Prospects for individual economies

United States

The prospects for the US economy have changed over the past three months. Despite annualised first quarter GDP growth at 3.1 per cent out-pacing that in the previous quarter, concerns about a slowdown, or even a prospective recession, have grown. There are several factors behind this change of view. Some key economic indicators have weakened. The levels of industrial production and personal income (excluding transfers) are now below their peak values set late last year. These indicators play a role in the National Bureau of Economic Research's analysis of peaks and troughs in economic activity.[6] In addition, a much-followed leading indicator of recession, the spread between long– and short-dated Treasury bills, has fallen, implying a greater probability of a recession a year ahead (Lenoel, 2018, 2019). The New York Federal Reserve's model for this relationship in June showed a 30 per cent probability of recession a year ahead.

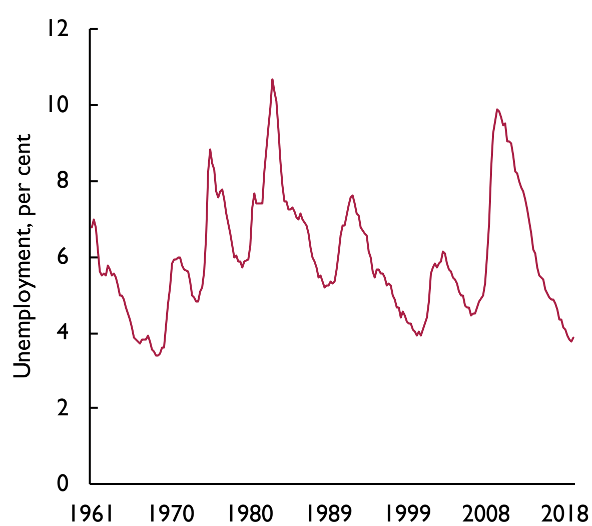
Having increased policy rates to 2.25–2.50 per cent in December, the US Federal Reserve moved early this year to change the market expectation that further increases were likely. In June the Federal Reserve's interest rate outlook chart changed again, indicating that a rate reduction was the likely next policy move this year. The Fed has been criticised by President Trump for raising rates and not letting the economy 'run hot' at a time when inflation has remained stubbornly below the 2 per cent target.

Last year GDP growth of 2.9 per cent was supported by the fiscal boost, but the effects of this will wane this year. At the same time, the quite rapid growth of investment spending, particularly on residential construction and structures, has started to moderate. The rate of unemployment fell to a near 50 year low at 3.6 per cent in May (figure 8) but average earnings growth has not risen notably in response to what appears to be a tight labour market. Although the unemployment rate is low, in four of the first six months this year the monthly increase in non-farm payroll employment has been lower than a year earlier, indicating a slowing in the pace of expansion. One concern from the historical pattern is that the rate might not hold steady at its low, but start to rise again.

The scope for the Federal Reserve to reduce interest rates is provided by the quiescent behaviour of inflation over recent years and rates are expected to be reduced in July. The pace of average earnings growth has been steady and inflation expectations have remained stable. While the annual inflation rate of the headline consumer prices index has had periods of running at over 2 per cent, the core personal consumer prices inflation rate has only seen occasional months at such rates. This is expected to continue this year, but the outlook here might depend on how the major uncertainty surrounding the US economy – trade talks – progresses.

With a more accommodative monetary policy, we expect GDP to grow by about 2½ per cent this year, down from 2.9 per cent last year, with a further reduction in pace in 2020 to around 2 per cent. The trade and tariff discussions remain a key source of uncertainty and downside risk for the both the US and the global economies. After announcing on 24 February that he would extend the 1 March trade deal truce deadline and with seeming relatively optimistic signs about the progress of negotiations between the US and China, on 10 May President Trump unexpectedly announced a tariff rate of 25 per cent on $200 billion of imported goods from China. Tariffs on a further $300 billion of imports were being considered. With the national security order effectively banning the use of technology from Huawei in the US, tensions and uncertainties over trade have risen recently. One effect may have been reduced global business confidence and investment. A direct effect of the tariffs has been to raise the prices of imports into

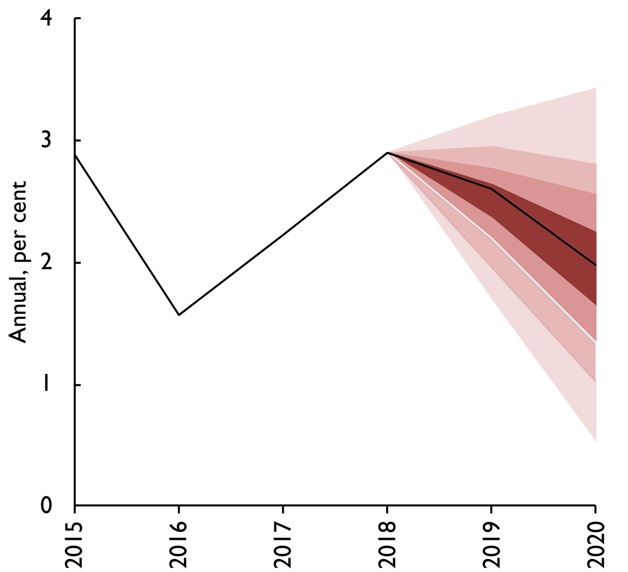
Figure 8. US: Unemployment rate



Source: FRED database, St Louis Federal Reserve.

https://doi.org/10.1177/002795011924900106 Published online by Cambridge University Press

Figure 9. US: Annual GDP growth fan chart



Notes: The fan chart is intended to represent the uncertainty around the central forecast shown by the central line. There is a 10 per cent chance that GDP growth in any particular year will lie in any given shaded segment in the chart. There is a 20 per cent chance that GDP growth will lie outside the shaded area of the fan.

the US of goods subject to them. In turn, this might pass through into higher general price inflation.

