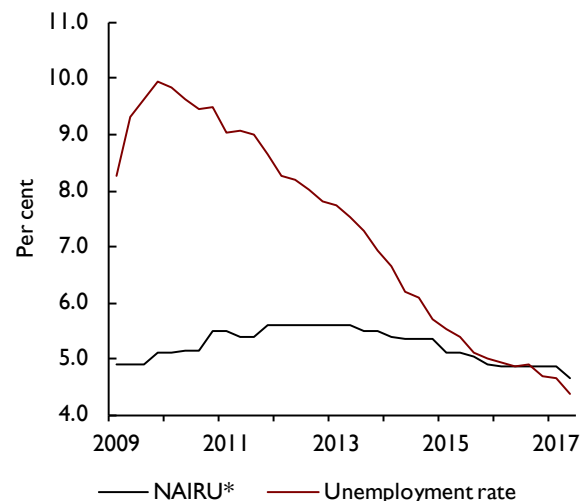
Employment growth strengthened in the second quarter of 2017, with the unemployment rate close to 16-year lows. Non-farm payrolls increased by 194,000 a month in the second quarter, up from 166,000 a month in the first quarter and also higher than the 2016 average increase of 187,000 a month. The 12-month growth rate of non-farm employment, which peaked at 2.3 per cent in early 2015, was 1.6 per cent in June 2017. Unemployment fell to 4.3 per cent in May, its lowest level since May 2001, but rose marginally to 4.4 per cent in June. The labour force participation rate in June was 62.8 per cent, within the 62.6–63.0 per cent range of fluctuation that has prevailed since December 2015 and only a little higher than the 38-year low of 62.4 per cent reached in September 2015. The strengthening labour market thus seems recently to have offset the demographic factors tending to reduce participation, but not to have clearly outweighed them.

Consumer price inflation has fallen back in recent months to rates more clearly short of the Fed's medium-term objective of 2 per cent. In May 2017, the 12-month increase in the price index for personal consumption expenditures was 1.4 per cent, the same as the increase in the corresponding core rate. Market-based measures of inflation expectations have fallen back as well in recent months: the five-year break-even rate in mid-July was about 1.6 per cent, down from 2.0 per cent in late January. Wage increases also seem to have abated in recent months, despite low unemployment. In the year to June, average hourly earnings rose by 2.5 per cent, down from the 2.9 per cent increase in the year to December 2016. The broader employment cost index, which takes account of benefits as well as wages and

salaries, similarly rose by 2.4 per cent in the year to March 2017.

In June, the Fed's Open Market Committee raised its target range for the federal funds rate by 25 basis points to 1.0–1.25 per cent "in view of realised and expected labour market conditions and inflation". This was the fourth increase since December 2015. The FOMC's median projection of GDP growth in 2017 was revised marginally up, to 2.2 from 2.1 per cent, and its forecast of unemployment was revised down for each year between 2017 and 2019, to a low of 4.2 per cent from 4.5 per cent, but its forecast of inflation in 2017 was lowered to 1.6 from 1.9 per cent. The Committee's median estimate of the longer-run unemployment rate was lowered to 4.6 from 4.7 per cent – the latest in a number of such downward revisions in recent years (see figure 6). With regard to the recent decline in inflation, Chair Yellen argued that it seemed to be transitory, reflecting in particular one-off price reductions (including in telecoms charges) and that inflation still seemed likely to move up to about 2 per cent in the near term. The Committee's median expectation of the future path of the federal funds rate was virtually unchanged, with one further increase of 25 basis points expected in

Figure 6. US: unemployment rate and the Fed's estimate of its normal level (NAIRU)



Source: Federal Reserve Bank of St. Louis; Bureau of Labor Statistics.
Note: *Federal reserve estimate of long-run unemployment rate, midpoint, fourth quarter.

2017, followed by three such increases in both 2018 and 2019. While the Committee viewed the near-term risks to the outlook as roughly balanced, it said that it was “monitoring inflation developments closely” in relation to its “symmetric inflation goal”.

Also in June, the FOMC set out details of the balance sheet normalisation programme that it expects to begin implementing this year – “relatively soon”, Yellen indicated – “provided that the economy evolves broadly as anticipated”. The programme, designed to reduce the Fed’s balance sheet to a more normal size following the expansion brought about by its large-scale asset purchases during 2008–14 will involve gradually rising caps on reductions in the Fed’s security holdings. The caps for Treasury securities will start at \$6 billion and increase by \$6 billion every three months until it reaches a maximum of \$30 billion. For mortgage-backed securities, the cap will start at \$4 billion and rise by \$4 billion every three months until it reaches a maximum of \$20 billion. No specific target was set for the longer-term size of the balance sheet.

With regard to overall financial conditions in the US, the reduction of monetary accommodation associated with the recent increases in the federal funds rate has been partly offset by the declines in longer-term interest rates, depreciation of the US dollar, and increases in stock market prices discussed above in the Overview.

Prospects for fiscal policy beyond the current fiscal year ending in September remain uncertain. In late May, the President submitted a budget proposal to Congress including a plan to balance the federal budget by 2027. The plan assumes that GDP growth will rise to 3 per cent a year by 2021 – one of its elements that have been widely criticised as unrealistic, including by the Congressional Budget Office (CBO). Congress will be working on the budget in the period ahead. It will also need to address the issue of the federal debt ceiling, which was reached in March. Since then, the Treasury has been using ‘extraordinary measures’ (such as redeeming certain investments in federal pensions programmes) to fund government spending. In late June, the CBO advised that the government would run out of such extraordinary sources by early to mid-October, at which time the US would be at risk of default. The Treasury Secretary has urged Congress to address the debt ceiling issue before the end of July.

In mid-June, the Treasury Secretary published proposals for reform of banking regulations, including recommendations to reduce the applicability, frequency

and severity of the stress-testing process, to apply more narrowly a looser interpretation of the ‘Volcker rule’ ban on proprietary trading, and to reduce the power of the Consumer Financial Protection Bureau. Some of the recommendations will need Congressional approval to be put into effect, but many can be implemented by regulators without legislative action. Further reports are expected on other areas of regulation in the financial sector.

Canada

Following its adjustment to the decline in global oil prices in 2014–15, the economy has grown since the middle of 2016 at above-potential rates. In the first quarter of 2017, GDP rose by 0.9 per cent to a level 2.3 per cent higher than a year earlier. Growth in the first quarter was generated entirely by domestic demand, with less reliance on consumer spending than in 2016. Thus although consumer expenditure growth remained strong, at 1.0 per cent, in the first quarter, business non-residential fixed investment and housing investment surged by 2.7 and 3.7 per cent, respectively. Indicators for the second quarter suggest continued solid growth: monthly GDP rose by 0.2 per cent in April and the Bank of Canada’s business outlook indicator rose in the summer survey to its highest level since 2011. We forecast GDP growth of 2.7 per cent in 2017 as a whole, followed by a slowing to 2.2 per cent next year, reflecting capacity constraints.

