Prospects for individual economies

United States

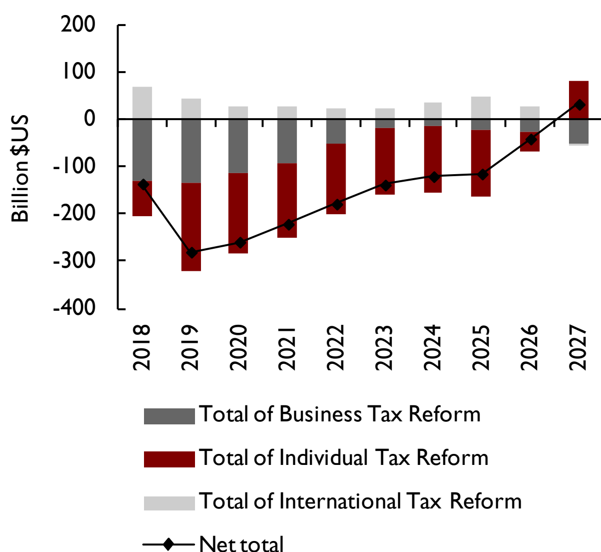
Output continued to expand at a solid pace in the final quarter of 2017. The increase in GDP of 2.6 per cent (annualised rate) reflected positive contributions from real consumer spending (3.8 per cent annual pace) and business fixed investment (7.9 per cent). There were, however, drags on growth from trade and inventories. Monthly indicators from late 2017 suggest that economic activity will continue to expand at a solid pace in 2018 and that the labour market will strengthen further.

In December Congress passed the Tax Cuts and Jobs Act (TCJA), which lowers business and personal tax rates, and intends simultaneously to raise tax revenue via the elimination of a number of tax exemptions and deductions. According to estimates by the Congressional Budget Office (CBO) and the staff of the Joint Committee on Taxation (JCT), enacting tax changes would reduce revenues by about $1,649 billion and reduce outlays by about $194 billion over the period of 2018–27, which would lead to an increase in the deficit of $1,455 billion over the next ten years (see figure 8). Net tax reductions are front-loaded, with about 45 per cent of the estimated decline in tax revenues materialising in the first three years. We expect the fiscal stimulus to have a modest but positive impact on output, and as a result we have revised up our projections for GDP growth for 2018 and 2019 from 2.3 per cent in both years to 2.6 and 2.5 per cent, respectively.

The TCJA is expected to stimulate business investment spending, and the resulting increase in the capital stock should have positive supply-side effects. However, we do not anticipate a significant surge in the pace of business investment growth, as a combination of provisions encouraging business investment together with the removal or limitation of some business tax breaks and deductions may cancel in their effect on investment incentives for some businesses. Even though the headline corporate tax rate is reduced from 35 to 21 per cent, the effect on the effective tax rate paid by US corporations is likely to be smaller.

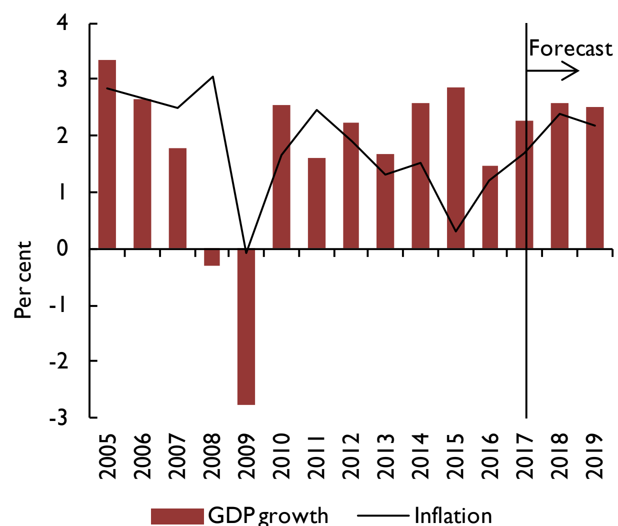
For households, the tax cuts for individuals are expected to have a positive but moderate impact on household spending. Similar to business taxes, individual tax cuts are front-loaded, and even though tax rate reductions affect most tax payers, they are temporary and are planned to expire at the end of 2025. The individual tax cuts favour

Figure 8. US: Projected change in revenues (US $bn)



Source: Congressional Budget Office; staff of the Joint Committee on Taxation.

Figure 9. US: GDP growth and inflation



Source: NiGEM database and NIESR forecast.

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higher earners, who tend to spend less and save more out of their additional income. For some taxpayers, net taxes may even increase after adjustments to exemptions and deductions are taken into account. How much of an increase in after-tax income is spent will also depend on how forward looking consumers are and whether they are credit constrained or not. Simulation analysis using the National Institute's global econometric model (NIGEM) illustrates that the positive impact on GDP (relative to the baseline) from the fiscal stimulus broadly halves (in the second and the third years after the shocks are applied) if consumers anticipate future tax increases and change their consumption behaviour accordingly (Liadze and Hacche, 2016).

As output growth is anticipated to be robust in the short term and remain above trend, labour market conditions are expected to tighten further with the unemployment rate declining to below 4 per cent this year. Despite the continued strengthening of labour market conditions, the pace of wage increases has so far remained gradual and there is no evidence of a surge in broad-based wage pressures. However, this could change if, supported by the fiscal stimulus, the economy operates well above its potential, and as a result inflationary pressures rise. Our projection is for earnings growth to pick up slightly to 3 per cent this year but for inflation to remain close to the target.

The Federal Reserve is well aware of the risk of higher inflation. On 13 December it announced a 0.25 percentage point increase in the Fed funds rate – the third in the last year, and continues to project three more increases to take place in 2018.

Canada

At the beginning of 2018, the Canadian economy has reached a position on the business cycle ahead of most advanced economies. GDP growth is estimated at just below 3 per cent in 2017 and capacity constraints have started to bind. According to the Bank of Canada's *Business Outlook Survey*, 30 per cent of firms faced labour shortages in the third quarter of 2017 and 46 per cent of firms reported more intense labour shortages relative to a year earlier, with only 11 per cent of firms reporting less intense shortages (figure 10). The Bank of Canada's output gap estimates imply that the difference between economic output and its potential has been close to zero since the second quarter of 2017.