It is not only China that has been affected by US tariffs. Imports of steel and aluminium from many countries have been affected, as have external producers of solar panels and washing machines. The potential imposition of tariffs on automobile imports remains a concern to external producers and the effects of these are examined in Box A, noting the potential downside effects on GDP growth. Unexpectedly, on 30 May President Trump announced that a 5 per cent tariff rate would be imposed on all goods from Mexico until there were actions to reduce the inflow of illegal migrants from Central America through Mexico into the US. After some Mexican government actions, these tariffs were not imposed. But the 'weaponisation of tariffs' has added a new uncertainty to the global trading environment.

With the uncertainty over trade policy and the state of the economic cycle, the main risks appear to be to the downside. But a positive trade agreement with China could emerge and the Federal Reserve is expected to loosen monetary policy, thereby creating upside risks to our forecast. With inflation expectations seemingly anchored and equity markets still strong, the risks appear balanced on a path of slowing growth this year and next, as shown in figure 9.

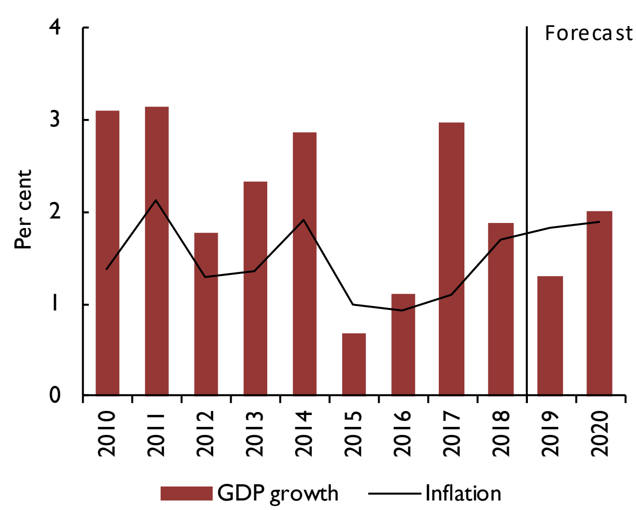
Canada

The first quarter of this year marked a second consecutive quarter of weak growth for the Canadian economy. GDP grew by 0.1 per cent, the same as in the fourth quarter of 2018. In the first quarter, domestic demand made a strong contribution to growth, but its effect was almost completely cancelled out by a decline in net external demand. Household consumption increased by 0.9 per cent, following similar gains in disposable income. Export prices were up 2.5 per cent, while import prices were flat. Targeted trade restrictions introduced by China are having direct effects on Canadian agricultural exports.

Consumer price inflation increased from a trough of 1.4 per cent in January to 2.4 per cent in May. Core inflation seems to be well anchored around the 2 per cent target and in its May monetary policy announcement, the Bank of Canada expressed its confidence that economic growth would pick up in the second quarter and maintained its benchmark interest rate at 1.75 per cent.

However, recent survey data do not suggest that an acceleration in economic activity is currently happening. PMI indices in May and June pointed towards a decline in manufacturing output and the Bank of Canada's Business Outlook Survey indicated only a very marginal improvement in business sentiment in the second quarter. We forecast GDP growth of 1¼ per cent in 2019 after 1.9 per cent in 2018, with slight strengthening to about 2 per cent in 2020.

Figure 10. Canada: GDP growth and inflation



Source: NiGEM database and NIESR forecast.

https://doi.org/10.1177/002795011924900106 Published online by Cambridge University Press

Euro Area

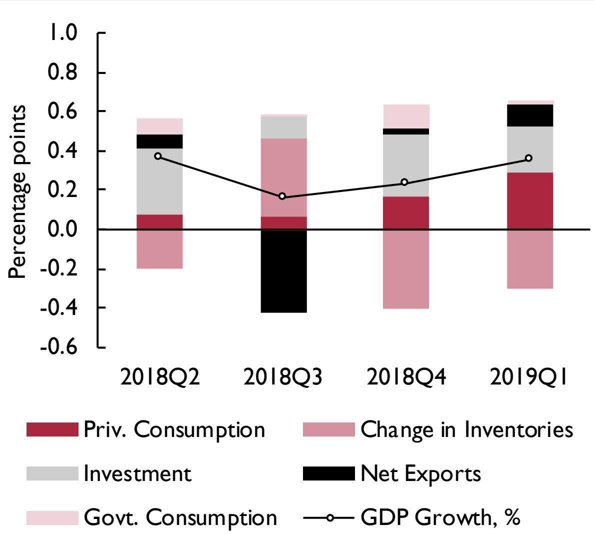
The Euro Area had strong growth in 2016 and 2017 as the response to the monetary policy accommodation provided by the European Central Bank (ECB) worked through and output growth was boosted by the stronger global growth. However, this period of above trend growth has proved to be transitory, with GDP growth in 2018 slowing to 1.9 per cent.

The slowing in output growth intensified in the second half of 2018. Germany and Italy contributed substantially to this drop, with both countries recording falls in GDP in the third quarter and Germany only avoiding a technical recession by the narrowest of margins (after a fall of 0.2 per cent in the third quarter, GDP was flat in the final quarter). Italy slipped into recession in the final quarter, when Greece also had a fall in GDP (but after a strong 0.9 per cent increase in the previous quarter).

