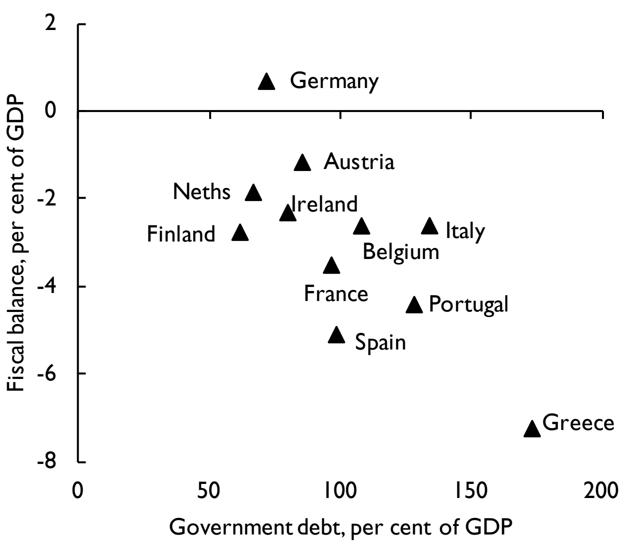
Prospects for individual economies

Euro Area

The economic recovery strengthened early this year, driven by all major components of domestic demand, supported by highly accommodative monetary policy, low oil prices and slightly expansionary fiscal policy. Since the first quarter, however, growth appears to have slowed back. Unemployment has declined somewhat further, but it remains higher than before 2010 and widely disparate among member countries. Inflation has remained stubbornly low. In early June, the ECB began purchasing corporate bonds – an extension, announced in March, to its programme of asset purchases designed to ease monetary and credit conditions further. With growth prospects now damaged by the UK's decision to leave the EU and related uncertainties (see Box A), further easing action by the ECB seems likely to be called for in the period ahead. Assuming unchanged policies, our GDP growth projection for 2016 has been revised down marginally, to 1.4 from 1.5 per cent, and more significantly for 2017, to 1.3 from 1.7 per cent.

In the first quarter of 2016, the Euro Area was the fastest growing of the advanced economies, with GDP rising by 0.6 per cent to a level 1.7 per cent higher than a year earlier. Growth in the first quarter was driven by domestic demand, including a notable upturn in fixed investment related partly to unseasonably mild weather for construction; as in 2015, net exports contributed negatively to the rise in GDP. Higher frequency indicators, including for retail sales and industrial production, suggest that the expansion slowed back in the second quarter.

Figure 5. Fiscal space in selected Euro Area countries



Note: Ratios are based on average values in 2015.

Unemployment fell to 10.1 per cent in May, its lowest level since July 2011 and 2.0 percentage points below the peak reached in April 2013, but still 2.9 percentage points above the trough of March 2008. Less than half of the rise in unemployment that occurred during the recession has therefore been reversed: the rate of decline seen over the past three years continues, unemployment will not return to its pre-recession trough until late 2021. Differences in unemployment among member countries remain extremely large, with rates ranging from 4.2 per cent in Germany to 9.9 per cent in France, 11.5 per cent in Italy, 19.8 per cent in Spain and 24.1 per cent in Greece. Employment growth in the Area has strengthened since 2014, reaching 1.4 per cent in the year to the first quarter, up from 0.8 per cent in the preceding year.

Consumer price inflation, on a 12-month basis, has been broadly stable in recent months at around zero, well short of the ECB's medium-term objective of "below, but close to, 2 per cent": in June, it was 0.1 per cent, with inflation negative in seven of the Area's nineteen member countries. Annual core inflation, meanwhile, has recently been running a little below 1 per cent: in June, it was 0.9 per cent. The modest appreciation of the euro since spring last year – by about 3.5 per cent in trade-weighted terms between April 2015 and June 2016 – as well as the decline in oil prices between mid-2014 and early 2016, has contributed to the persistence of low inflation. The partial recovery of oil prices since February is expected to boost inflation to some extent in the coming months, but output gaps will continue to retard progress towards the ECB's objective. There have been signs of a modest pickup in wage increases: the annual increase in hourly labour costs has trended upwards from about 1.0 per cent in late 2103 to 1.7 per cent in the first quarter of 2016.

On 21 July, the ECB left its benchmark interest rates unchanged at the levels set in March, confirming that "we expect them to remain at present or lower levels for

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an extended period of time, and well past the horizon of our net asset purchases". The ECB also confirmed that monthly purchases under its extended Asset Purchase Programme (APP) would continue at €80 billion a month on average, the level to which it was increased last April, "until 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 inflation aim". With regard to the UK referendum, President Draghi observed that "Euro Area financial markets have weathered the spike in uncertainty and volatility with encouraging resilience. The announced readiness of central banks to provide liquidity, if needed, and our accommodative monetary policy measures, as well as a robust regulatory and supervisory framework, have all helped to keep market stress contained." He also indicated that after reassessing the situation in light of information becoming available in "the coming months", the ECB would "act by using all the instruments available within its mandate" if warranted to achieve its objective.