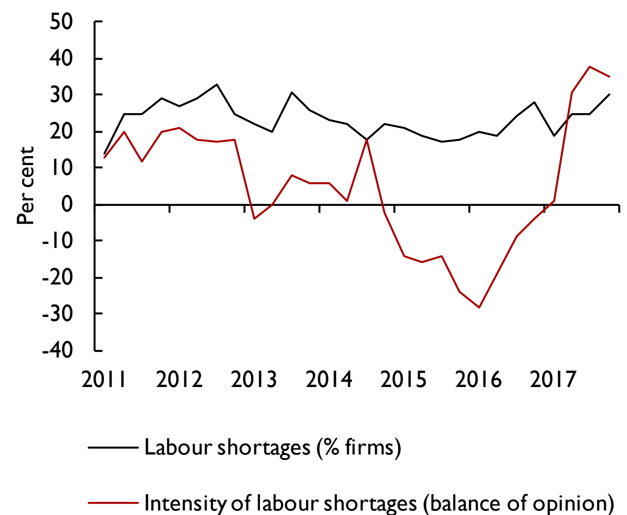
Domestic demand was the main contributor to output growth of 0.4 per cent in the third quarter of 2017, moderated by a decline in exports of around 3 per cent. Economic indicators for the final quarter of 2017 surprised on the upside, with the unemployment rate falling to 5.3 per cent in December, the lowest since 2007.

In terms of emerging wage pressure, average hourly earnings grew by 2.8 per cent in the year to November 2017, and the rise in commodity prices put pressure on firms' input prices. While the pass-through to output prices has generally been slow, annual consumer price inflation jumped above 2 per cent in November, suggesting that prices may rise more quickly in the near term. Two out of three of the Bank of Canada's preferred measures of core inflation moved closer to the central bank's target of 2 per cent, reaching 1.8 and 1.9 per cent. In response to the build-up of inflationary pressure, the Bank of Canada raised the policy rate by a quarter of a percentage point in January 2018, the third increase since it began its tightening cycle in July 2017.

While a ratio of household debt relative to income of nearly 170 per cent makes Canadian households vulnerable to rises in interest rates, regulatory changes to mortgage lending and increases in disposable income have recently alleviated this risk somewhat and helped narrow the gap between residential mortgage credit growth and income growth.

Looking ahead, businesses remain positive about sales activity despite rising uncertainty about the re-negotiation of NAFTA, which so far has made little progress since it

Figure 10. Canada: labour shortages



Source: Bank of Canada *Business Outlook Survey*.

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was started in August last year. According to the *Business Outlook Survey*, investment intentions for 2018 remain strong, which will help reduce capacity constraints. We expect growth to continue close to its recent pace in 2018 and forecast a slight moderation of growth to just over 2 per cent in 2019 as the momentum from relatively rapid growth dissipates.

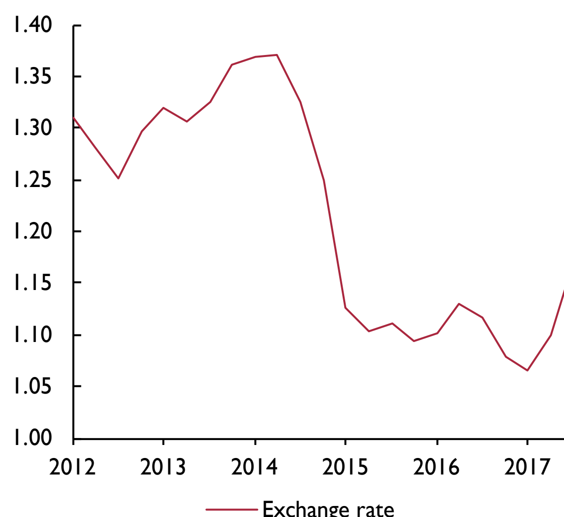
Euro Area

The Euro Area economy expanded by 0.6 per cent in the final quarter of 2017, following the 0.7 per cent recorded in the two previous quarters. Consumer spending growth was strong in both previous quarters but investment growth proved more volatile, as did net trade. Export growth has been running at over 1 per cent a quarter for the past year despite the strengthening of the euro. With latest activity indicators running strongly – the IHS Markit Composite PMI in January showed the fastest growth for nearly twelve years – the forecast shows the momentum from 2017 remaining strong, with GDP growth forecast to continue at over 2 per cent this year, but edging down to a still relatively strong 1.8 per cent next year as near-term momentum fades slightly, with the recent appreciation of the euro relative to the US dollar (figure 11) slightly dampening the pace of growth.

Consumer price inflation was 1.4 per cent in the twelve months to December, with food and transport price inflation the main drivers of upward price pressure. Inflation has been persistently some way below the 2 per cent level despite the extent of the monetary stimulus provided by the ECB. It has, however, over the year as whole been around 1 percentage point higher than a year earlier. In our near-term forecast, we expect inflation to remain below 2 per cent, but with the gap narrowing as output growth runs at a pace close to or exceeding the rate of increase of potential output, adding to inflationary pressure. Our central forecast is for inflation, based on the harmonised consumer price index, to average around 1½ per cent in 2018 and 2019.

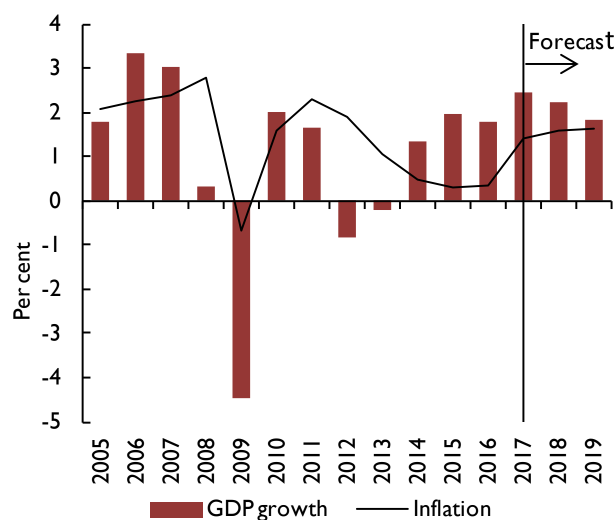
In the third quarter of 2017 the unemployment rate fell again, to 9 per cent. This was around 1 percentage point lower than a year earlier and the lowest since early 2009. Nonetheless, on the official definition slightly more than 14 million people remain unemployed. With growth expected to remain strong, the unemployment rate is expected to fall further in the near term but at a slower pace. As in the US and UK, the fall in unemployment has not so far resulted in a rapid rise in wage growth and while wages are likely to pick up, the extent of this is not anticipated to impact adversely on price inflation.