GDP growth performance has improved at the start of this year, with Euro Area GDP growth in the first quarter of 0.4 per cent, stronger than the previous two quarters. There were some special factors behind the fall in German GDP in late 2018, and it may be that the first quarter saw some 'catch-up' effects. Household spending saw a pick-up in its contribution to quarterly GDP growth in the first quarter, making the strongest contribution to GDP growth, as shown in figure 11.

The weakness in growth has been in the industrial sector. Manufacturing output fell by 0.3 per cent in each quarter in the second half of last year and it was flat in the first quarter of this year. The recent monthly IHS/Markit PMI indicators have shown renewed weakness, with the manufacturing output PMI index falling to a three-month low in June and still indicating falling manufacturing output. However, the index has shown some signs of stabilising in recent months. Within the Euro Area, manufacturing activity in France stands out as having remained relatively robust and the June figures for Germany, while still negative, are a little stronger than previously.

Figure 11. Euro Area: Contributions to quarterly GDP growth



Source: NIESR, Eurostat.

The fall in manufacturing activity has obscured the performance of the service sector. The service sector PMI output index has not shown the weakness of the manufacturing side and in June showed the strongest growth in activity since last October. While services growth is not rapid, the sector has been more resilient than the production sector. In the first quarter services activities continued to grow, with transport and accommodation up 0.7 per cent, and information and communication continuing its steady growth at 0.4 per cent.

Inflation remains below 2 per cent – headline HICP inflation fell from 1.7 per cent in April to 1.2 per cent in May, with the annual comparison affected by Easter being later this year – and underlying inflation (which excludes energy and food) was 0.8 per cent in May, the same as in March. With continued low inflation, weak economic activity and concerns that activity could weaken further, the ECB has adopted a more accommodative policy stance by further extending the period for which it is likely to hold interest rates until the middle of 2020. A new series of quarterly longer-term refinancing operations (TLTRO-III) has been announced, to start in September.

These measures should help to firm confidence but uncertainty over US tariff policy with respect to European motor vehicles remains a particular concern. The effects of such tariffs are examined in Box A. Absent further tariff impositions, the ECB's policy stance should help to support economic activity in the second half of this year, with growth also bolstered by continued service sector growth. Our forecast for GDP growth this year and next is slightly weaker than our May forecast, at 1¼ per cent and 1½ per cent respectively.

With inflation expected to remain below 2 per cent, domestic price pressures are not expected to lead the ECB into an early reversal of its approach. Into the medium term, the continued slower annual rate of productivity growth and prospective demographic trends point to annual growth in the Euro Area being slightly below 1½ per cent a year.

https://doi.org/10.1177/002795011924900106 Published online by Cambridge University Press

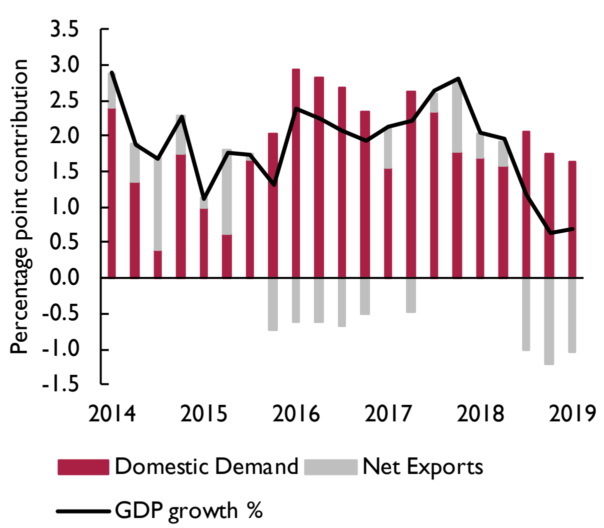
Germany

We have revised down our GDP growth forecast for 2019 from 0.8 per cent to about ½ per cent despite a surprisingly strong first quarter GDP growth outturn of 0.4 per cent, but with GDP growth rising to 1¼ per cent in 2020. Lead indicators suggest that GDP could fall in the second quarter and remain weak in the third quarter as well. The main reason for this weakness appears to be global – trade uncertainty, the intensification of Brexit uncertainty, and sluggish trade growth, with lower new car sales in China contributing to the problems for the auto sector.

Within the German economy, there is a mixed picture. The manufacturing sector, which is heavily exposed to export demand, is facing a protracted slowdown in the face of rising global uncertainty and slower external demand growth. By contrast, domestic demand and service sector activity remains robust, with household consumption supported by high and rising levels of employment and pay. At the same time, fiscal measures have helped boost disposable income. Spending is expected to remain an important driver of economic growth in 2019 and 2020 and is likely to support service sector output as well as the construction sector.

Investment spending expanded by more than 3 per cent in the six months that includes the final quarter of last year and the first quarter of this year despite the marked slowdown in overall economic activity. Looking ahead, we expect investment spending to ease in line with the deterioration in business conditions, but we do not envisage a sharp deterioration mainly because, unlike previous upswings, there does not appear to have been an excessive build-up in investment this time and also because borrowing conditions in Germany remain favourable, with the 10-year bond interest rate below 0 per cent. Government investment is also likely to continue to support economic growth.

Figure 12. Germany: Components of annual economic growth



Source: NiGEM database.

The labour market remains tight, with wage growth above 3 per cent and the unemployment rate at a record low. Wage growth is expected to remain elevated in 2019 and we also envisage a further expansion in employment. That said, the expansion will be modest mainly because of slower economic growth but also because the labour force will start to shrink.