Unemployment continued to decline in the first half of 2017, reaching 6.5 per cent in June, more than two percentage points below the peak reached in 2009 but still above the lows of slightly below 6 per cent reached in late 2007 and early 2008, before the impact of the global financial crisis. Recent data on prices and wages indicate little inflationary pressure. Consumer price inflation in the year to June was 1.0 per cent, down from 2.1 per cent in the year to January, and the Bank of Canada’s various measures of core inflation in the year to June ranged between 1.2 and 1.6 per cent. Wage growth has also been modest: average hourly earnings in June were only 1.3 per cent higher than a year earlier.

In July, the Bank of Canada raised its main policy interest rate, for the first time since 2010, by 25 basis points to 0.75 per cent. With all measures of inflation below its 2 per cent target, and with most having recently declined, the Bank explained its action by arguing first, that transitory factors had recently been holding inflation down and second, that with continuing above-potential growth the economy could be expected to reach full capacity

by the end of 2017, with inflation reaching the target of 2 per cent within a year. The Bank also referred to the need to take account of the 18–24 month lag expected to operate between monetary policy and inflation. Yet, as in other advanced economies, recent persistently low core inflation, out of line with past experience, points to a risk of tightening monetary policy too soon.

The rate hike contributed to a 7 per cent appreciation of the Canadian dollar against the US dollar between the beginning of May and late July; indeed the Canadian dollar was the strongest major currency in the past three months.

The move towards the normalisation of interest rates may help mitigate vulnerabilities in the financial system related to the high level of household debt – close to 170 per cent of disposable income at the end of March 2017 – and rapid house price growth, especially in some major cities. At the same time, as the Bank of Canada has acknowledged, high household debt may make the economy more sensitive to higher interest rates than in the past.

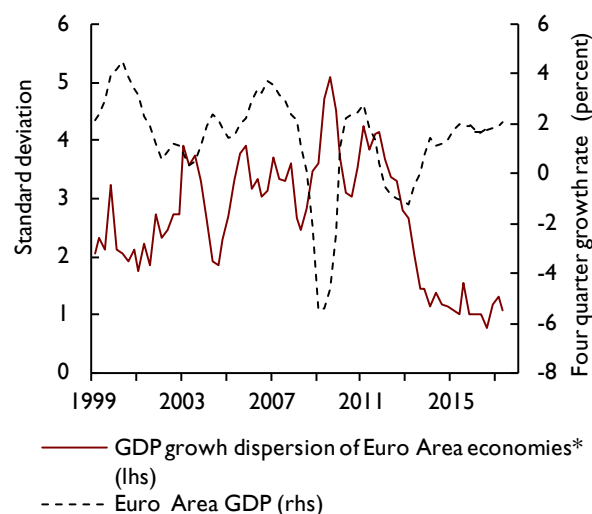
The main risks to our forecast, both on the upside and downside, lie in future unexpected movements in oil prices and changes in US fiscal and trade policies. Expansionary fiscal policies promised by the new US administration, together with their financial repercussions, could have significant spill-overs to Canada, and the renegotiation of NAFTA now underway may also have significant implications for the Canadian economy.

Euro Area

Recent data have added evidence that economic growth has strengthened and broadened since early 2016. Unemployment, though still high, has declined further. The threat of deflation apparent early last year has disappeared, but consumer price inflation has remained below the ECB's medium-term objective of 'below, but close to, 2 per cent' and wage increases have remained subdued, even in countries where unemployment is low. The ECB, at its June meeting, made no change either to its benchmark interest rates or to its asset purchase programme, but it did remove the downward bias in its forward guidance on interest rates. In recent weeks markets have paid increased attention to the question of how soon the ECB will begin withdrawing stimulus.

GDP grew by 0.6 per cent in the first quarter of 2017 – the third consecutive quarter of acceleration – to a level 1.9 per cent higher than a year earlier. As in

Figure 7. Euro Area : GDP growth and dispersion of national GDP growth rates



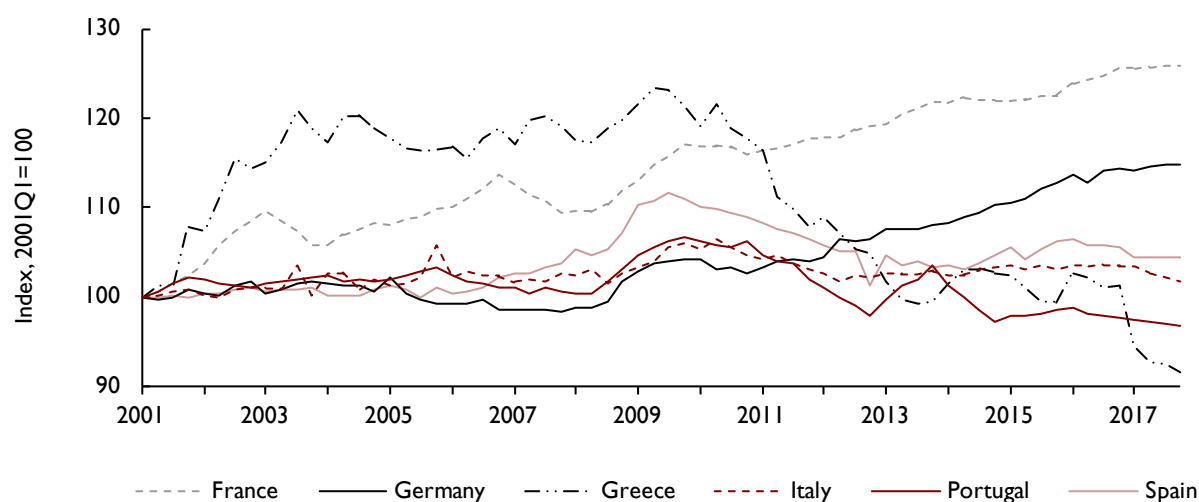
Source: NiGEM database and NIESR forecast.

Note: *Dispersion is calculated as standard deviation of four-quarter GDP growth rates of fifteen Euro Area member economies; 2017 includes forecast.

the preceding quarter, growth was driven entirely by domestic demand, with fixed investment again making a notably strong contribution and consumer spending continuing to grow moderately. Net exports were flat in the first quarter, having declined in the previous three months. Preliminary indications for the second quarter suggest that growth may have accelerated slightly further: the 12-month growth rate of industrial production rose to 4.0 per cent in May, and in June the European Commission's economic sentiment indicator was the highest in almost ten years. The recent strengthening of GDP growth has been accompanied by a significant decline in the dispersion of member countries' growth rates, by some measures to its lowest levels since the introduction of the euro: see figure 7.