Figure 11. Euro Area: exchange rate (US$ per one euro)



Source: NiGEM database.

Figure 12. Euro Area: GDP growth and inflation



Source: NiGEM database and NIESR forecast.

The policy stance of the ECB will continue to be a focus for financial markets and the forecast incorporates current policy statements and forward financial market views. Box D examines the possible economic effects of a reduction in the size of the ECB's balance sheet.

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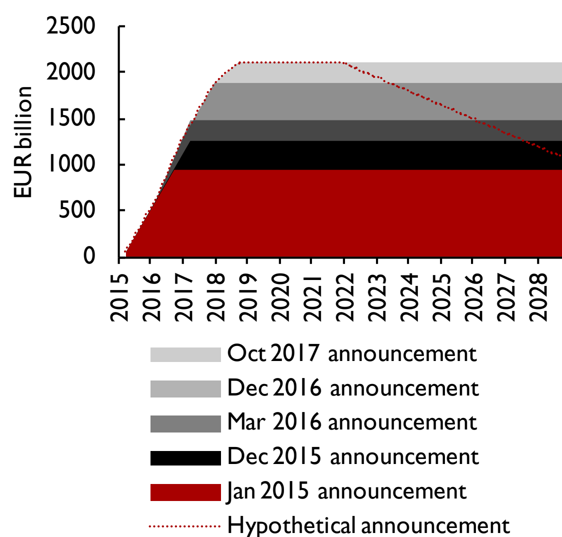
Box D. Quantitative tightening in the eurozone?

As the Euro Area economy recovers, the European Central Bank in January 2018 started to reduce the pace at which it purchases public and private sector assets each month. Purchases will continue at least until September, by which time the central bank will decide whether to keep expanding its balance sheet. The ECB will have several options available and the economic outlook will be critical for its decision. It may choose to hold stable the stock of assets held, which by then will be substantially above €2 trillion, by reinvesting proceeds from maturing debt. This is the assumption we make in our baseline forecast. Alternatively, the ECB may make an announcement about a future reduction of assets held, by letting debt mature or actively selling bonds on secondary markets. Figure D1 illustrates the evolution of government debt purchased by the ECB according to information provided at different points in time. An example of a balance sheet reduction is depicted by the dotted line: it may entail holding the stock of assets stable for some time while setting the expectation that within a decade the amount of government debt held by the central bank will reduce by €1 trillion. This box tries to gauge the effects such an announcement of 'quantitative tightening' may have on the Euro Area economy.

Figure D1. Information at different points in time about the evolution of government debt held by the ECB under the Public Sector Purchase Programme



Source: European Central Bank (ECB).
Notes: Shaded areas indicate the information available to market participants about the evolution of government debt held by the ECB at different points in time, according to press statements provided by the Governing Council on the Public Sector Purchase Programme. (PSPP). For instance, PSPP was announced in January 2015, with monthly purchases to be conducted at least until September 2016, implying a total stock of government debt of then €1trillion, without information given about future reductions.

We proceed to analyse this in two steps. First, we estimate the impact such an announcement could have on long-term interest rates. By selling government bonds, the central bank would increase the overall supply of such bonds in the market, thereby putting pressure on long-term bond yields. To estimate by how much long-term yields would rise, we conduct an event study of the bond market reaction to announcements by the ECB of quantitative easing. For analytical tractability we assume that a tightening of balance sheet policy has symmetric effects. We decompose sovereign bond yields into a component that reflects expectations about future policy rates and a component that captures risk and liquidity premia, including the compensation investors require for liquidity limitations due to central bank balance sheet policies. We then estimate the reaction of the premia component to the initial set of announcements related to the ECB's Public Sector Purchase Programme of €1 trillion of sovereign bonds to be purchased. Our estimates aim to isolate the response to ECB announcements from the responses to other news and macroeconomic trends.

Table D1. Long-term interest rate response to the announcement of ECB PSPP of €1trillion, in basis points

	Euro Area	Germany	France	Italy
Our estimates	–45	–18	–57	–62
De Santis (2016)	–56	–41	–68	–77
Altavilla *et al.* (2015)	–47	–18	–27	–60

Source: Chadha *et al.* (forthcoming).
Note: Response of 10-year government bond yields to announcements related to the ECB's PSPP. Our results are based on NIESR's term premium estimates and control for other news and macroeconomic fundamentals. Euro Area estimates are weighted averages.

Table D1 summarises our findings. On average, Euro Area bond yields declined by around 45 basis points as a result of the quantitative easing, with the impact varying across countries. Member states of the common currency area with more vulnerable fiscal positions, like Italy, benefited more than Germany. Our results are similar to findings in the literature, depending on control variables employed. Assuming symmetry, they imply that an announcement of a quantitative tightening, that corresponded to a €1 trillion balance sheet reduction, would raise long-term interest rates by around half a percentage point.

A second step consists of estimating the effect on the economy. Long-term interest rates determine the borrowing conditions faced by the government. They also affect what firms have to pay in order to fund investment through the user cost of capital. Tighter borrowing conditions depress investment, output and inflation. We employ the National Institute Global Econometric Model, NiGEM, to simulate the effect of a positive shock to long-term interest rates. Besides assuming symmetry between