On 8 June, the eurosystem began purchases under the corporate sector purchase programme (CSPP), a new component of the APP announced by the ECB in March; in June as a whole, APP purchases amounted to €85.1 billion, including €6.4 billion of corporate bonds. Also, on 22 June, the ECB conducted its first operation under its new series of targeted longer-term refinancing operations (TLTRO II), intended to give banks additional incentives to lend to the private sector. (See May *Review*, 2016, p. 56.) The growth of bank credit has continued to pick up gradually: in the year to May, loans to non-financial corporations rose by 1.4 per cent, while loans to households rose by 1.6 per cent.

Germany

Our growth forecast for 2016 is unchanged from the May *Review*, but our forecast for 2017 has been revised down slightly, to 1.5 from 1.7 per cent. The economy expanded by 0.7 per cent in the first quarter of 2016, the strongest quarterly growth in two years and 0.2 percentage point more than we assumed in our May forecast. This was driven by domestic demand, with a large part of the boost coming from fixed investment, particularly in the construction sector, reflecting unseasonably mild weather at the start of the year. Moderate growth in private and government consumption continued, while net exports contributed negatively to output growth despite a recovery in exports following a drop in the previous quarter. More recent data indicate, not surprisingly, that GDP growth in the second quarter was significantly slower than in the first.

Looking ahead, the underlying picture for fixed investment is positive, given highly accommodative monetary conditions and strong demand for housing, in particular, reflected in recent increases in house prices – by about 6 per cent in the six months to June. Growth of household consumption continues to be supported by high employment and moderately rising real wages. It is likely be further boosted later this year and in 2017 by increases in state pension payments resulting from a change in the measurement of average wages, to which they are linked. This will increase pension incomes by between 4 and 5 per cent from the third quarter of 2016 compared with 2015. It is not expected to be offset by higher contribution rates. Net trade is forecast to continue subtracting marginally from GDP growth this year and next. Growth of export volumes weakened in the course of 2015, turning negative in the final quarter. Taking into account downward revisions to growth forecasts for some of Germany's trading partners and the continuing slowdown in China, the projected growth of export volumes has been revised down to 2.4 per cent in 2016, from 3.7 per cent in May, and 3.4 per cent in 2017, from 5.8 per cent in May. The growth of import volumes has also been revised down, but by less, and is expected to continue exceeding the growth of export volumes this year and in 2017. This will help narrow Germany's large current account surplus, although it is projected to remain above 6 per cent of GDP in 2017 and the medium term.

The government budget is expected to remain in surplus over our forecast horizon, by 0.3 per cent of GDP in 2016 – slightly smaller than our projection in May – widening to 0.7 per cent in 2017. The first quarter of 2016 saw strong tax revenue performance, offset by increased spending, particularly on services and welfare benefits related to the elevated level of migration in 2015. So far in 2016 immigration has been considerably lower than last year, and we have revised down slightly the associated additional spending for 2016 and 2017.

As the refugees who arrived in Germany in 2015 have been gradually absorbed, they have increased the labour force. However, they still account for a significantly smaller part of labour force growth than migrants from other EU countries. Employment growth has continued to exceed that of the labour force, bringing the unemployment rate down to a new post-reunification low of 4.2 per cent in May 2016. We expect unemployment to remain close to this level in the remainder of this year and in 2017.

Harmonised consumer price inflation, on a 12-month basis, has recently fluctuated close to zero: it was 0.2 per cent in June and averaged zero in the second quarter. The increase in global oil prices since February will put some upward pressure on prices in the coming months, although this will be partly offset by the strengthening of the euro since late last year. We expect inflation to pick up in 2017, to 1.4 per cent on average, still remaining well below the ECB's medium-term objective.

France

The economy expanded by 0.6 per cent in the first quarter of 2016, the strongest quarterly growth performance in a year, despite significantly negative contributions from net exports and inventory accumulation. Private consumption, the largest component of domestic demand, rose by 1.0 per cent, reflecting a bounce-back after flat consumer spending in the preceding quarter, but also apparently boosted by ticket sales for the European football championships. These temporary factors are unlikely to have been sustained in the second quarter, but we continue to forecast robust consumption growth, of 1.7 per cent in 2016 as a whole. Meanwhile the negative contribution from net exports is likely to have been reversed in the second quarter, with exports boosted by a number of large aeronautical contracts. Nevertheless, in 2016, as a whole, net exports are projected to subtract 0.6 percentage points from GDP growth.

Overall, the unexpectedly strong growth performance in the first quarter is unlikely to have been repeated in the second: the Banque de France has estimated that GDP rose by 0.2 per cent. Assuming similar or slightly faster growth in the second half of the year, our forecast for GDP growth has been revised marginally for 2016, to 1.2 per cent, and more significantly for 2017, to 1.1 per cent.

In April, unemployment fell below 10 per cent for the first time since September 2012, and it remained at 9.9 per cent in May. Youth unemployment in May stood at 23.3 per cent. We expect unemployment to decline somewhat further, to 9.5 per cent on average next year – still above pre-crisis levels of about 7 per cent. Faster progress in reducing unemployment is likely to require labour market reforms. In May, the government used its decree powers to pass through parliament a jobs bill that opens the way to company-level agreements on working hours, facilitates redundancies in cases of economic slowdown, and simplifies various other labour rules. This led to protests and strikes that at one point caused the government to release strategic fuel reserves to relieve shortages. More radical reforms are considered by many to be needed for employment and growth performance to be improved significantly.