Unemployment in the Area fell to 9.3 per cent in April and May 2017, its lowest level since March 2009 and 2.8 percentage points below its March 2013 peak but still 2.0 percentage points above its March 2008 trough. Joblessness remains extremely uneven among member countries, ranging from 3.9 per cent in Germany to 9.6 per cent in France, 11.3 per cent in Italy, 17.7 per cent in Spain, and 22.5 per cent in Greece. The growth of employment in the Area picked up marginally to 1.5 per cent in the year to the first quarter, implying labour productivity growth (in terms of GDP per head) of only 0.4 per cent in this period.

Figure 8. Real consumer wages in selected Euro Area economies



Source: NiGEM database and NIESR forecast.

Consumer price inflation, on a 12-month basis, fell back to 1.3 per cent in June, its lowest rate since last December, mainly reflecting the waning influence of last year's partial recovery of energy prices. Core inflation in the year to June was 1.1 per cent. No member country has experienced negative consumer price inflation, on a 12-month basis, since last December (except for Ireland in June). Wage increases have remained subdued: in the year to the first quarter of 2017, hourly labour costs rose by 1.5 per cent, less than the 1.7 per cent increase in the year to the first quarter of 2016. Reflecting the variations in labour market slack among member countries, the increase in labour costs in Germany in the year to the first quarter of 2017, at 2.5 per cent, was above the average for the Area, while the corresponding increases for France, Italy, and Spain were below average, at 1.2, 0.8, and 0.1 per cent, respectively.

The ECB, at its June meeting, revised its growth projections for 2017–19 marginally upwards from its March forecast and its inflation projections slightly downwards. It also changed its assessment of the risks around its new forecast to “broadly balanced” from “tilted to the downside” in March. Partly on the basis of these projections, the ECB kept its benchmark interest rates unchanged, including its deposit rate at –0.4 per cent, and indicated that it expected them “to remain at their present levels for an extended period of time, and well past the horizon of our net asset purchases”. This forward guidance on interest rates removed the

downward bias contained in the previous, March, guidance, by replacing “present or lower levels” with “present levels”. The ECB confirmed that its net asset purchases of €60 billion a month “are intended to run until the end of December 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 inflation aim”. It also retained the downward bias in its guidance on asset purchases by reiterating that “If the outlook becomes less favourable, or if financial conditions become inconsistent with further progress towards a sustained adjustment in the path of inflation, we stand ready to increase our asset purchase programme in terms of size and/or duration”.

With regard to reform of the Area's policy arrangements, June 2017 was the target date for completion of Stage 1 (‘Immediate Steps’) of the proposals set out in the ‘Five Presidents’ Report’ on *Completing Europe's Economic and Monetary Union* of June 2015 (see August 2015 *Review*, Box A). This objective was not met in important respects: thus concrete steps have not been taken towards the establishment of a common backstop for the Single Resolution Fund and agreement has not been reached on the establishment of a European Deposit Insurance Scheme. At the end of May, the European Commission released a *Reflection Paper on the Deepening of the Economic and Monetary Union*,⁴ which addressed many of the same issues as the Five Presidents’ Report (see Box A).

Box A: Completing the EU's Economic and Monetary Union: progress and plans

The global financial crisis of 2007–9 and the crisis in the Euro Area in 2011–13 highlighted several shortcomings of EMU. Steps were taken during or in the immediate aftermath of the 2011–13 crisis to improve the coordination of fiscal and other economic policies; to create a safer financial sector, including with the establishment in 2014 of a Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM) at the ECB, as key pillars of a banking union; and to establish emergency rescue funds, which became the European Stability Mechanism (ESM) in 2012.

However, important gaps remained, and in June 2015 the Five Presidents' Report (FPR) on *Completing Europe's Economic and Monetary Union* set out 'the principal steps necessary to complete EMU at the latest by 2025', to be implemented in two stages (see August 2015 Review, Box A). 'Stage 1' (the 'Immediate Steps'), was to be completed by June 2017. It would be followed by 'Stage 2', 'completing EMU', to be completed by 2025. Included in Stage 1 was agreement on a European Deposit Insurance Scheme (EDIS) – a third pillar of the banking union – and on concrete steps towards a credible common backstop to the Single Resolution Fund (SRF). Neither of these objectives has been met. However, there has been progress:

- Economic and fiscal union: on the basis of FPR recommendations, the European Fiscal Board was created in October 2015 as an independent advisory body to help evaluate the implementation of fiscal rules, and agreement was reached in September 2016 on the establishment of National Productivity Boards in member countries; the European Semester of economic policy coordination has been revamped, with closer attention to spillovers and the challenges of the Area as a whole; and the Commission has established a Structural Reform Support Service to pool expertise.
- Banking union: a proposal for an EDIS to be introduced by 2025 was put forward by the Commission in November 2015 and is a subject of negotiation.
- Capital markets union: in September 2015, the Commission published an action plan for a capital markets union. A June 2017 mid-term review of the plan reported that most planned measures had been delivered and set out a revised agenda, taking into account recent developments, including the prospect of Brexit.

The FPR promised that 'To prepare the transition from Stage 1 to Stage 2, the Commission will present a White Paper in spring 2017 assessing progress made in Stage 1 and outlining the next steps needed, including measures of a legal nature to complete EMU in Stage 2'.

A *White Paper on the Future of Europe* was published by the Commission in March 2017, but rather than fulfilling the promise of the FPR it set out five possible scenarios for the development of the EU by 2025. It was followed in May 2017 by a Commission Reflection Paper on the Deepening of the Economic and Monetary Union,¹ which seeks to take forward the FPR by setting out suggestions for completing EMU by 2025. Like the FPR, it suggests two phases of action, the first of which would now be completed by 2019. The main elements are as follows:

Phase 1: 2017–19

- Economic and fiscal union: strengthen further the European Semester of economic policy coordination, with focus on promoting economic and social convergence among member countries; reflect on establishing in Phase 2 a macroeconomic (fiscal) stabilisation function for the Area.
- Banking union: implement further risk-reducing measures for the financial sector, including in the areas of prudential management, insolvency and restructuring; establish a comprehensive strategy to reduce non-performing loans; reach agreement both on a common fiscal backstop for the SRF (such as a credit line from the ESM) and on an EDIS, for both be put in place and made fully operational by 2025.
- Capital markets union (CMU): establish a full CMU, with steps towards a single supervisor; work towards establishing sovereign bond-backed securities.
- Democratic accountability and effective governance: stronger dialogue with European Parliament; progress towards unified external representation (at IMF, etc.).