The rise in wages comes during a period when labour productivity is falling. On our measure, German labour productivity, measured in hours, fell by 0.6 per cent in the four quarters to the first quarter of 2019, which implies rising unit labour costs over this period, and alongside that an erosion in competitiveness and gradually mounting domestic inflationary pressures.

Headline inflation eased from a recent peak of 2.2 per cent in the third quarter of 2018 to an average of 1.6 in the first half of this year. We expect inflation to remain close to 1½ per cent for the rest of 2019 and about 1¾ per cent in 2020 as domestic inflationary pressures are offset by lower energy prices.

France

The French economy is expanding at a steady but moderate pace and we expect GDP to grow in both 2019 and 2020 at a rate close to 1½ per cent, slightly lower than the 1.7 per cent achieved in 2018. Fiscal policy is supporting domestic demand but weaker growth in Europe is negatively affecting the export sector.

Fiscal policy announcements have been stimulative this year, with increased transfers and government consumption and a temporary reduction in both corporate and household taxes. The risk is that this will raise the budget deficit and the debt-to-GDP ratio which, at 98.5 per cent in 2018, is already the sixth highest in the European Union. Compared to the 5-year fiscal plan prepared at the end of 2017, debt has drifted upwards (figure 13), and it will be very difficult for the Government to reach its target of a debt-to-GDP ratio of 91.4 per cent in 2022.[7]

Inflation stayed between 1 and 1½ per cent in the second quarter, as in the first quarter. In the consumption basket,

https://doi.org/10.1177/002795011924900106 Published online by Cambridge University Press

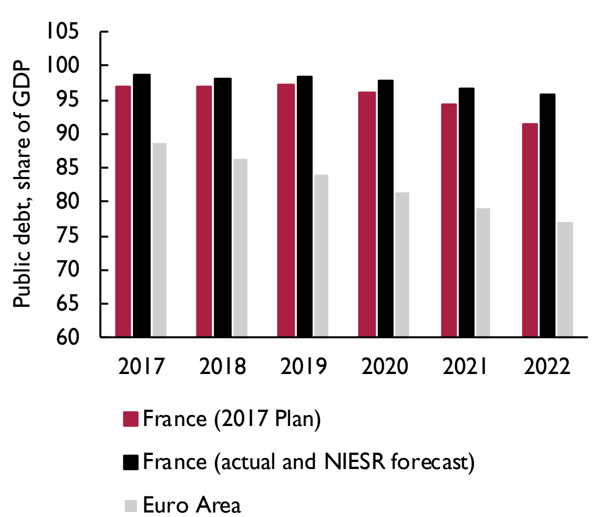
prices of services and food increased but manufactured goods prices decreased. The unemployment rate declined slightly faster than expected, from 9.0 per cent in October 2018 to 8.6 per cent in April and May this year. This is perhaps a signal that the recent reforms have made the labour market a bit more flexible.

We expect strong gains in purchasing power for households in 2019, with real personal disposable income increasing by 2¼ per cent compared to 0.7 per cent in 2018. This results from higher social benefits, lower taxes and lower consumer price inflation than in 2018. Household confidence turned positive again in June after having dropped at the end of 2018, according to INSEE's June survey of households. With this positive backdrop, we expect household consumption growth to edge up from 0.9 per cent in 2018 to 1¼ per cent in 2019.

There are indications that the economy is likely to have continued its recent momentum in the second quarter, despite a challenging international environment. Service and manufacturing output levels in the three months to April were respectively 4.7 and 1.3 per cent higher than a year ago and the June PMI surveys for services and manufacturing were both above their long-term average.

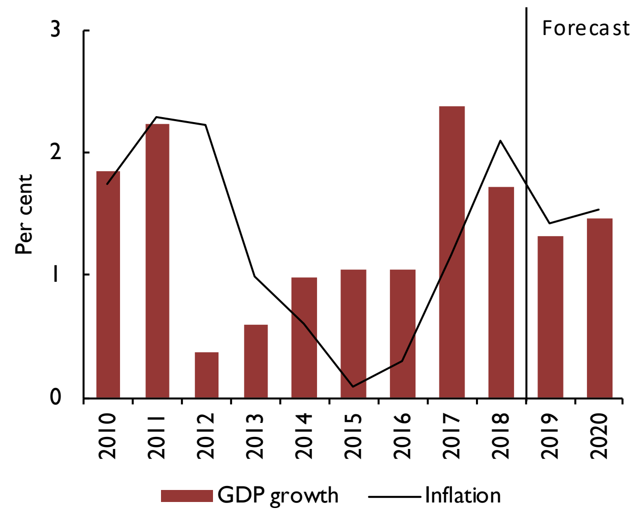
The two main risks for the French economy are a reversal in the fiscal stimulus and lower than expected growth in Europe. The increase in the deficit in 2019 was driven by temporary measures that could act as a negative shock once they end and the focus returns to reducing the deficit. The other risk for France is that, with 60 per cent of its exports going to other EU countries, a sharp slowdown in Europe would negatively affect the French economy.

Figure 13. France: Planned versus actual public sector debt-to-GDP ratio (per cent)



Source: Rapport économique, social et financier (2018), NiGEM database and NIESR forecast.

Figure 14. France: GDP growth and inflation



Source: NiGEM database and NIESR forecast.
Note: Inflation is based on HICP.