Consumer price inflation, on a 12-month basis, has remained close to zero in recent months; in June it was 0.3 per cent. Annual core inflation has been stable in recent months at 0.6 per cent. Wage increases have also been subdued, at 1.6 per cent in the year to the first quarter, on Eurostat data. This suggests a weakness of underlying price and wage pressures that may be disguised in the coming months as the rise in global energy prices since early this year feeds through to 'headline' consumer prices.

Data for 2015 show a marginally better fiscal position than we built into our May forecast. This improvement is enough to bring our projection for the budget deficit in 2017 under 3 per cent of GDP, at 2.8 per cent; this forecast is, of course, subject to a significant margin of error. In our central projection, the debt–GDP ratio rises to 97.5 per cent of GDP at end-2017 from 96.1 per cent in 2015.

Italy

Sluggish economic growth has continued but some significant risks have been increasingly clouding the outlook. GDP grew by 0.3 per cent in the first quarter of 2016 to a level 1.0 per cent higher than a year earlier. Growth was driven by a broad, though modest, expansion of domestic demand, with household consumption contributing 0.2 percentage point. Net trade made a negative contribution to growth of 0.2 percentage point, with a larger decline in exports than in imports. More recent data point to continued weak output growth in the second quarter. With sluggish investment growth, household demand constrained by low employment and stagnant real wages, and net exports benefiting only modestly from limited gains in international competitiveness, growth is expected to remain weak in the period ahead. Our GDP growth forecast for 2016 is unchanged from the May *Review*, but our projection for 2017 has been lowered to 0.5 from 1.0 per cent.

Significant risks to our growth forecast include uncertainties surrounding the effects of UK's vote to leave the EU, high and persistent unemployment, a troubled banking sector, and domestic political uncertainty surrounding a referendum on constitutional changes that the prime minister has called for October; he has promised to call a general election if he loses the vote.

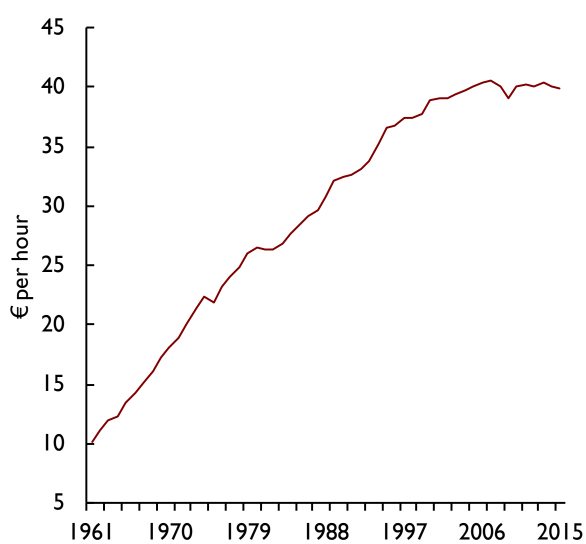
Unemployment has remained high, fluctuating around 11.6 per cent over the past year: in June it was 11.5

per cent. Large and persistent output and employment gaps have been reflected in continued negative inflation. Consumer price inflation, on a 12-month basis, was -0.2 per cent in June, little changed from earlier in the year. Wage growth, according to Eurostat data, has weakened since 2014: in the year to the first quarter wages fell by 0.5 per cent, compared with a rise of 1.8 per cent in the Euro Area as a whole. Italy's relatively low wage and price inflation should help improve its international competitiveness and support net exports, but declining real wages will meanwhile constrain household spending.

Another concern is the weakness of the banking sector, which after more than a decade of little growth in incomes and productivity (see figure 6), and a financial crisis, is burdened with a large and growing volume of non-performing loans (NPLs), recently representing about 12 per cent of all loans (see figure 7) and 20 per cent of GDP. Increasing concerns about Italian banks have been reflected in a decline of more than 60 per cent in their stock market values since mid-2015.

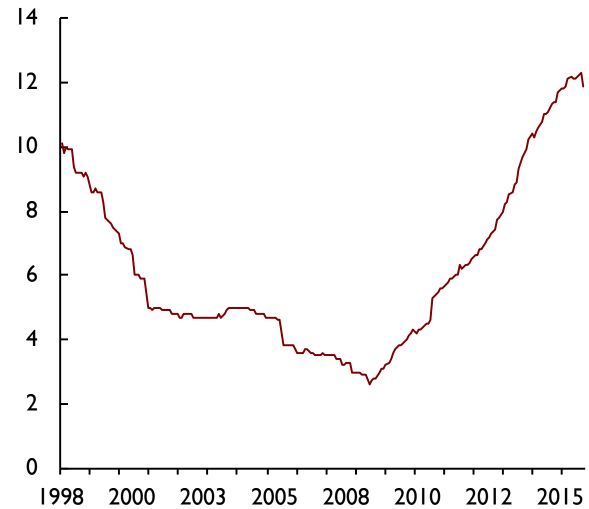
In April, the government announced that a €5 billion fund, named 'Atlante', was being set up, mainly on the basis of private sector contributions, to buy junior tranches in securitised assets backed by NPLs and to 'backstop' capital raisings by weak banks. The volume of transactions that Atlante has been called on to carry out since May has made it clear that it is not an adequate solution. The government has recently been discussing with EU partners and the Commission what further steps can be taken consistent with the EU's state aid rules and its Bank Recovery and Resolution Directive, while at the same time avoiding bail-ins of retail bondholders. Also, in June, the European Commission agreed that Italy could provide liquidity guarantees to its banks of up to €150bn until the end of the year.