Phase 2: 2020–25

- economic and fiscal union: continue promoting economic and social convergence on the basis of new standards; adopt simpler fiscal rules under Stability and Growth Pact; decide on design of central stabilisation function and begin its operations.
- Banking union: fully implement EDIS; change regulatory treatment of sovereign bonds to further loosen bank-sovereign loop.
- Capital markets union: develop and begin issuance of a European safe asset (comparable with US Treasury securities).
- Democratic accountability and effective governance: establish full-time permanent chair of Eurogroup; establish fully unified external representation; set up a Euro Area Treasury, responsible for economic and fiscal surveillance and the management of the macroeconomic stabilisation function; set up a European Monetary Fund to give the Area autonomy from 'other international institutions'.

NOTE

¹ https://ec.europa.eu/commission/sites/beta-political/files/reflection-paper-emu_en.pdf.

This box was prepared by Graham Hache.

Germany

The economic expansion has gathered pace since the middle of last year, with GDP growth reaching 0.6 per cent in the first quarter of 2017 and indicators for the second quarter suggesting continuing robust growth: industrial production, for example, was 5 per cent higher in May than a year earlier. Unemployment remained unchanged in May at 3.9 per cent, the level to which it fell last November and the lowest since December 1980. Within the EU only the Czech Republic has an unemployment rate lower than Germany's. The number of employed persons in Germany reached a record high in May. We forecast GDP growth of 1.9 and 1.8 per cent this year and next, respectively, revised marginally upwards for both years from the May *Review*. Unemployment is expected to average 3.8 per cent this year, rising slightly to 3.9 per cent in 2018.

Despite the economy's recent robust growth performance and low unemployment rate, movements in prices and wages provide little evidence of inflationary pressure. Wage inflation has remained moderate: the rise in hourly labour costs was 2.5 per cent in the year to the first quarter, with no acceleration apparent. Consumer price inflation picked up at the end of 2016 following a sharp increase in energy prices, but fell back to 1.5 per cent in the 12 months to June 2017. We expect inflation, in terms of the consumer spending deflator, to average 1.5 per cent this year and next.

Business investment bounced back strongly in the first quarter of this year, following a contraction in the previous quarter. The IFO business confidence index in June was the highest since 1991 and we expect investment to remain strong throughout 2017. However, uncertainty surrounding Brexit negotiations may weigh on business investment: the UK is Germany's third largest trading partner, behind the US and France, accounting for 7 per cent of total exports. On the other hand, the prospect of Brexit and related uncertainties may boost investment in Germany if producers in the UK decide to relocate production to within the future EU.

The current account surplus narrowed slightly to 8.3 per cent of GDP in 2016, from a record high of 8.6 per cent in 2015. This remains extremely high by any standards: in US dollar terms it is the largest surplus in the world. A downside risk to our growth is the possibility that the US, which accounts for 10 per cent of German exports, takes protectionist measures aimed at reducing its bilateral deficit. A 'hard' Brexit could similarly hamper German export growth after 2018.

Federal elections are due on 24 September. Angela Merkel's CDU party has promised tax cuts against the background of a record government budget surplus of 0.8 per cent of GDP in 2016. The CDU's partner in the current coalition government, the SPD party, has promised to increase government spending. Both sets of policy proposals indicate the likelihood of some degree of fiscal stimulus after the elections.

France

France has shared in the improved growth performance of the Euro Area over the past year. GDP growth in the first quarter of 2017 was 0.5 per cent, the same as in the preceding quarter. Growth was maintained at the same rate in the first quarter despite stagnation in consumer spending and a downturn in net trade, thanks to a pick-up in the growth of fixed investment and an upturn in stockbuilding. Indicators for the second quarter, including industrial production and PMIs, point to continued moderate growth. Low inflation and declining unemployment should support GDP growth in the remainder of 2017, and we have revised our forecast of GDP growth this year upwards to 1.5 from 1.2 per cent, and next year to 1.6 from 1.4 per cent. The electoral season having drawn to a close with the election of a pro-Macron majority in the National Assembly, political circumstances seem relatively propitious for policy actions to address the structural issues of the French economy – namely, weak international competitiveness, high unemployment, a budget deficit still exceeding the EU ceiling and high public spending.

Private consumption ground to a halt in the first quarter of 2017 because higher inflation (related largely to energy prices) reduced purchasing power, as we forecast in the May *Review*. The more recent decline of consumer price inflation – from about 1.5 on an annual basis in the first quarter to 0.8 per cent in June – should have boosted consumer spending, and there is evidence that this has occurred in the strong growth of retail sales volumes in May and the relatively strong retail PMI reading of 56.3 in June. For 2017 as a whole, we expect moderate growth of 1.4 per cent in consumer spending, which is still lower than the 2.1 per cent growth rate of 2016.

A question that arises in forecasting consumer spending is whether it is likely to be boosted by a decline in the household saving rate, which is relatively high compared to the UK. If history is any guide, this seems unlikely. The household saving rate declined from 16.7 per cent of disposable income in 2009 to 13.9 per cent in the fourth quarter of 2016, its lowest level since 1990 and

in the lowest decile of its frequency distribution since 1961. Another difference with the UK is that the saving rate in France has tended to be negatively correlated with the unemployment rate, as can be seen in figure 9. The recent decline in unemployment – from about 10.0 late last year to 9.6 per cent in most of the period between February and May 2017 – may therefore be associated with an increase, rather than a decline, in saving. The decline in unemployment since late last year is attributable entirely to a decline in the labour force, which seems temporary: the employment rate has been stable. We nevertheless expect the unemployment rate to continue declining gradually, reaching 9 per cent by the end of 2018, as the economy continues to grow at rates slightly above potential.

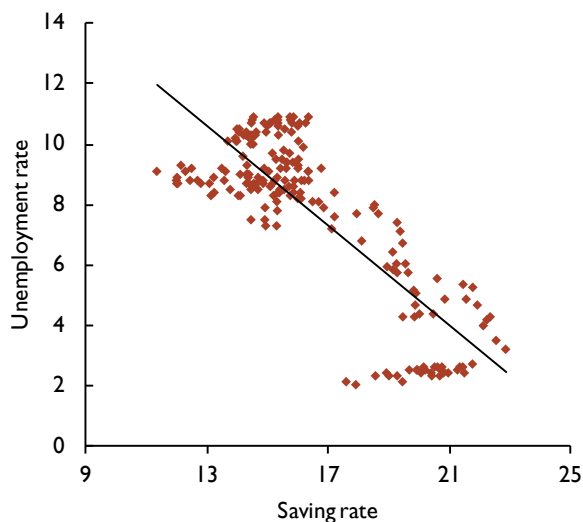
To reduce unemployment more significantly – say, to the rates close to 7 per cent seen in 2008 – policy action is needed to reduce its high structural component, and this is rightly a priority of the new government. The National Assembly voted on 13 July to empower President Macron exceptionally to implement new labour laws directly without going through the usual parliamentary process. Labour market reforms during President Hollande's tenure failed to achieve their unemployment reduction aims because they focused excessively on reducing the cost of labour. According to a study by Carbonnier *et al.* (2017),⁵ these reforms appear to have had no direct impact on employment, but instead increased wages and

corporate profits. While the content of the new labour market reforms is not yet publicly known, their clearly stated objective is to make the labour market more flexible. Some of the proposed measures include the creation of a new employment contract whose duration would be linked to the duration of a project; more flexibility for employee negotiations at the company level rather than on a sectoral basis; a cap on the cost of dismissals; and a reduction in the administrative cost of hiring.