Italy

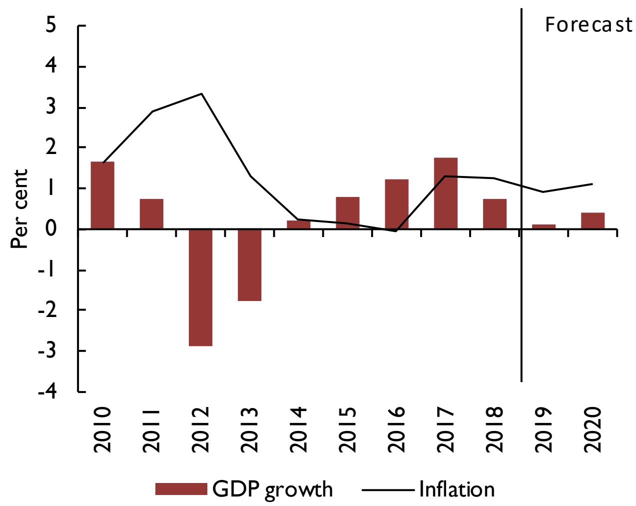
Provided there are no further adverse shocks, the Italian economy looks set to emerge from the recessionary period that started in the middle of 2018 and into a period of modest economic growth. Lead indicators suggest that the economy has stabilised in the second quarter of this year, with the service sector set to make a positive contribution to quarterly growth. The manufacturing sector, by contrast, continues to remain weak mainly because of exports. Given ongoing uncertainties related to the global trade environment, the external outlook for Italy is likely to remain subdued in the near term and as a result we have revised lower our forecast for 2019 GDP growth from 0.4 per cent to just below ¼ per cent. If realised, this will be weakest performance since 2013.

We expect GDP growth to recover slightly to ½ per cent in 2020, with the economy supported by domestic demand. Households' income will be boosted by the government's fiscal package.

The main headwind to Italian GDP growth is business investment. There are several structural factors that

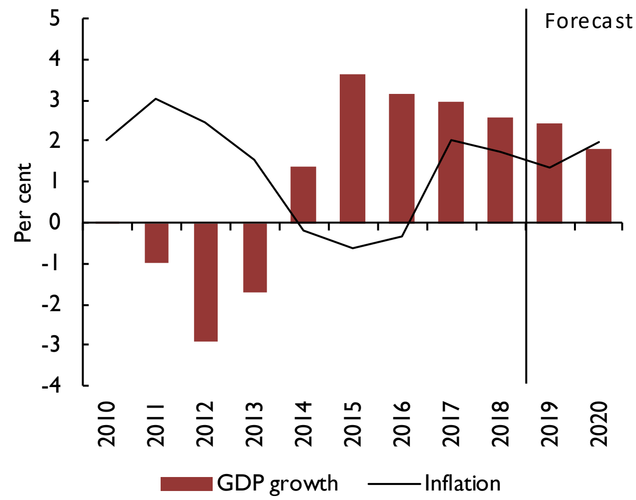
https://doi.org/10.1177/002795011924900106 Published online by Cambridge University Press

Figure 15. Italy: GDP growth and inflation



Source: NiGEM database and NIESR forecast.
Note: Inflation is based on HICP.

Figure 16. Spain: GDP growth and inflation



Source: NiGEM database and NIESR forecast.
Note: Inflation is based on HICP.

are at play. The recent standoff between the Italian government and the European Commission over rising public debt levels has led to a sell-off in Italian government bonds and higher borrowing costs for corporates and, although an agreement has been reached and the Commission has decided not to trigger the 'Excessive Deficit Procedure', uncertainty remains. Notwithstanding the commitments made by the Italian government, we expect the deficit to widen from 2.2 per cent of GDP this year to 2.5 per cent in 2021 and public debt to remain around 130 per cent of GDP. The government is likely to remain under continuous fiscal pressure from the European Commission and the financial markets, with little room for fiscal policy boosts, leaving the Italian economy and banking system vulnerable to adverse shocks.

Spain

The pace of Spain's economic recovery is expected to continue to slow despite notably robust economic activity in the first quarter of 2019. The Spanish economy grew by 0.7 per cent in the first quarter of 2019, slightly stronger than previous quarters, and it continues to show stronger growth than other large economies in the Euro Area. Notwithstanding this first quarter performance, our current projections point towards a gradual slowing over the medium-term forecast horizon. After running at 2.6 per cent in 2018, our revised forecast suggests that GDP growth will ease to about 2¼ per cent in 2019 and 1¾ per cent in 2020. This anticipated slowdown will still mark a relatively strong growth performance in a context where the previously expansionary effects of monetary policy are gradually diminishing and, in the wake of the slowdown in consumer credit, the rate of private consumption growth is expected to slow.

The unemployment rate is expected to decline to 13½ per cent this year, and a further fall to 11½ per cent is anticipated for 2020. The reduction in unemployment does not appear to be placing significant pressures on domestic inflation, and inflation fell sharply to under 1 per cent in the second quarter of 2019. However, we expect harmonised consumer price inflation to display a rising trajectory, from 1¼ per cent in 2019 to 1¾ per cent in 2020.