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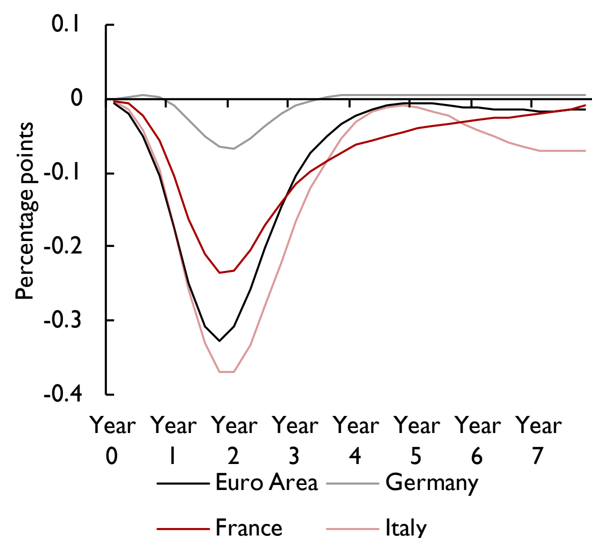
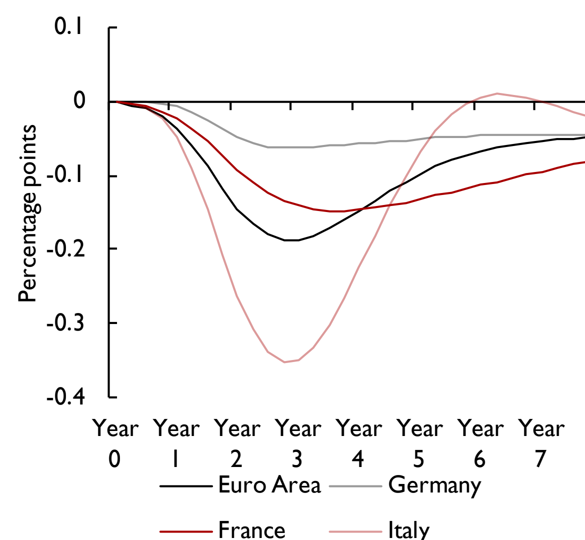
Box D. (continued)

Figure D2. Response of real GDP growth to quantitative tightening (difference from base)



Source: NiGEM simulation.

Figure D3. Inflation response to quantitative tightening (difference from base)



Source: NiGEM simulation.

quantitative tightening and easing, we let the shock materialise over the course of one year as expectations are adjusted. We further assume that the ECB policy rate will remain unchanged beyond the end of asset purchases, in line with forward guidance given by the Governing Council. Figure D2 depicts the impact on the growth rate of real output from the hypothetical announcement of quantitative tightening. Around two years after the announcement, Euro Area GDP growth is estimated to be around 0.3 percentage points lower than our baseline forecast. GDP growth in Italy is affected somewhat more, whereas the impact on German GDP growth is negligible. Quantitative tightening would generate some deflationary pressure and prices would grow by around 0.2 percentage points less in the Euro Area as a whole, with varying effects across countries (figure D3). These results are similar to those found by Clemens *et al*. (2017) for an early QE exit scenario in the Euro Area.

A number of caveats should be mentioned. Our estimates of the financial market response to QE announcements capture the impact of the stock of assets purchased and abstract from additional effects that the continued process of purchasing may have on yields (flow effects). In contrast to QE programmes by other central banks, ECB QE was announced at a time at which markets were relatively calm, which may have led to smaller bond yield responses. The impact of quantitative tightening may also depend on the business cycle and not be symmetric to the impact of QE.

Overall our findings imply that an announcement by the ECB of a reduction in its balance sheet would only have a small effect on the economy through the long-term interest rate channel. This supports the view that the ECB may want to use the current recovery, which was stronger than initially anticipated in 2017, to unwind unconventional monetary policy measures adopted during the crisis. However, our results also show that effects are likely to vary across countries, with some more vulnerable to a tightening announcement than others.

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This box was prepared by Arno Hantzsche and Iana Liadze.

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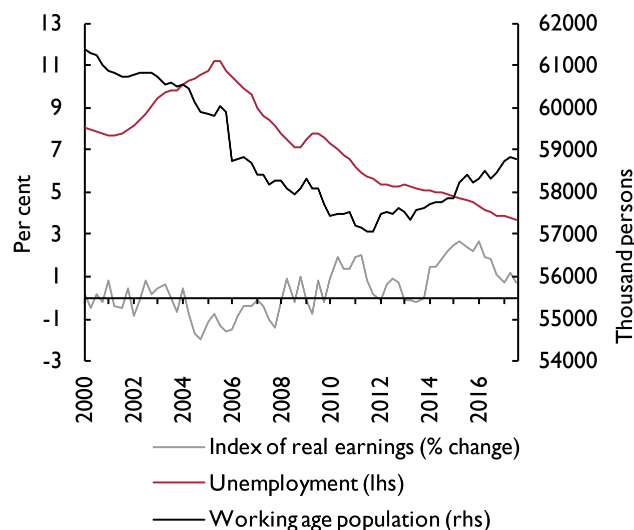
Germany

The economy expanded by 0.8 per cent in the third quarter of 2017, up from 0.6 per cent in the previous quarter. Growth was supported by net trade and investment while household consumption and government spending were broadly unchanged. Industrial production data indicate that this robust growth has persisted into the fourth quarter, expanding by 2.8 and 5.6 per cent year-on-year in October and November respectively. We forecast output growth at around 2–2½ per cent this year, with this high rate of growth normalising next year to below 2 per cent.

The unemployment rate fell slightly to 3.6 per cent in November 2017 (the lowest since 1980), from an upwardly revised 3.7 per cent in October. Despite this very low unemployment rate, wage growth has been comparatively weak, perhaps due to high levels of immigration boosting the labour supply, see figure 13. The Federal Statistics Office's index of real earnings increased by 0.7 per cent year-on-year in the third quarter of 2017, down from 1.2 per cent in the previous quarter, while nominal earnings increased by 2.5 per cent in the quarter, lower than the 2.9 per cent recorded in the previous quarter.

Consumer prices rose by 1.7 per cent in the twelve months to December, down from 1.8 per cent in the twelve months to November. In our near-term forecast, output growth exceeds the rate of increase of potential output, adding to inflationary pressure. We expect inflation to average 1.8 per cent in 2018, falling to 1.7 per cent in 2019.

Figure 13. Germany: labour market and wage developments



Source: DeStatis, NiGEM database.

Coalition talks between Angela Merkel's conservative Christian Democrats (CDU/CSU) and the left-of-centre Social Democrats (SPD) have resulted in possible discussions to depart from the traditional budgetary discipline and eradicate the entire €45 billion fiscal surplus by increasing government spending. Whether this is implemented or not depends on the final outcome of negotiations which are still ongoing. In the absence of complete information we have not assumed an increase in spending, so such an increase would represent an upside risk to our near-term output forecast. We anticipate the government balance to average 1.3 and 1.1 per cent of GDP this year and next respectively.

The current account balance remained very high, at 8.2 per cent of GDP in the third quarter of 2017. We expect to see a slight decline in the fourth quarter of 2017, with the current account balance averaging 7¾ per cent of GDP in 2018 and 2019.