Figure 6. Italy: output per hour worked



Source: NiGEM database.
Note: 2010 prices.

Figure 7. Italy: share of non-performing loans in total loans (per cent)



Source: Datastream.

The government's budget deficit in 2015 was 2.6 per cent of GDP; we expect it to decline slightly this year to 2.4 per cent. In May, the European Commission granted Italy additional budget flexibility for 2016, under the Stability and Growth Pact, in recognition of the government's efforts on structural reforms, increased costs related to the migrant crisis, and increased security spending. The flexibility, which provides additional fiscal space equivalent to around €14bn for this year, or 0.85 per cent of GDP, will enable Italy to avoid 'excessive deficit procedures' for failing to meet targets for debt reduction.

Spain

Spain's vigorous economic recovery continued in the first quarter of 2016 with GDP growth of 0.8 per cent, the same as the two preceding quarters. According to a preliminary estimate by Banco de España, GDP growth in the second quarter was only marginally weaker, at 0.7 per cent. In the first quarter, growth in private consumption remained strong, with a contribution of 0.7

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percentage point to GDP growth, while fixed investment decelerated after strong expansion in the second half of last year. Net trade continued to contribute negatively to output growth, deducting 0.3 percentage point partly on account of a small decline in exports.

We expect domestic demand to continue driving output growth in the period ahead, with net exports continuing to make negative contributions, particularly given the weak growth of activity in Spain's main trading partners. Our forecast of GDP growth in 2016 is unchanged at 2.7 per cent, but for 2017 our projection has been revised down to 2.2 per cent from 2.6 per cent. With the domestic political situation having been clarified by the result of the June general election, the main downside risks to our forecast relate to uncertainties surrounding the UK's vote to leave the European Union, continuing high unemployment and persistently large fiscal deficits. The UK's vote to leave the EU raises several risks for the Spanish economy, including for its banking system: some of Spain's largest banks have large exposures to the UK, and their stock market values have declined significantly since the referendum result.

Consumer price inflation has remained negative, significantly below the Euro Area average: in the year to June, the consumer price index fell by 0.9 per cent. Core inflation, on a 12-month basis, has been 0.7 per cent in recent months, below the peak of 1.1 per cent reached in March. Meanwhile wage increases, as measured by Eurostat, have also been subdued: in the year to the first quarter of 2016 they amounted to 0.7 per cent, compared to the Euro Area average of 1.8 per cent.

Spain's low inflation is partly a reflection of its continuing wide output and employment gaps. Unemployment, at 19.8 per cent in May 2016, remains a cause of concern. While unemployment has fallen significantly from its early 2013 peak of 26.3 per cent, it remains far higher than its pre-crisis level of about 8 per cent. It is likely that hysteresis effects are increasing structural unemployment, with a consequent burden on public finances.

The government's budget deficit in 2015 was 5.1 per cent of GDP, significantly higher than the target of 4.2 per cent set by the European Commission. The target for 2016, of 2.8 per cent, also seems infeasible: our forecast is 4.4 per cent. In mid-July, EU finance ministers confirmed the Commission's earlier conclusion that Spain (like Portugal) was in breach of the EU's fiscal rules under the Stability and Growth Pact, and that it had failed to take sufficient action to correct the situation. This opens the way for possible fines and other sanctions. The government subsequently announced measures to help Spain meet its target for 2017, including an increase in corporation tax and increased efforts to stem tax evasion.

United States

In July, the economy began its eighth year of expansion since the recession of December 2007–June 2009.[1] Over the past year, growth has been notably uneven, with output growth slowing markedly in late 2015 and early 2016 before picking up again in recent months, while employment growth was relatively well maintained until it slowed significantly in the second quarter of this year. Unemployment has fluctuated since last October within the Federal Reserve's current range-estimate of its longer-term level, 4.7–5.0 per cent: in June it was 4.9 per cent. Inflation has remained below the Federal Reserve's medium-term objective of 2 per cent, and wage increases have risen only modestly. The Fed has maintained its target range for the federal funds rate at 0.25-0.50 per cent – the level to which it was raised last December – and the median projection of the FOMC at its June meeting, as in March, was that it would be appropriate to raise it by a further 50 basis points by the end of 2016. However, projections for 2017, 2018 and the longer run were lowered.