The risks to the growth outlook appear to be tilted to the downside. In particular, political tensions surrounding the forming of a new government, coupled with the continuing regional political issues, and possible international adoption of protectionist measures, provide uncertainty for the outlook. In addition, scope for further progress on structural reforms to improve competitiveness and productivity exist (Rincon-Aznar *et al*., 2019).

https://doi.org/10.1177/002795011924900106 Published online by Cambridge University Press

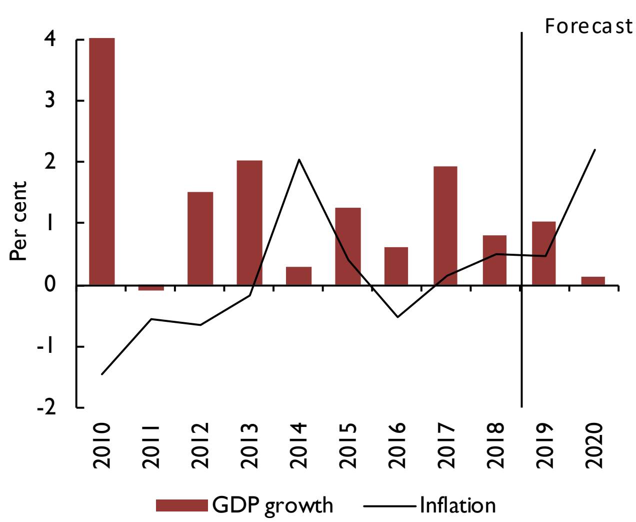
Japan

Japanese GDP grew by 0.6 per cent in the first quarter of this year, continuing the strong performance from the fourth quarter of 2018. Net exports contributed 0.4 percentage points to first quarter growth, potentially obscuring underlying weakness in the domestic economy, with declining imports a sign of weakness in Japanese domestic demand. It is also worth noting that the strong growth in the final quarter of 2018 itself followed an unusually large fall in GDP in the preceding quarter.

We expect a pick-up in domestic demand ahead of the planned rise in the consumption tax from 8 to 10 per cent currently scheduled for October 2019, largely due to intertemporal shifts in household consumption, before consumption falls by over 1 per cent in the medium term relative to our previous forecasts (Liadze and Piggott, 2019). Recent strength in Japanese retail sales may point towards this shifting already occurring, as retail sales grew 0.5 per cent in April and accelerated to 1.2 per cent in May.

Prime Minister Abe has ruled out postponing the increase "unless an event with the magnitude of the Lehman Brothers shock happens";[8] while the Bank of Japan has promised to maintain its current accommodative monetary policy stance until the effects of the tax rise fade. Our forecast view assumes the tax rise goes ahead,

Figure 17. Japan: GDP growth and inflation



Source: NiGEM database and NIESR forecast.
Note: Inflation is based on consumer expenditure deflator.

reflecting policy announcements mitigating the overall impact of the increase, as the government would have to expend significant political capital were it to cancel the mitigating schemes. Prime Minister Abe's recent announcement that he will not seek dissolution of the lower house has ended speculation that he would seek a mandate to postpone the consumption tax, as in 2014.

The Tankan survey of largest manufactures fell in June to its lowest level since 2016, with global trade tensions weighing on Japanese producers. However, the equivalent figure for services was far stronger, with the number of respondents reporting favourable business conditions increasing from the previous month. The balance between the tailwinds in the services sector and the headwinds affecting Japanese manufacturing is likely to determine overall growth prospects over the coming quarters. We expect GDP to grow by almost 1 per cent in 2019, with growth of around ¼ per cent in 2020 as the effects of the tax increase feed through, with households strengthening spending in 2019 at the expense of 2020.

Headline inflation rose to 0.7 per cent in May, representing a pick-up from inflation of 0.2 per cent in January and February, but still substantially below the Bank of Japan's 2 per cent inflation target. We forecast inflation to average ½ per cent this year, increasing to 2¼ per cent in 2020 as the effects of the consumption tax increase pass through to prices. We view key downside risks to the inflation forecast from the possibility of looser policy from the Federal Reserve and continued weakness in Japanese wage growth, with Japanese real wages falling 1.1 per cent in April, representing the fourth consecutive monthly decline.

The Bank of Japan kept policy on hold at its June meeting, potentially exposing Japan to a stronger yen, as the Federal Reserve's recent shift in language may put upward pressure on the yen. A stronger yen would likely put downward pressure on Japanese inflation, though this would likely be offset by the increase in consumer prices stemming from the consumption tax increase. A potentially more concerning consequence for the Japanese economy would be the impact on exports arising from a stronger yen. Japanese annual export growth has fallen for six straight months, with large falls in exports to China, South Korea and Australia.

https://doi.org/10.1177/002795011924900106 Published online by Cambridge University Press

China

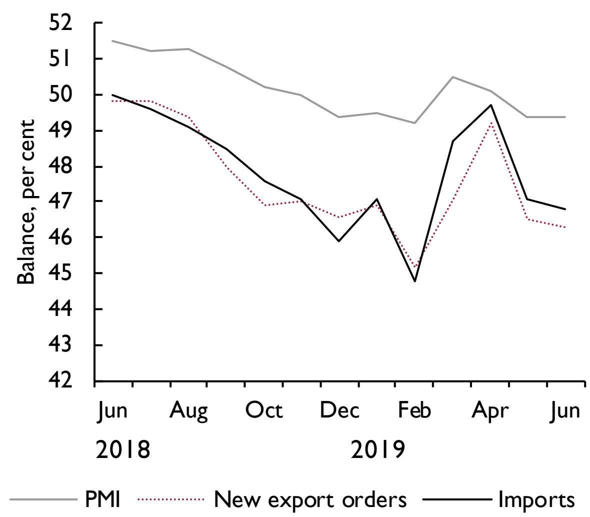
China's GDP growth continues to moderate slowly and is projected to average about 6¼ per cent in 2019, after a gradual deceleration in the annual growth rate every quarter for the past year. Amidst internal and external risks and uncertainties, annual GDP growth is expected to be the weakest since the early 1990s. However, with supportive monetary and fiscal policies, China's economy has shown signs of resilience which have been reflected in recent PMI activity figures. Our forecast anticipates that China's CPI inflation rate will increase from 2.1 per cent in 2018 to 2½ per cent in 2019. This partly reflects the hike in pork prices; however other domestic inflationary pressures remain subdued, giving the Chinese monetary authorities room to provide further stimulus if required.