France

The French economy has maintained the improved growth performance it achieved in late 2016. In the fourth quarter of 2017 GDP grew by 0.6 per cent following 0.5 per cent in the third quarter. On average over the year GDP growth picked up from 1.1 per cent in 2016 to 1.9 per cent in 2017.

While quarterly GDP growth has recently been steady, its expenditure composition has been somewhat erratic. In the third quarter of 2017, household consumption growth increased to 0.6 per cent from 0.4 per cent in the second quarter despite a slowdown in real income. Foreign trade was a drag on GDP growth, contributing a negative 0.5 percentage points after a positive 0.6 in the second quarter. Imports accelerated sharply to 2.6 per cent in the third quarter from 0.0 per cent in the second, supported by the growth in household consumption. Conversely, exports decelerated significantly to 1.1 per cent in the third quarter from 2.2 per cent in the second. Meanwhile fixed investment, which played an important role in the economic recovery, decelerated for the second quarter in a row to 0.9 per cent growth in the third quarter from 1.6 and 1.1 per cent in the first and second quarters respectively.

More recent indicators suggest continued robust output growth in the fourth quarter. Industrial output

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increased by 2 per cent in the three months ending in November compared to the previous three months, and INSEE's business climate indicator reached a 10-year high in December. Our forecast for GDP growth has been revised up marginally to 1.9 per cent in 2018 and 1.8 per cent in 2019 as we expect exports to be pushed up by the broad-based strengthening of economic activity in Europe.

Fiscal policy is expected to be stimulative in 2018 as the tax cuts for businesses and households discussed in the November 2017 *Review* are rolled out. In particular, fixed investment on behalf of the government, which declined by 10 per cent since 2012, is expected to rebound in 2018 as the first tranche of the 5-year and €50 billion investment plan is phased in.

The French labour market benefited from both an improved business environment and liberalisation measures, and unemployment declined to 9.2 per cent in November 2017, down from a high of 10.5 per cent in mid-2015. The downward trend is forecast to continue in the coming months, with the average rate falling to 9 per cent this year and 8½ per cent in 2019. Consumer price inflation on a 12-months basis was stable at 1.2 per cent in December 2017, unchanged from October and November. We expect inflation to remain in the 1–1½ per cent range in 2018–19 as above potential growth is balanced by slack in the labour market.

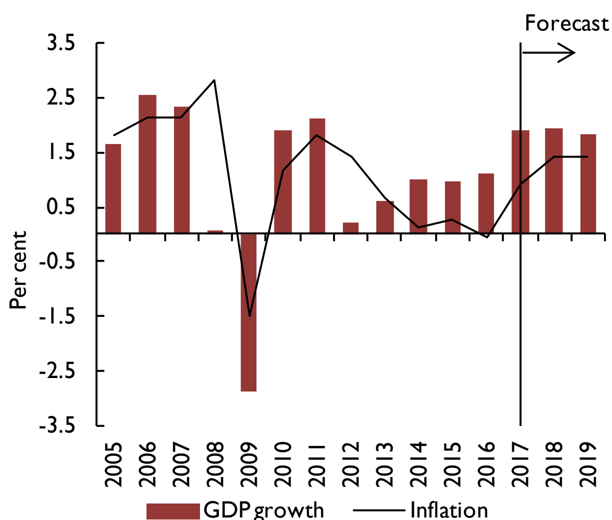
Italy

GDP growth gained momentum in the third quarter of 2017 to a rate of 1.7 per cent year-on-year, the strongest since 2011. Economic sentiment indicators in 2017 have painted a healthy picture of growth, and the manufacturing PMI reached a near seven-year high in January 2018. As a result, we expect GDP growth to be steady over the near-term forecast period, at around 1.4 per cent in 2018 and 1.3 per cent in 2019. The stronger performance of the economy seems to be broad-based, driven by solid domestic demand and improved financial conditions. The financial vulnerability of Italian households and businesses has diminished and is expected to continue to do so as the economy strengthens.

Following a period of negligible inflation between 2014 and 2016, the headline HICP inflation rate has hovered around 1.3 per cent for most of 2017, and should stabilise at around this level this year also. Though the acceleration since 2016 has been driven by rising energy prices, the core index was firmer in 2017, at a projected 0.8 per cent annual increase, up from 0.5 per cent in 2016.

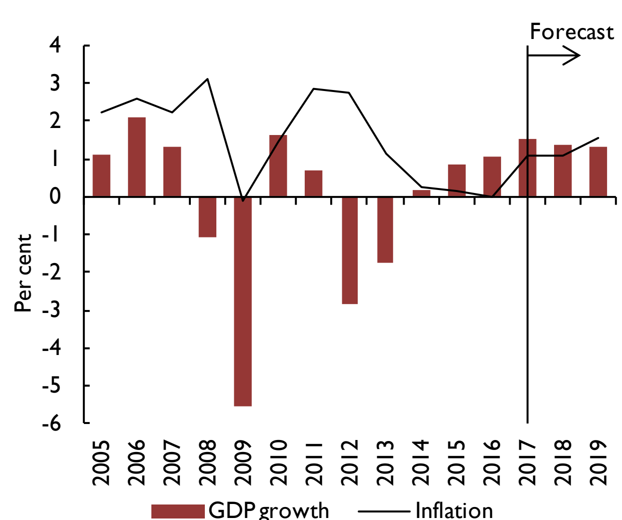
The slack in the labour market remains sizeable, but is likely to decrease somewhat over the forecast period. We expect the unemployment rate to be around 11.3 per cent in 2017, down from 11.7 per cent in 2016, and to decline further over the coming years. The continued

Figure 14. France: GDP growth and inflation



Source: NiGEM database and NIESR forecast.

Figure 15. Italy: GDP growth and inflation



Source: NiGEM database and NIESR forecast.

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high level of youth unemployment at 32.2 per cent in December 2017 – although at a five-year low – remains a policy concern. The structural reforms in place to improve labour market inclusion and social cohesion are essential to sustain growth and reduce the fragility in the labour market.

According to the recently approved financial package, Italy's budget deficit is projected to fall to close to 1 per cent of GDP in 2018, down from 1.6 per cent of GDP in 2017. For the medium term, the fiscal deficit target is planned to fall below 0.2 per cent of GDP in 2020. The debt-to-GDP ratio, which showed its first decline in 2015 since the crisis, is projected to fall to 131 per cent of GDP in 2017, and to 127 per cent by 2020.