The trade deficit increased sharply to 3.1 per cent of GDP in the first quarter, the largest deficit since 2011. The main components of the deficit in services were in transport (reflecting the rising market share of foreign low-cost airlines and eastern European truck delivery companies), tourism, (which continued to be affected by past terrorist attacks) and business services. France has suffered from a declining share of world exports, indicative of the need to improve its international costs competitiveness.

On the fiscal side, France is not on track to reduce its budget deficit to 2.8 per cent of GDP this year, as promised to the European Commission in the April budgetary update. The deficit stood at 3.3 per cent in the first quarter and, absent a fiscal consolidation plan, our forecast is for a tenth consecutive year of breaching the Maastricht Treaty limit of 3 per cent. President Macron's fiscal plan, which includes new investments and tax cuts first, followed by a gradual reduction in public expenditures, seems likely to worsen the deficit in the short term.

Figure 9. France: unemployment and saving rates since 1961



Source: NiGEM database.

Italy

The pace of economic growth has picked up since early 2016, with GDP expanding by 0.4 per cent in the first quarter of 2017 to a level 1.2 per cent higher than a year earlier – the highest four-quarter growth rate since 2010, but still 0.7 percentage point lower than that for the Euro Area. Growth in the first quarter was driven by domestic demand, with consumption expenditure and fixed investment rising by 0.5 and 0.8 per cent respectively. Net exports were a drag on growth in the quarter, with imports rising more than exports. Indicators for the second quarter, including PMIs and industrial production, suggest continuing output growth at a rate similar to that in the first three months of the year. In light of recent data, we have raised our forecast of GDP growth in 2017 as a whole to 1.3 from 1.0 per cent, while keeping our forecast for 2018 unchanged at 1.1 per cent. The growth rate now forecast for this year

would be the highest since 2010. Growth could again surprise on the upside in the near term, including as a result of a stronger European recovery. But there are also significant downside risks, including political risks relating to a general election to be held no later than next spring, financial fragilities, and a possible re-evaluation of credit risk as interest rates rise in the course of the ECB's monetary policy normalisation. Uncertainties about US policies and Brexit negotiations add to these risks.

Unemployment has continued its uneven descent from the peak of 13.0 per cent in late 2014, reaching 11.3 per cent in May 2017. The May unemployment rate is still 2 percentage points above the average of the Euro Area and the third highest among its member countries, lower only than in Greece and Spain.

Following a spell of mild deflation in 2016, inflation returned towards the end of last year, rising to 2.0 per cent, on a 12-month basis, in April 2017, largely reflecting rising energy prices, before easing to 1.2 per cent in June. Wage growth seems to have picked up to modest rates: after a period of decline and stagnation, hourly labour costs rose by 0.8 per cent in the year to the first quarter of 2017, roughly half the increase in the Euro Area as a whole, thus helping Italy to continue regaining international competitiveness.

Progress has been made in strengthening banks' balance sheets, including through actions to strengthen the capital buffers of some large banks and the promotion of bank consolidation. In late June, the government agreed to provide €5.2 billion to the Intesa Sanpaolo bank to facilitate its takeover of two banks from the Venice region, Banca Popolare di Vicenza and Veneto Banca. The two banks' good assets would be transferred to Intesa Sanpaolo, while their bad assets would be transferred to a 'bad bank', along with the banks' equity and subordinated bonds, which would be used to cover losses. Senior and retail bondholders, as well as depositors, in the two banks would be protected. The European Commission approved the government's aid on the grounds that otherwise the Veneto regional economy would have been disproportionately hurt. Also, in early July, the European Commission confirmed that it had approved the five-year restructuring plan for the Monte dei Paschi di Siena bank, involving a recapitalisation in which 70 per cent of the bank will come to be owned by the state.

With regard to fiscal policy, high public debt – 133 per cent of GDP at the end of 2016 – leaves Italy exposed to shocks, with little room to respond. A gradual

adjustment, as outlined in April in the authorities' multi-year budget plans, aiming for an overall deficit of 1.2 per cent of GDP in 2018 and a broadly balanced budget by 2019, is needed to put debt on a declining trajectory.

Spain

The economy has continued its strong recovery from the deep recession that bottomed out in late 2013. GDP grew by a further 0.8 per cent in the first quarter of 2017 to a level 3.0 per cent higher than a year earlier, approaching its pre-crisis peak. All major components of final domestic demand, along with net exports, contributed to growth in the first quarter; the only negative demand factor was a downturn in stockbuilding. The recent pace of economic growth is expected to be maintained in the remainder of 2017, and we forecast GDP growth of 3.1 per cent for the year as a whole, moderating to 2.5 per cent in 2018.

Unemployment (on Eurostat data) has fallen steadily from its 2013 peak of 26.3 per cent to 17.7 per cent in May this year. The recent improvement is accounted for by a rise in employment. Although the recent decline in unemployment has been significant, its level remains almost twice as high as the Euro Area average and far above the low of 7.9 per cent reached in Spain ten years ago.

Following a period of deflation between mid-2014 and mid-2016, in terms of 12-month changes in the consumer price index, inflation returned and rose to a peak of 3.0 per cent in February 2017, largely reflecting rising energy prices, before easing back to 1.6 per cent in June. With output and employment gaps still substantial, there is little reason to expect significant inflationary pressure; wages were virtually flat in the year to the first quarter of this year, indicating further declines in real wages.

The fiscal position in Spain has continued to improve. The deficit has declined from a peak of 11 per cent of GDP in the wake of the financial crisis in 2009 to 4.5 per cent in 2016. The improvement reflects fiscal reforms and expenditure restraint, but also the expansion of the economy, which has boosted revenues and lowered some expenditures. The high public debt ratio, about 100 per cent of GDP, still leaves little room for fiscal policy to respond to negative economic shocks and points to the need for further progress in deficit reduction.