China's central bank has managed a stable monetary policy, increasing money supply and aggregate financing in order to support GDP growth. In 2018 China's monetary authorities conducted medium-term lending and open market operations, and reduced the reserve ratio to provide liquidity to the financial system. Market liquidity was also supported by the discount rate policy and short-term lending and other financial support towards small and medium companies.

In terms of fiscal policy, China is cutting tax to support businesses and stimulate manufacturing production which has been adversely impacted by trade tensions with the US and slowing world trade (Hurst and Liadze, 2019; Kara and Liadze, 2019). China is on course to cut tax by 2 trillion yuan (about 2 per cent of GDP) in 2019, with 893 billion already implemented between January and May. With the supportive economic measures, China's official manufacturing PMI shows signs of stabilisation in the second quarter of this year after a slowdown from last autumn. The PMI in June was 49.4, the same as in May. Similar trends are evident in PMI-related new export and import orders. International trade figures have started to show some positive signs after suffering negative effects from slowdown of the domestic economy and trade tensions with the US.

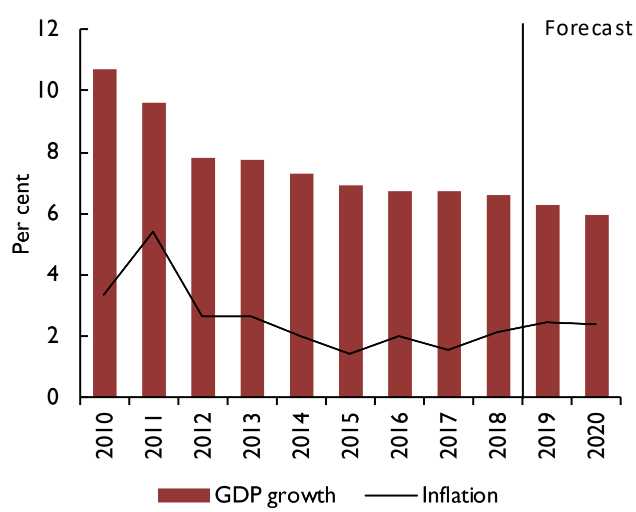
Trade talks with the US are still sources of uncertainty for China and the world economy in general. At the time of writing, China and the US have agreed to resume trade talks, and to put any retaliatory measures on hold. It was a positive surprise for Chinese investors to see the US ease some restrictions on Huawei Technologies Co recently. However, the results of the proposed talks are very hard to predict given the highly uncertain political and economic situations. Should trade tensions increase sharply, or domestic economic conditions worsen, more aggressive monetary and fiscal stimulus will likely be provided. Taking these and demographic factors into consideration, we forecast China's GDP will grow at a slightly slower pace of 6 per cent in 2020.

Figure 19. China: Manufacturing and trade indicators



Source: National Bureau of Statistics, China.

Figure 18. China: GDP growth and inflation



Source: NiGEM database and NIESR forecast.

https://doi.org/10.1177/002795011924900106 Published online by Cambridge University Press

India

Annual GDP growth in India slowed to 5.8 per cent in the first quarter of 2019, down from a 6.6 per cent annual expansion in the final quarter of 2018. This slowdown was expected in our previous forecast, consistent with a tendency for growth in India to slow in quarters preceding national elections, before rebounding post election as uncertainty fades. Overall, we expect the economy to grow by 7¼ per cent in 2019, and 6¾ per cent in 2020.

The new finance minister faces the challenge of responding to the highest unemployment rate in 45 years and the news that India was overtaken by China as the fastest-growing major economy, while finding funding for pre-election promises made by Prime Minister Modi's government, including $12.5 billion of cash transfers to rural farmers. The government's first budget since the election set out its intention to grow the economy to $5 trillion by 2025, requiring a growth rate of about 8 per cent a year. Simultaneously, the deficit target for the coming fiscal year was reduced slightly to 3.3 per cent from 3.4 per cent.

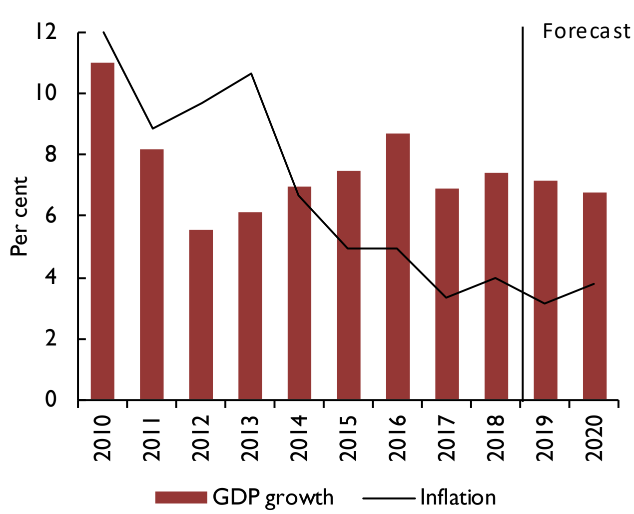
It is currently unclear how the government will balance these twin objectives of stimulating faster growth while controlling public spending. It is possible that the government will seek to support the domestic credit sector, which has been under pressure since the default of one of India's largest non-bank lending companies last year. The announcement of a recapitalisation programme in the budget appears to point towards boosting future credit growth to support the overall economic growth aims.