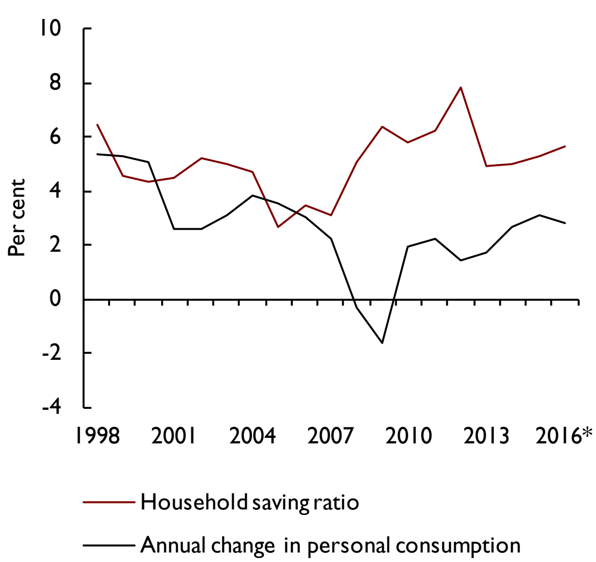
Figure 8. US: annual change in productivity

Source: NiGEM database and NIESR forecast.
Note: Productivity is defined as output per employment hour; 2016 includes forecast projections.

GDP rose by 2.4 per cent in 2015 as a whole – the same as in 2014. However, quarterly growth slowed markedly at the end of last year, to 1.4 per cent at an annual rate, and further in the first quarter of 2016, to 1.1 per cent. This deceleration is accounted for mainly by a downturn in non-residential fixed investment, partly reflecting the weakness of the energy sector, and slower growth of consumer spending, with an associated increase in the saving rate. Higher frequency data indicate a revival of consumer spending in recent months, and several projections of GDP growth in the second quarter (annualised) are in the 2.0–2.5 per cent range.

The downward trend in employment growth has continued in recent months. Non-farm payrolls increased by 147,000 a month, on average, in the second quarter, compared with 195,000 in the first quarter, 229,000 in 2015, and 251,000 in 2014. The 12-month growth rate of employment, which peaked at 2.3 per cent in February 2015, fell to 1.7 per cent in May and June 2016, the lowest since early 2014. Since last October, unemployment has fluctuated in the 4.7–5.0 per cent range, which is the 'central tendency' of the Federal Reserve's estimates of its longer-run level; in June it was 4.9 per cent. Other indicators, however, indicate that labour market slack is greater than the unemployment rate suggests. Thus the labour force participation rate, at 62.7 per cent in June, though slightly higher than last September's 38-year low 62.4 per cent, remains lower than throughout the period 1978–2014. This is reflected in the employment–population ratio, which stood at 59.6 per cent in June, higher than the 58.2 per cent trough reached in mid-2011, but lower than throughout the period 1985–2008. Moreover, labour earnings have remained subdued. Average hourly earnings increased by 2.6 in the year to May, with little acceleration apparent in recent months. The employment cost index, which takes account of benefits as well as pay, increased by 1.9 per cent in the year to March.

Figure 9. US: household saving ratio and change in personal consumption



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

The performance of labour productivity has remained weak after trending downwards in recent decades (figure 8). Thus output per hour in the non-farm business sector, which rose by only 0.7 per cent in 2015, declined by 0.6 per cent in the first quarter of 2016.

Consumer price inflation, on a twelve-month basis, has been broadly stable in recent months: in terms of the price index for personal consumption expenditures, it was 0.9 per cent in May, while the corresponding core inflation rate stood at 1.6 per cent. Financial market-based measures of inflation compensation have declined slightly since late April, suggesting a possible decline in expected future inflation, although this is not supported by survey evidence. Thus the five-year breakeven inflation rate in late July was about 1.4 per cent, down from 1.6 per cent in late April but significantly higher than the trough of 0.9 per cent reached in mid-February, before the upturn in oil prices.

At its meeting in mid-June, the FOMC left the target range for the federal funds rate unchanged at 0.25–0.50 per cent. Chair Yellen noted that the result of the following week's UK referendum on membership of the European Union was "one of the uncertainties that factored into" the decision not to raise rates. The median projection for the federal funds rate at end-2016 was unchanged from March, implying two increases of 25 basis points between July and December. However, the number of FOMC participants projecting only one increase in this period rose to six from only one in March. Also, the median projections for end-2017 and end-2018 were lowered by 50 and 25 basis points respectively, and the median projection for the longer run was also lowered by 25 basis points. These downward revisions were made even though projections of growth and inflation were little changed.

Canada

The upturn in oil prices since February, as well as the depreciation of the Canadian dollar since mid-2014, has boosted prospects for the economy. Output expanded by

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0.6 per cent in the first quarter of 2016, following 0.1 per cent growth in the previous quarter, mainly owing to a rebound in exports benefiting from the improvement in Canada's international competitiveness. However, GDP growth is expected to have been weak or negative in the second quarter because of May's wildfires in Alberta, which reduced oil sands production by an average of 0.8 million barrels a day in May (more than one fifth of Canadian oil production) according to estimates from the US Energy Information Administration. Related disruption is expected to have averaged 0.4 million barrels a day in June.

Business investment has been weak in recent quarters, particularly in the energy sector, and we have revised down our profile for business investment in light of the data for the first quarter of 2016. However, our forecast for the growth rate of business investment in the near term has been revised up slightly to take account of support from higher commodity prices and accommodative monetary and financial conditions. Increased government investment announced in the March budget is expected to continue to foster economic growth. Our forecast for GDP growth this year has been revised down slightly to 1.5 per cent, with our projection for 2017 lowered marginally at 2.0 per cent. A downside risk to our forecast remains the booming housing market, which many analysts fear is an unsustainable bubble.