In the banking sector, in the first test-case of the Euro Area's post-crisis bank resolution regime, the Single Supervisory Mechanism at the ECB declared in early

June that Banco Popular, following a run on its deposits, was “failing or likely to fail”. This allowed the Single Resolution Board to organise the sale of Popular to Banco Santander for €1, with the holders of Popular’s equity and junior bonds being ‘bailed in’ and with no cost to the state. Established in 1926, Banco Popular had been one of the largest lenders in Spain, but suffered balance-sheet problems related mainly to non-performing loans that had been mounting for some months, leading to a run on deposits that eventually reached crisis levels.

Japan

Since early 2016 Japan has experienced unusually steady economic expansion, exceeding most expectations and also most estimates of the economy’s potential growth. In the first quarter of 2017, GDP rose by 0.3 per cent to a level 1.3 per cent higher than a year earlier. This was the fifth consecutive quarter of positive GDP growth, making this the longest period of uninterrupted quarterly growth since 2005. Government spending, which was flat, and stockbuilding, which turned down, were the only main expenditure components that did not contribute positively to GDP growth. The strongest component of domestic demand in the first quarter was private non-residential fixed investment, which rose by 0.6 per cent. Export growth remained rapid, though dipping to 2.1 from 3.4 per cent in the preceding quarter, while import growth was broadly unchanged, at 1.4 per cent.

Through the rest of 2017, we expect robust export growth to continue, supported by rising demand in key trading partners, especially China. The growth of consumer spending seems likely to remain subdued because of low real wage growth. The June Tankan survey shows improved business sentiment, a positive sign for private investment spending. From next year onwards we expect the economy will transition to a growth path with domestic demand, especially consumption, contributing relatively more to output growth, underpinned by modestly faster wage growth. We forecast that the economy will grow by 1.3 per cent in 2017 as a whole, by 1.0 per cent in 2018, and by 0.8 per cent in the medium term – a rate close to the economy’s potential growth rate.

Unemployment rose to 3.1 per cent in May 2017, after three consecutive months at a 23-year low of 2.8 per cent. Other indicators continue to suggest a very tight labour market. The applicants-to-jobs ratio rose in May for a third consecutive month to reach a 43-year high of 1.49 – higher than at the peak of the asset price bubble of the

late 1980s. Moreover, the labour force participation rate has continued to rise: for 15–64 year olds, it increased from 76.6 per cent in March 2017 to 77.8 per cent in May, with male and female participation rates increasing by 0.9 and 1.5 percentage points respectively. These indicators suggest that the increase in unemployment in May could well be a symptom of lags in job-matching combined with an increase in participation. We expect unemployment to remain low this year and next, averaging 3.0 per cent in both years.

Wage growth has remained sluggish, despite the evident tightness of the labour market. In the year to first quarter of 2017, cash earnings increased by just 0.4 per cent, and there was little further change in the next two months. As with our forecast published in May, we expect nominal wages to pick up, both as a result of the labour market tightness and as a response to persistent, albeit low, price inflation as trades unions seek to protect real incomes in future negotiations. However, revisions to wage data, combined with the weak start to the year, have led us to push back the point at which the pick-up occurs to 2018. We now forecast nominal wage growth to average 0.7 per cent this year, down from 2.4 in the *May Review*, before rising to 1.8 per cent next year. A key risk to our forecast is that wage growth may continue to disappoint, negatively affecting consumption and output growth as well as inflation.

Consumer price inflation, on a 12-month basis, remained stable in May at 0.4 per cent – the eighth consecutive month of positive annual inflation, but still well short of the Bank of Japan’s 2 per cent target. Excluding energy and food, core inflation in the year to May was zero. Compared with the forecast in our *May Review*, weaker world oil prices, partly offset by a slightly more depreciated yen in trade-weighted terms, lead us to lower our inflation forecasts slightly to 0.3 per cent this year and 0.5 per cent in 2018.

In late July, the Bank of Japan announced that it was pushing back the projected timing for reaching its inflation target for a sixth time, to around April 2019 from a year earlier. At the same time, it kept its monetary stimulus programme unchanged.

The IMF’s recent *Article IV Consultation Report* lauded the success of the first two arrows of ‘Abenomics’ (monetary and fiscal policies) in creating, alongside favourable external conditions, improved growth outcomes, but stressed the continuing need for the labour market reforms that form part of the ‘third arrow’. The government’s ‘work style reform

package' includes measures to improve labour market conditions for employees, which in turn could help to improve productivity performance and the economy's long-run potential growth. The package includes measures both to ensure that non-regular workers' pay is equivalent to that of regular workers and to reduce overtime hours. However, as has been true since the inception of *Abenomics*, the third arrow has lagged the other two, and recent political developments suggest that obstacles to the implementation of reforms may have increased.

China

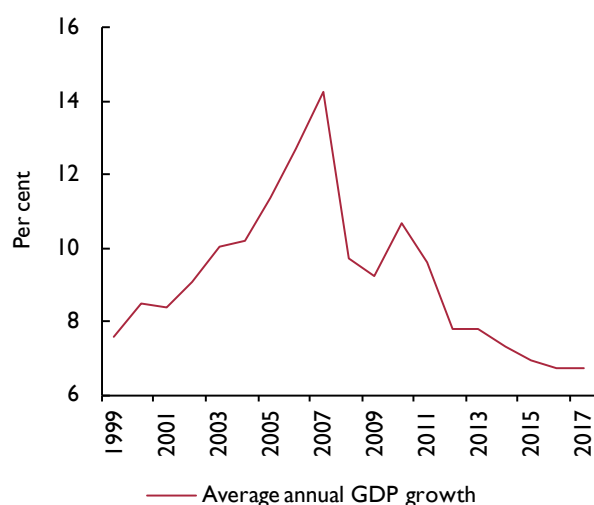
The gradual slowing of economic growth that began in 2010 has been interrupted since late last year. In both of the first two quarters of 2017, GDP was 6.9 per cent higher than a year earlier – a growth rate higher than both the 6.7 per cent average for 2016 and the official objective for 2017 as a whole of 'around 6.5 per cent'.

Recent data suggest that while the growth of industrial production has remained strong – factory output grew by 7.6 per cent in the year to June – the pick-up in overall growth is due mainly to strong expansion of the real estate sector. Thus property investment increased by 8.5 per cent in the year to June 2017, faster than the 6.9 per cent growth rate in 2016. Rising housing

prices, despite restrictions imposed last year by local governments on home purchases and mortgage lending, have remained a policy concern. In the past six months, regulators and the monetary authorities have taken a range of measures – including increases in mortgage rates charged by state banks, stricter down-payment rules, and limits on ownership of multiple dwellings – aimed at curbing speculation in the housing market. These seem to have begun to have an impact in the largest cities, where housing sales have fallen and price increases have moderated. However, demand seems to have shifted to smaller cities where house sales have continued to increase, and in the year to May 2017 house prices across 70 cities increased by 9.7 per cent, up from the 9.3 per cent increase seen in the year to September 2016, when current restrictions began to be applied.