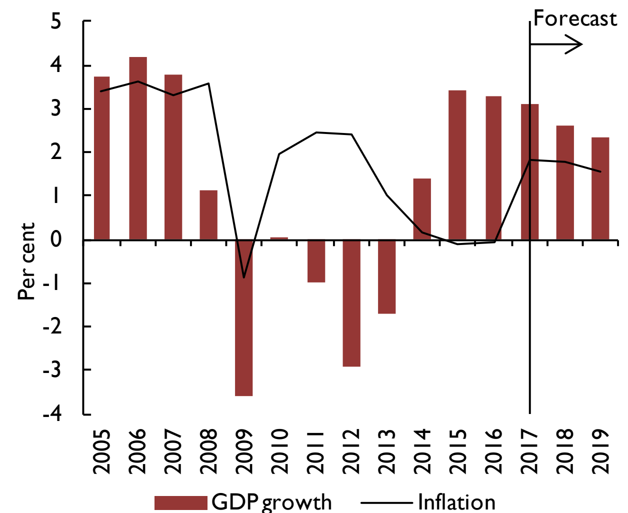
The large stock of non-performing loans (NPLs) held by banks and the high level of public debt pose downside risks to our forecasts. The government has dedicated 1.2 per cent of GDP to deal with the banking sector (€20 billion), half of which has been used already. This has proved crucial for reducing the size of NPLs since mid-2017. On the political side, the likelihood of the general elections due in March 2018 leading to a hung parliament is high, as no party or coalition is close to a majority irrespective of the new electoral law. This could lead to a prolonged period of political uncertainty, and possible stalling of the reform programme.

Spain

The recovery in the Spanish economy is continuing strongly. Economic growth hit 3 per cent in 2017 for the third year in a row. Moderate inflation also returned last year. While the unemployment problem in Spain persists, the unemployment rate has fallen substantially – from 26 per cent in 2013 to 17 per cent in 2017. As figure 16 illustrates, we forecast that the Spanish economy will continue to grow, but at a more gradual pace as catch-up growth is reduced. Inflation is not expected to pick up, but it is anticipated that it will run closer to 2 per cent than in the years before 2017.

A lingering risk, however, comes from the political situation in Spain. The Catalan regional election, held on 21 December with a participation rate of 80 per cent, resulted in pro-independence parties winning a majority of seats, reinforcing the sentiment of October's referendum. The Bank of Spain noted in its Macroeconomic Projections in December that the uncertainty associated with this regional dispute may have negative economic consequences. A key indicator of economic policy uncertainty peaked at its highest

Figure 16. Spain: GDP growth and inflation



Source: NiGEM database and NIESR forecast.

level in more than a decade in October and, although it has fallen back since, remains elevated. While uncertainty and its effects are difficult to measure, such indicators have increasingly been referred to by central banks with the implication that in response to increased uncertainty, the risk to growth is that agents sometimes 'wait and see', postponing consumption and investment and so reducing growth prospects and also reducing any inflationary impacts.

Greece

After a lost decade, the Greek economy showed signs of recovery in 2017, expanding by what is likely to be the fastest rate since 2007. Figure 17 shows that growth is no longer being restricted by private consumption but is now being boosted by it. At the same time, the unemployment rate has fallen from a peak of 27 per cent in 2013 to 21 per cent, while prices have started to rise after four years of deflation. We forecast that these positive macroeconomic trends will continue in 2018 and beyond.

The fiscal position has improved in Greece as the ratio of government debt to GDP has fallen from a peak of nearly 180 per cent to 173 per cent in 2017. The more favourable fiscal and economic outlooks are linked, as a reduction in unemployment will tend to reduce the size of the budget deficit, while re-emerging economic growth and inflation will increase nominal GDP. In addition,

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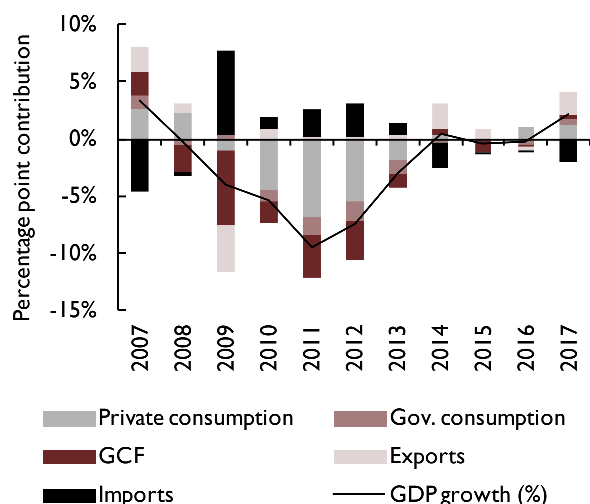
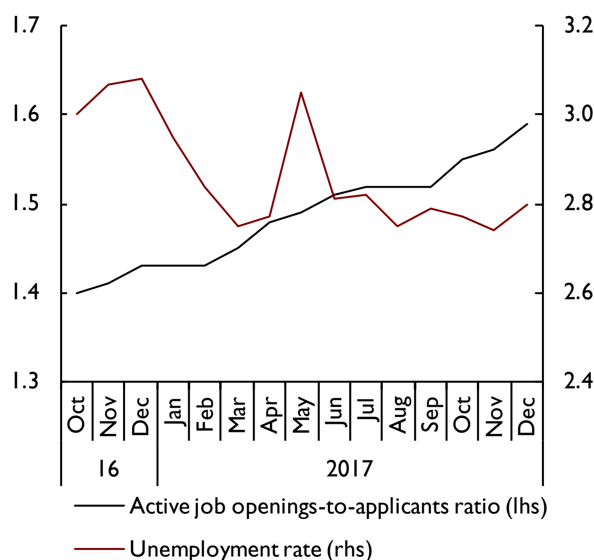
Figure 17. Greece: GDP growth decomposition, 2007–17



Source: NiGEM.

Figure 18. Japan: unemployment rate and the job openings to applicants ratio



Source: The Japan Institute for Labour Policy and Training.

the yield on Greek debt has fallen to pre-crisis levels. However, the stock of debt is still particularly high and relatively small increases in yields could threaten fiscal sustainability.