Consumer price inflation, on a 12-month basis, has fluctuated around 1.5 per cent in recent months, and this was its level in June. Core inflation has remained close to 2 per cent: it was 2.1 per cent in June. In line with market expectations, the Bank of Canada kept its benchmark overnight rate at 0.5 per cent in July, stating that inflation is on track to reach its 2 per cent target in 2017 as temporary effects of exchange rate pass-through and past declines in consumer energy prices dissipate.

Unemployment has fallen from its peak of 7.3 per cent reached last February to 6.8 per cent in June, its lowest level since July 2015. There have also been flows from part-time to full-time employment, which are indicative of a reduction in underemployment. We expect unemployment to average 7.0 per cent in 2016 and 7.1 per cent in 2017.

Japan

The economy bounced back from its contraction of 0.4 per cent in the fourth quarter of 2015 with GDP growth of 0.5 per cent in the first quarter of 2016. Both domestic demand and net exports contributed positively to the upturn. With private and government consumption growing quite vigorously, the main drag on growth in the first quarter was from fixed investment, which contracted in both the private and public sectors. More recent, high frequency, indicators of activity, including industrial production, retail sales, and PMIs, have been weak, suggesting modest growth at best, and the Bank of Japan's June Tankan survey showed a deterioration in business sentiment since March, especially in the non-manufacturing sectors and among small and medium-sized enterprises.

The appreciation of the yen over the past year – by close to 20 per cent in trade-weighted terms between June 2015 and late July 2016 – is forming a drag on net exports, although the currency's broad external value is still about 20 per cent lower than in late 2012, before the advent of 'Abenomics'. The declines in import prices associated with the past year's appreciation should, on the other hand, boost real incomes and consumer spending.

Partly because of the yen's recent appreciation, progress in raising inflation towards the Bank of Japan's 2 per cent target seems to have stalled. In the year to May, consumer prices fell by 0.4 per cent – the third consecutive month of negative inflation, while the 'core core' inflation measure, which excludes energy and food, was 0.6 per cent.

The labour market remains tight, with unemployment at 3.2 per cent in May, for the third consecutive month. The jobs–applicants ratio rose to 1.36 in May, its highest level since October 1991. Nevertheless, there is little sign of any increase in wage growth, despite government pressure. In fact, nominal wages fell by 0.2 per cent in the year to May, partly reflecting an increase in the proportion of part-time workers, whose wages on average fell by 0.5 per cent, while wages for full-time workers were flat.

Given the weakening of the inflation outlook, and also the recent strength of the yen, the case seems clear for further monetary easing by the Bank of Japan, either by lowering official interest rates further below zero or by an expansion of asset purchases. On the assumption of unchanged monetary policy, our inflation forecast has been lowered to –0.4 per cent for 2016, on average, and 0.1 per cent for 2017, pointing to the very limited progress in raising inflation towards the 2 per cent target.

With regard to fiscal policy, the prime minister announced in early June that the increase in the sales tax from 8 to

10 per cent that had been scheduled for April 2017 was being postponed until October 2019. Also, following the government party's success in the upper house elections of the Japanese parliament in July, the prime minister announced that an economic stimulus package would be prepared by the end of the month. There therefore seems little prospect in the short term of progress in tackling Japan's public debt burden, either through healthier fiscal balances or through stronger nominal GDP growth.

Taking into account the postponement of the increase in the consumption tax, as well as recent data, our forecast for GDP growth has been revised upwards marginally for 2016, to 0.3 per cent from 0.2 per cent, and more significantly for 2017, to 0.5 per cent from –0.1 per cent. Our forecast takes no account of the prospective fiscal stimulus package, whose details have not been announced.

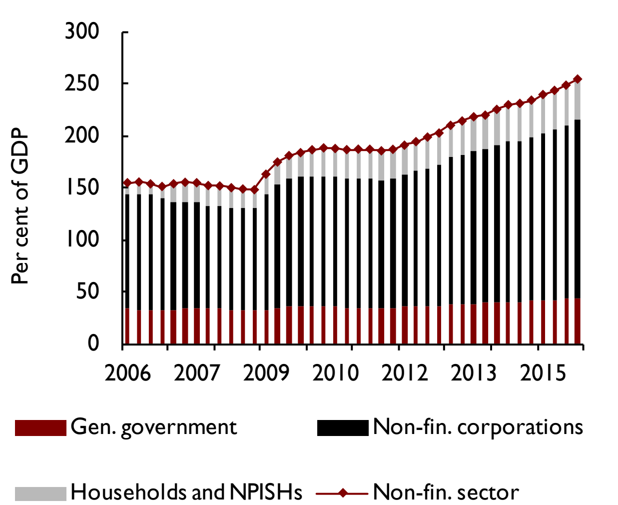
Stronger growth performance should help the government to return to the structural reform agenda that remains key to the long-term prospects for the economy.