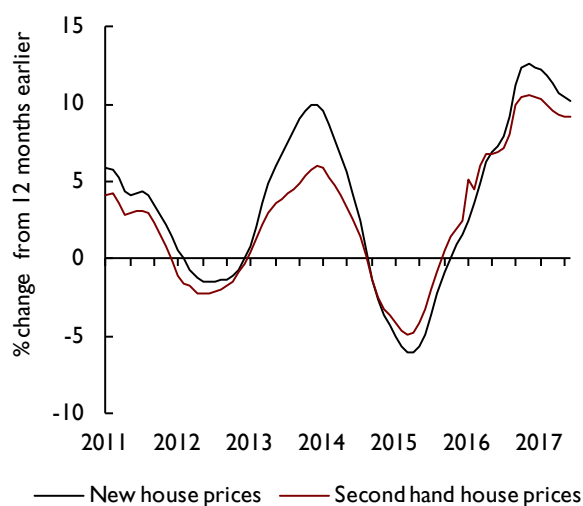
After diverging significantly at the beginning of this year, consumer and producer price inflation have to some extent converged in recent months. Producer price inflation, on a 12-month basis, reached its recent peak of 7.8 per cent in February, and then softened to 5.5 per cent in May. Meanwhile annual consumer price inflation, having fallen abruptly to 0.8 per cent in February, picked up to 1.5 per cent in May and June, still well below the People's Bank's 3 per cent target. Monetary policy recently has focused less on inflation than on reducing financial risks facing the economy,

Figure 10. China: GDP growth



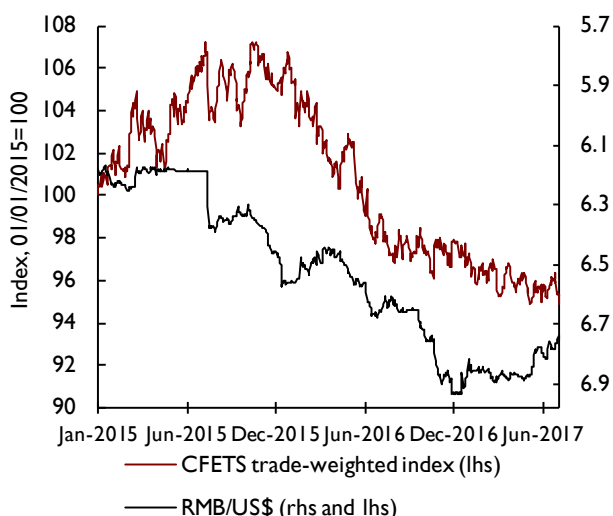
Source: NiGEM database and NIESR forecast.
Note: 2017 includes forecast.

Figure 11. China: house price changes



Source: Datastream.

Figure 12. China: trade-weighted and US dollar exchange rate



Source: Datastream and NIESR calculations.

a declared priority of the government. To promote financial stability, monetary policy has been tightened, though with no change in short-term benchmark rates, through official operations to raise money market rates, with the objectives of curbing speculative housing activity and containing corporate debt. In addition, to curtail the flow of funds towards the shadow banking sector and leveraged investors, interbank market regulation has been tightened. The increases in 10-year government bond yields from about 2.5 per cent last October to about 3.5 per cent in July is indicative of the tightening that has occurred, and it seems to have discouraged the use of borrowed money to invest in bonds.

Capital outflows declined significantly in the first quarter of this year following the introduction of tighter foreign exchange controls. Reduced pressure from capital outflows has contributed to steadier performance of the exchange value of the renminbi this year, and since the end of 2016 it has appreciated by about 2 per cent against the US dollar (see figure 12). China's foreign exchange reserves have also risen since January, by about \$50 billion – a small increase compared to the \$1 trillion decline in the preceding 2½ years; at the end of June the stock of reserves stood at \$3.057 trillion. In late May, the People's Bank announced a change to the way it sets the renminbi's daily fix, apparently to gain more control for sake of stability.

India

Recent revisions to GDP data indicate that the economy grew by 7.9 per cent in 2016, rather than 7.5 per cent as previously estimated. The revisions were largely to data for the first half of the year and suggest that growth moderated as the year progressed. In the year to the first quarter of 2017 the economy grew by 6.1 per cent, the weakest four-quarter growth rate since the final quarter of 2014, probably reflecting in part the disruptive effects of last November's demonetisation of currency notes. Government and private consumption remained the main drivers of the economy with growth of 31.9 and 7.3 per cent respectively in the year to the first quarter; meanwhile investment contracted by 2.1 per cent. The unusually large increase in government spending in the year to the first quarter largely reflects significant increases last year in civil service pay and pensions. After two years of general weakness in both exports and imports, export and import volumes expanded by 10.4 and 11.9 per cent, respectively, in the year to the first quarter. We expect GDP growth to strengthen in the course of this year, driven mainly by household consumption as low inflation supports real income growth but also by rising net exports. We forecast average GDP growth of 7.5 and 7.7, respectively, this year and next.

Consumer price inflation, on a 12-month basis, peaked at 6.1 per cent in July 2016, and has since steadily declined, reaching a historic low of 1.5 per cent in June 2017, below the 2 per cent lower tolerance limit of the Reserve Bank's inflation target of 4 per cent. The decline is accounted for mainly by falling food prices: the consumer food price index fell by 2.1 per cent in the year to June. Given that forecasts for the current monsoon season's rains remain good, food prices seem likely to remain a drag on 12-month headline inflation throughout this year. These considerations have led us to lower our forecast for average inflation to 2.3 per cent this year from 3.5 per cent in our May forecast and to 4.1 per cent in 2018, down from 5.6 per cent.

Recent declines in government bond yields, from about 7 per cent in early May at the 10-year maturity to about 6.5 per cent in late July, suggest that markets expect the recent decline of inflation and evidence of a seemingly weakening economy to lead the Reserve Bank to reduce its main policy rate, the repo rate, at its August meeting from the 6.25 per cent level set last October. This possibility is an upside risk to both inflation and GDP in our forecast.

On 1 July, the new general sales tax (GST) was rolled out across India as an attempt to simplify the notoriously

complicated state-based sales taxation system. While the version of the GST that was implemented is likely to be an improvement over the previous system, it is relatively complicated. There are seven different tax brackets with rates between zero and 43 per cent, together with a range of exemptions such that some key products will continue to be taxed directly by the states. Estimates by some analysts that the introduction of the GST in more simplified form could have raised potential output by as much as 2 per cent have therefore been scaled back substantially.