Japan

Supported by domestic demand and exports, the Japanese economy expanded by 0.6 per cent in the third quarter of 2017, making it the seventh consecutive quarter of growth, and the longest spell of uninterrupted growth in sixteen years. Economic activity in 2018 is expected to be somewhat softer compared to last year's performance, as fiscal stimulus in 2017 gives way to fiscal consolidation in 2018. However, the strong international environment is expected to continue to support export performance and, as a result, we anticipate GDP expanding by over 1 per cent again this year.

As the economy has expanded, labour market conditions have continued to tighten. Employment has increased by more than 3 per cent since the beginning of 2014, despite the declining working age population. As this continues to shrink, unless the government introduces measures to increase the labour force pool, the labour market will remain tight. The unemployment rate dropped to 2.7 per cent in November 2017 – the lowest since 1993 – before increasing slightly to 2.8 per cent in December and the ratio of job openings to applicants continued to climb to the highest level since 1974. However, so far, as in some other economies, wage growth has not accelerated and we are not forecasting a significant pick-up in pay pressures.

Modest wage growth has helped to keep inflation pressures low so far, with headline consumer price inflation remaining under 1 per cent. The Bank of Japan's (BoJ) preferred measure for core inflation, excluding fresh food and energy, stayed below 0.5 per cent, even though it edged marginally up to 0.3 per cent on a year-on-year basis in November, from 0.2 per cent in the previous three consecutive months. The modest increase in income gains so far has not been enough to push inflation close to the BoJ's 2 per cent target. Hence, we expect the BoJ to maintain its accommodative monetary policy in the foreseeable future.

China

Marginally exceeding expectations, GDP is estimated to have increased by 6.9 per cent in 2017 – the fastest rate of expansion in two years. Stronger domestic demand supported by targeted fiscal and monetary measures as well as stronger export performance contributed to improved economic activity. Rising incomes coupled with stable and low inflation supported private consumption. Looking ahead we expect economic growth to soften to around 6½ and 6¼ per cent in 2018 and 2019 respectively, as rebalancing from a production-

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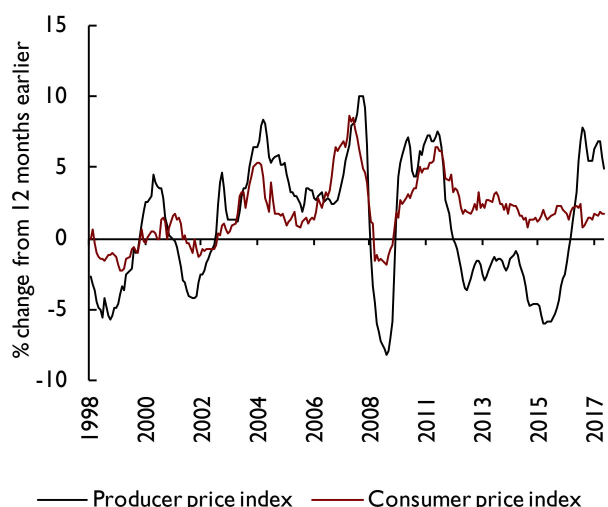
Figure 19. China: consumer and producer price inflation



Source: Datastream .

based economy to a more consumer-led one continues, while regulatory oversight, aimed at reducing financial vulnerabilities, is strengthened.

Consumer price inflation, on a 12-month basis, has remained below 2 per cent since February 2017. Producer price inflation remained elevated, even though it has eased from its February 2017 peak of 8 per cent. Higher producer prices together with increased demand generated by the government's large infrastructure projects helped industrial profits to improve last year.

A series of measures introduced by the authorities aimed at dampening speculative price pressures seems to have affected the housing market. Price growth of both new and second-hand homes has slowed from recent peaks and seems to have stabilised since September 2017, at about 5 per cent, on a year-on-year basis.

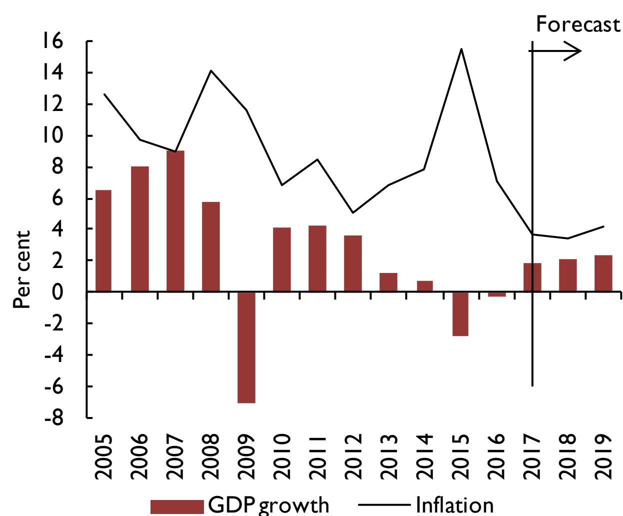
The renminbi continued to strengthen against the US dollar. Tighter regulation, including capital control measures, seems to have halted the renminbi depreciation that occurred between the beginning of 2015 and the start of 2017, and contributed to its appreciation in US dollar terms by about 7 per cent since the beginning of 2017. Foreign exchange reserves, measured in US dollars, have risen for eleven consecutive months, and reached $3.14 trillion at the end of December 2017 – the highest since September 2016. The authorities seem to be willing to keep capital controls in the foreseeable future, as recently announced additional measures to reduce further "speculative" outflows of funds indicate.

Russia

Economic activity stabilised in 2016, with GDP contracting slightly in the year as a whole, after the recession that began in mid-2014. Since then, GDP growth has been on a broadly upward trajectory, with growth of 0.1 per cent in the second quarter of 2017 and 1.2 per cent in the third quarter. Slower inventory restocking as well as reduced investment activity have been drags on annual growth. For example, wholesale trade growth, a proxy for inventory performance, fell from 9 per cent year-on-year in the second quarter to 5 per cent year-on-year in the third quarter, while machine and equipment import growth rates halved to 20 per cent over the same period. However, international sanctions remain a factor hindering recovery. In addition to the EU's extension of its economic sanctions until 31 January 2018, President Trump signed into law new sanctions in retaliation for the Russian government's alleged interference in the 2016 US elections in early August. Taking into account also the economy's long-established structural problems, we forecast that estimated GDP growth of 1.9 per cent in 2017 as a whole will broadly continue, with about 2 per cent growth in 2018 and 2.4 per cent in 2019.