China

China's continuing efforts to rebalance its economy while avoiding a sharp economic slowdown has proved increasingly challenging. The transition process is complex and has unsurprisingly led to increased vulnerabilities in both corporate and financial sectors. There have also, at times over the past two years, been increased capital outflows, marked exchange rate pressures, and broader financial market instability. Policies designed to protect the economy from the effects of the global financial crisis have led to an increase in total (public and private) debt, to more than 250 per cent of GDP by the end of 2015, 100 percentage points higher than in 2008 (see figure 10). Non-performing loans in the banking system have risen to 1.8 per cent of total loans in June 2016 – the highest since 2009 – according to official data, but private estimates put the ratio much higher. The government also faces the challenge of reducing overcapacity in some of the largest, industrial, sectors of the economy while at the same time supporting economic growth.

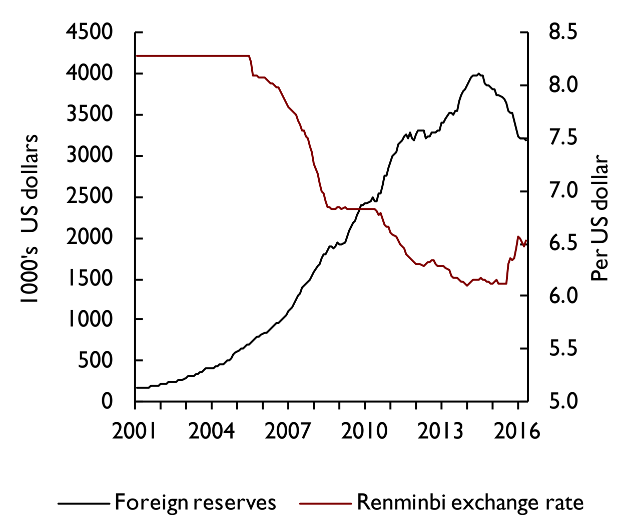
The government has been pursuing several avenues in its efforts to soften the impact on the economy of deleveraging and restructuring. First, it has used monetary policy, cutting benchmark interest rates five times in 2015 while also reducing banks' reserve ratios and easing lending controls for homebuyers. Second, the government has continued to use fiscal policy to support growth, taking advantage of its relatively low indebtedness, at about 44 per cent of GDP. Thus in recent months there have been announcements of a number of spending initiatives in particular regions and on particular infrastructure projects. Also, in May, the extension of value-added tax to all major service sectors, replacing a business tax, was expansionary on net. Third, a framework is being developed to encourage banks to swap bad corporate loans for equity, although this scheme has been met with some scepticism owing

Figure 10. China: non-financial sector debt



Source: BIS.

Figure 11. China: exchange rate and reserves



Source: Datastream.

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to the questionable value of much of the equity. Fourth, underperforming state-owned enterprises are being encouraged to restructure and become more productive by the redirection of credit from them to better performing ones. Even in some of these policy approaches, the potential for short-tem conflict between restructuring and growth is apparent.

Capital outflows and currency pressures, particularly apparent at times in 2015, have eased in recent months. Thus China's official foreign exchange reserves, having fallen from their all-time (and all-country) peak of $3.99 trillion in June 2014 to $3.20 trillion in February 2016, have since been virtually stable. Meanwhile, since the first quarter the renminbi has depreciated by about 2 per cent against the US dollar and by 4 per cent in trade-weighted terms.

Consumer price inflation has remained below the central bank's target of 3 per cent, leaving room for further monetary easing. Consumer prices rose by 1.9 per cent in the year to June, down from 2.3 per cent in the spring mainly on account of lower food price inflation. Producer price inflation, on a 12-month basis, was negative in June for the 52nd consecutive month, although the rate of decline of prices, at 2.6 per cent, has waned significantly since the end of 2015.

The government's accommodative fiscal and monetary policies appear thus far to have kept GDP growth on its planned path. Thus after 6.9 per cent growth in 2015, close to the target of "about 7 per cent", GDP grew by 6.7 per cent in the year to the second quarter, as in the year to the first, closely in line with the 2016 target range of 6.5–7.0 per cent. Our forecast is largely unchanged, at 6.6 and 6.2 per cent growth for this and next, respectively.

India

The economy grew by 7.9 per cent in the year to the first quarter of 2016, driven mainly by private consumption; fixed investment contracted, and net exports also contributed negatively to GDP growth in the quarter. We expect private consumption to remain the principal driver of growth in the remainder of this year and in 2017, helped by significant increases in civil service pay and pensions announced in June following a ten-yearly review. Our growth projection for 2016 is unchanged at 7.5 per cent.

Consumer price inflation, on a 12-month basis, stabilised in May and June at 5.8 per cent, a two-year high, after rising from a low of 3.7 per cent in July 2015. Recent inflation is thus close to the upper bound of the Reserve Bank's target of 4, plus or minus 2, per cent. The recent increase in inflation is largely accounted for by rising food prices. This year's monsoon is expected to be of the normal variety, which should not lead to any further spikes in food prices. On this basis, we forecast that inflation will fall back to 5.4 per cent, on average, in 2017, from 5.8 per cent this year.

The Reserve Bank has held its benchmark interest rate at 6.5 per cent since it was lowered to this level in April. The announcement in June that Governor Rajan would relinquish his position in September, after one term, surprised observers but had little impact on financial markets. The rupee's exchange rate against the US dollar has been broadly stable in recent months.