Brazil

After two years of recession, economic expansion resumed in the first quarter of 2017, with GDP growing by an unexpectedly vigorous 1.0 per cent, albeit to a level still 0.4 per cent lower than a year earlier. Growth in the first quarter was generated by a surge in exports, only partly offset by import growth; all major components of domestic demand weakened further. On the supply side, growth was concentrated in the agricultural sector, with production benefiting from a favourable harvest season. Indicators for the second quarter have been mixed: data on retail sales and industrial production, and manufacturing PMIs, suggest modest growth, but the Central Bank's economic activity index was virtually unchanged in April and May from the first quarter. We forecast modest economic growth of 0.4 per cent in 2017 as a whole, strengthening to 0.9 per cent in 2018. Political uncertainty remains a downside risk to our forecast.

There are signs that some growth momentum was lost after new corruption allegations, involving the President, emerged in May, raising new doubts about the likelihood of the passage by parliament of fiscal and structural reforms. The appearance of the allegations had significant, though largely transitory, effects on financial markets, with the ten-year government bond yield rising by about 110 basis points in late May, the stock market plunging by about 10 per cent between mid-May and mid-June, and the exchange value of the real in terms of the US dollar falling by about 7 per cent in the same period. These movements had been largely reversed by late July.

Partly as a result of the freeze of public spending in real terms implemented in 2016, the public expenditure component of GDP continued to decline in the first quarter of 2017. Nevertheless, partly due to higher borrowing costs, the fiscal deficit widened by 0.7 percentage points to 9.2 per cent of GDP in the twelve

months to April 2017 relative to the year up to February 2017. Further significant improvement of the fiscal position will require the overhaul of the country's public pension system being considered by parliament, but the implementation of this reform has become more uncertain as a result of the renewed political uncertainty.

The further decline of consumer spending in the first quarter of 2017 reflects the continued weakness of the labour market and income growth. Unemployment reached a historic high of 13.7 per cent in March, before falling to 13.3 per cent in May. Reforms to loosen Brazil's labour code, which could help improve employment in the medium term, were approved by the Senate in mid-July but have been held up by the corruption scandal. Real wages increased by 2.4 per cent in the year to April; improved growth in real wages is expected to support consumption over the course of this year.

Consumer price inflation, on a 12-month basis, fell to 3.0 per cent in June 2017, the lowest annual inflation rate since April 2007 and equal to the lower end of the Central Bank's current target range, which is centred on 4.5 per cent. The Central Bank lowered its benchmark 'selic' rate by a further 100 basis points, to 10.25 per cent, at the end of May, indicating that the likely future pace of monetary easing was slower and more uncertain as a result of the increased uncertainty about progress with reforms. In late June, the Central Bank announced that its inflation target was being lowered to 4.25 per cent for 2019 and 4.0 per cent for 2020, with the tolerance band of + or – 1.5 per cent remaining unchanged.

Reflecting weak investment and improving terms of trade, the current account deficit narrowed to 1.3 per cent of GDP in 2016 (from 3.3 per cent of GDP in 2015). The surge in exports in the first quarter of this year was only partly offset by import growth, and we expect the contribution of the trade balance to output growth to remain positive over the course of 2017.

Russia

Economic activity stabilised in 2016, with GDP contracting by just 0.2 per cent in the year as a whole, after the recession that began in mid-2014. Late last year, economic growth resumed at modest rates. GDP growth in the year to the first quarter of 2017 was 0.5 per cent, the second consecutive four-quarter expansion, and indications are that growth will strengthen in the course of this year. The resumption of growth has been supported by the partial recovery of global oil prices since early 2016 and by the depreciation of the rouble

during 2014–15 allowed by the flexible exchange rate policy, but it has also been assisted by the limited rise in unemployment during the recession, with increasing real wage growth, reaching 3.7 per cent in May 2017, supporting a recovery in consumer confidence. In the year to June 2017, industrial production rose by 3.5 per cent; its buoyancy in recent months suggests a strengthening of GDP growth in the second quarter. However, international sanctions remain a factor hindering recovery: the EU decided on 28 June to extend its economic sanctions until 31 January 2018. Taking into account also the economy's long-established structural problems, we forecast GDP growth of 1.4 per cent in 2017 as a whole followed by 1.6 per cent growth in 2018.

Consumer price inflation, on a 12-month basis, fell to 4.1 per cent in both April and May 2017, before rising to 4.4 per cent in June. Having peaked at 16.9 per cent in the year to March 2015, inflation has thus fallen close to the Central Bank's target of 4 per cent. The up-tick in inflation in the year to June may partly reflect the depreciation of the rouble against a weak US dollar during June 2017 stemming largely from a weakening of global oil prices. The Central Bank lowered its benchmark interest rate for the third time this year in mid-June to 9.0 per cent from 9.25 per cent and signalled the possibility of further cuts in the remainder of the year unless there is evidence that inflation expectations are failing to anchor

at around 4 per cent. We expect inflation to remain slightly above the target as the economy continues its recovery in 2017–18.

Russia's unprecedented agreement with OPEC in December 2016 to cut oil output by 300,000 barrels a day in the first half of 2017 has been implemented. In late May, the agreement was extended to the first quarter of 2018. The efficacy of this agreement remains uncertain, particularly given the growth of production in non-OPEC countries not participating in the agreement.

NOTES

- 1 A simple simulation using NiGEM indicates that an increase in government spending in Germany equivalent to 1 per cent of domestic demand would raise domestic GDP in the first year by 0.3 per cent and GDP in the Euro Area by 0.1 per cent.
- 2 See, for example, Lawrence H. Summers, 'Rethinking Secular Stagnation After Seventeen Months', April 2015: http://larrysummers.com/wp-content/uploads/2015/07/IMF_Rethinking-Macro_Down-in-the-Trenches-April-20151.pdf.
- 3 See, for example, Neel Kashkari, 'Why I dissented again', June 16, 2017: <https://medium.com/@neelkashkari/why-i-dissented-again-b8579ab664b7>. Also, Martin Wolf, 'Janet Yellen, and the inflation target, should both stay', *Financial Times*, June 21, 2017
- 4 https://ec.europa.eu/commission/sites/beta-political/files/reflection-paper-emu_en.pdf.
- 5 Carbonnier, C., Malgouyres, C., Py, L. and Urvoy, C. (2017), 'Incidence of corporate tax credit on profits, wages and employment: evidence from a French reform', working paper, http://www.ieb.ub.edu/files/PapersWSTAX2017/WSTAX2017_Carbonnier.pdf.