Consumer price inflation, on a 12-month basis, fell to 2.5 per cent in the last two months of 2017 from 3.3

Figure 20. Russia: GDP growth and inflation



Source: NiGEM database and NIESR forecast.

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in August 2017. Having peaked at 16.9 per cent in the year to March 2015, inflation has thus now fallen below the Central Bank's target of 4 per cent. The bumper harvest allied with a shortage of storage continues to exert downward pressure on food price inflation and is the main factor driving the reduction in overall inflation. However, the harvest effect should reduce its influence during the first half of 2018. Lower inflation has also been supported by the strength of the rouble against the US dollar, with higher oil prices weighing down on imported inflation as well. We expect inflation to remain slightly below the target as the economy continues its recovery in 2018.

The central bank lowered its benchmark interest rate for the sixth time in 2017 in mid-December to 7.75 per cent. The Governor suggested that the central bank would continue its gradual transition from moderately tight to neutral monetary policy with the possibility of further rate reductions in the first half of 2018.

India

The pace of growth of the Indian economy rebounded in the third quarter of 2017, growing by 6.3 per cent year-on-year, following five quarters of declining growth. The manufacturing sector was the main driver of increased activity, expanding by 7 per cent compared to the same quarter in 2016. This suggests that the effects of demonetisation have waned and the disruption due to the introduction of a national goods and services tax (GST) has been largely overcome. Growth was also boosted by increased spending by a government keen to strengthen economic activity in the run-up to regional elections in December 2017. This increase in government spending is expected to be temporary, but we anticipate private sector growth to continue to increase in the coming quarters, as lingering effects of demonetisation and the introduction of GST dissipate completely. We forecast output growth of close to 7½ per cent in 2018 and 2019.

Moody's upgraded India's sovereign rating in November, from Baa3 to Baa2, under the expectation that economic and institutional reforms under the Modi government will boost long-term growth prospects and reduce the burden of government debt. This upgrade is likely to bolster investment via a reduction in government and corporate borrowing costs.

Consumer prices rose by 5.2 per cent in the twelve months to December 2017, up from 4.9 per cent in the twelve months to November. This is the highest rate of inflation seen since July 2016 and has been driven by rising food and housing costs. The Reserve Bank of India kept its benchmark rate at 6 per cent in December, seen as being consistent with a neutral stance for monetary policy aiming at an inflation target of 4 per cent in the medium term, whilst supporting growth. We expect inflation to remain above target in the near and medium term due to the increasing prices of imported commodities, averaging 5.3 per cent this year and 4.5 per cent in 2019.

Brazil

2017 marked the year Brazil moved out of a severe recession that had started in 2014 and reduced economic output by around 8 per cent. GDP increased in each of the first three quarters of 2017. In the third quarter it was 1½ per cent higher than a year earlier.

A number of factors contributed to that positive development. On the supply side, agricultural production had a favourable harvest season at the beginning of the year and increased by around 10 per cent in the four quarters to 2017Q3. The services sector started to benefit from a recovery in private consumption, with services output increasing by around 1 per cent relative to a year earlier.

Domestic demand improved towards the second half of the year with private consumption increasing by more than 2 per cent in the third quarter of 2017, compared to the same quarter of 2016. A declining rate of consumer price inflation supported annual real wage growth of above 4 per cent in October. The unemployment rate fell from its historic peak in March of nearly 14 per cent to close to 12 per cent in October, further contributing to improvements in disposable income.

Annual consumer price inflation retreated to less than 3 per cent in the second half of 2017, below the Central Bank's target range of 3–6 per cent. This allowed the Monetary Policy Committee to continue its easing policy and reduce the benchmark 'selic' rate in December to 7 per cent. More accommodative monetary policy has supported investment, the annual growth rate of which recovered over the course of 2017 and the global and regional economic upturn bolstered export growth. This helped bring down the current account deficit to close to zero by the end of 2017.

Looking ahead, our projections for 2018 are mixed. A continued reduction in inflation expectations should provide room for monetary policy to remain accommodative and support the economic recovery.

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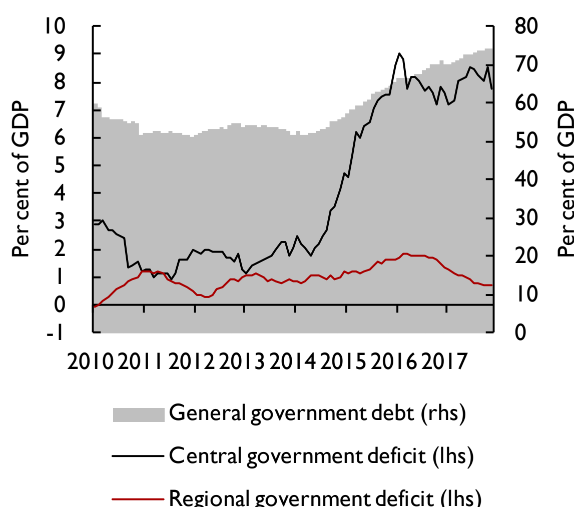
Figure 21. Brazil: fiscal position



Source: Central Bank of Brazil.

The ongoing global upturn will help Brazilian exports. On the other hand, political risks prior to the election scheduled for October 2018 could weigh on domestic demand as necessary structural reforms may no longer be undertaken. Credit conditions, in particular for businesses, remain poor according to the central bank's *Financial Stability Report*.

We perceive the largest downside risk, however, to stem from the weak fiscal position. Despite its commitment to a spending target, the central government's budget deficit remained around 8 per cent relative to GDP throughout 2017 (figure 21). As a result, the stock of public debt as a percentage of GDP, depicted by the shaded area in figure 21, has continued to increase. To improve the fiscal position, a reform of the public pension system has been proposed but it has been reduced in scope and a vote on it has been delayed. Unsustainable public finances could increase sovereign credit risk, and ultimately borrowing costs in the economy. However, a fiscal consolidation poses the risk of choking off domestic demand and raising income inequality. Positive news comes from the governments of Brazil's federal states, which used to be responsible for more than half of general government borrowing requirements but over the course of 2017 were able to reduce their fiscal deficits (red line in figure 21).

Taking these factors into account, we forecast economic growth of just below 2 per cent in 2018, strengthening only slowly to just above 2 per cent in the medium term. Annual consumer price inflation is expected to edge up to just below 4 per cent in 2018, within the central bank's target range.

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