With regard to the government's reform agenda, there were indications in July that legislation to introduce a national general sales tax (GST) – a unified value-added tax system, to replace various provincial taxes – would soon be introduced in the upper house of parliament for approval. The government's aim, which seems optimistic, is to put the GST in place by April 2017. The GST, when implemented, is expected to improve considerably the ease of doing business in India. Also, in May, parliament passed the first national bankruptcy law, intended partly to facilitate the recovery of overdue loans by banks. Finally, in June, the government announced a further relaxation of rules on inward direct investment.

Brazil

The economy surprised on the upside with a 0.3 per cent contraction of output in the first quarter of 2016. The surprise was against the background of significantly larger declines in GDP in the four preceding quarters and a contraction of 3.9 per cent in 2015 as a whole. The decline in output slowed in the first quarter partly on account of an acceleration of government consumption but more importantly because of a 6.5 per cent surge in exports after two quarters of weakness. Private consumption and investment both declined in the first quarter.

Looking ahead, there are mixed signals. We expect limited further scope for rapid export growth in the short term, given the weak expansion of export markets and a significant appreciation of the Real in recent months – by about 20 per cent against the US dollar since January. Unemployment has remained on an upward trend: at 11.2 per cent in April and May, it was almost 5 percentage points higher than in late 2014. And given the weak labour market, it is not surprising that consumer spending remains deeply depressed. Moreover, the fiscal deficit remains large and government consumption is increasingly constrained.

On the other hand, policy announcements by the new interim government, which came into office in May following the suspension of President Rousseff ahead of an impeachment trial, have been well received by markets – as indicated by the upward pressure on the Real – and consumer price inflation has slowed, which could enable the Central Bank to begin reducing official interest rates in the near term. Moreover, the exchange rate remains reasonably competitive despite the recent appreciation.

Taking these developments into account, we have revised our growth forecast upwards from May and now expect GDP to decline by 2.8 per cent this year before picking up by 1.2 per cent in 2017.

Consumer prices rose by 8.8 per cent in the twelve months to July 2016, less than the peak inflation rate of 10.7 per cent recorded last January but still significantly above the upper limit of the Central Bank's target range, which has been lowered for 2017 to 6.0 from 6.5 per cent. The Central Bank has kept its benchmark Selic rate unchanged at 14.25 per cent since July 2015. It could begin lowering rates soon to help support domestic demand. Such action could also ease upward pressure on the Real, which has been partly absorbed recently by official intervention. One of the initiatives of the interim government, announced in May, is a proposed constitutional amendment to give the Central Bank operational independence.

Banks have been coping with the recession relatively well. However, the share of non-performing loans has increased, to 3.8 per cent in May 2016, 0.8 percentage point higher than a year earlier. Recent filings for bankruptcy by large corporations add to concerns that banks' balance sheets may come under increasing pressure.

The interim government has obtained parliamentary approval for a primary fiscal deficit of 2.75 per cent of GDP for 2016 and has announced a number of reforms to reduce the imbalance, including constitutional amendments to freeze government spending in real terms for twenty years and to enable the containment of spending on pensions. The process of consolidating the fiscal position will unavoidably act as a drag on the economy.

Russia

The recession brought on by the decline in global energy prices and exacerbated by international economic sanctions seems to be easing. GDP declined by 1.2 per cent in the first quarter of 2016 – the smallest of five consecutive quarterly contractions. The GDP decline in the first quarter was dominated by a large fall in fixed investment, but household consumption also continued to contract, reflecting a sustained deterioration of real incomes. (More recent data show that in the year to May real wages fell by 1.0 per cent while real disposable incomes fell by 5.7 per cent.) The upturn in oil prices since February and also the competitive exchange rate, following the rouble's steep depreciation between mid-2014 and early this year, are supportive of stabilisation and recovery. We have revised our projection of the contraction of GDP in 2016 to 0.9 per cent. For 2017, we are now projecting only a marginal increase in GDP, of 0.1 per cent, down from our May forecast of 0.5 per cent growth.

Unemployment seems to have peaked for the current recession in March, at 6.0 per cent; by June it had fallen to 5.4 per cent, its lowest level in nine months. This contrasts with the peak of over 9 per cent reached in 2009 in the wake of the financial crisis.

In July, the European Council announced that economic sanctions against Russia related to its annexation of Crimea would continue for a further six months. In retaliation, Russia extended its ban on imports of European food products until December 2017, while easing economic sanctions against Turkey. Meanwhile formal as well as informal sanctions have continued to restrict Russia's access to international financial markets.

Consumer price inflation, on a 12-month basis, has eased significantly from the peak of 15.8 per cent reached in July 2015 in the wake of the rouble's depreciation. In June 2016, it was 7.5 per cent, little changed in four months. Inflation thus remains above the Bank of Russia's 4 per cent target for 2017. In June, the Bank reduced its benchmark rate by 50 basis points to 10.5 per cent, citing the decline in actual and expected inflation. It indicated that a further rate cut could be considered if inflationary risks fall further. Our forecast is for inflation to average 6.8 per cent in 2016 before falling to 4.5 per cent in 2017.

NOTE

1 We use the turning points identified by the Cycle Dating Committee of the NBER.

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