Inflation fell to 2.4 per cent year-on-year in the first quarter, but May's monthly data indicated a slight pick-up to 3.2 per cent, which is still below the central inflation target of 4 per cent. The Reserve Bank of India reduced the policy rate by 25 basis points in June, which marks the third 25 basis point cut of 2019, and the Reserve Bank has switched its policy stance from neutral to accommodative. In line with this, we forecast inflation to remain below target in 2019, before returning close to target in 2020.

Brazil

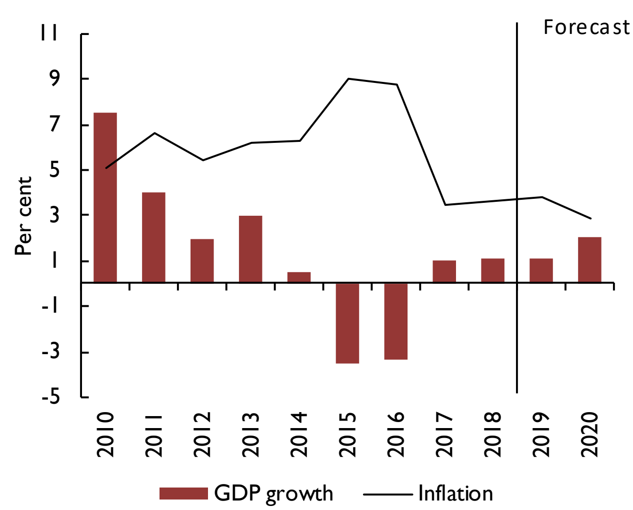
Brazil's central bank (BCB) has significantly revised down its outlook for output growth in 2019, with GDP forecast to grow by 0.8 per cent, down from 2 per cent expected previously. The monetary policy committee (Copom) noted that recent data indicated a "halt" in Brazil's economic recovery: GDP contracted by 0.2 per cent in the first quarter of 2019, the first quarterly fall in GDP since the final quarter of 2016. The contraction was largely due to a decline in gross fixed capital formation and softer household consumption, reflecting weaker business and consumer confidence.

Figure 20. India: GDP growth and inflation



Source: NiGEM database and NIESR forecast.
Note: Inflation is based on CPI.

Figure 21. Brazil: GDP growth and inflation



Source: NiGEM database and NIESR forecast.
Note: Inflation is based on CPI.

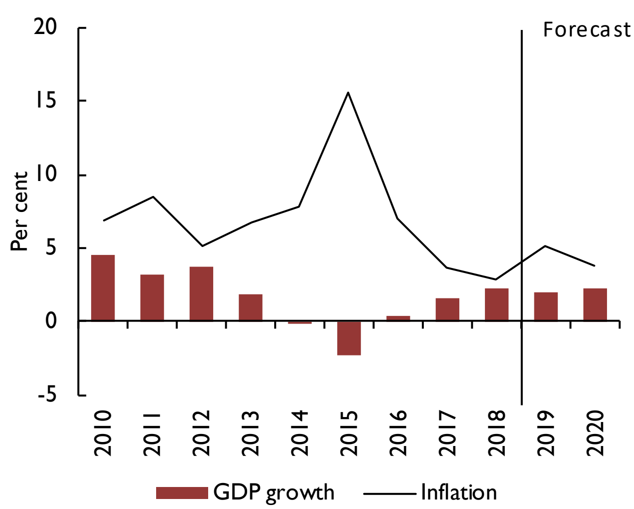
https://doi.org/10.1177/002795011924900106 Published online by Cambridge University Press

While the reduction in the output growth expectation appears substantial, it does bring the BCB's outlook in line with market expectations which have been declining for around four months.

The first quarter outturn was below our expectation and this, combined with steadily declining export growth has led us to revise down our 2019 GDP growth forecast to 1¼ per cent, from 1.9 per cent previously, with stronger growth, at 2 per cent, forecast for 2020. Economic activity could be aided by some fiscal reform and, although the expected savings are lower than the government's original goal of 1.2 trillion reals, the resolution of pension reform will reduce uncertainty and positively impact on business and consumer confidence. Markets appear to have priced in the bill passing, with the Brazilian real trading at 3.8 to the US dollar at the end of June, an appreciation from 4.1 in May.

The slower pace of economic growth has reduced inflationary pressure in the economy, and inflation is forecast to average 4 per cent during 2019 and 2020. The Copom has pointed to the high unemployment rate and low capacity ulitisation as indicating that the economy is operating with significant slack, and so allowing monetary policy to remain broadly accommodative. Favourable food price inflation and lower electricity prices led the committee to maintain the policy rate at 6.5 per cent in June and markets expect that the BCB will implement one or more rate cuts during this year to bring the Selic to around 5½ per cent by the end of the year.

Figure 22. Russia: GDP growth and inflation



Source: NiGEM database and NIESR forecast.
Note: Inflation is based on CPI.

Russia

Higher global oil prices since the low point in early 2016 have helped the Russian economy to return to growth and, after growing by 1.6 per cent in 2017, the economy expanded by 2.3 per cent in 2018 – the fastest annual rate since 2012. The robust GDP activity was supported by strong annual consumption growth of 2 per cent as households front-loaded spending in anticipation of the January 2019 increase in VAT from 18 per cent to 20 per cent.

Our expectation is that output growth will decelerate in 2019 to 1¼ per cent before recovering slowly into 2020 to about 1½ per cent. The slowdown in 2019 is likely to be broad based. Wholesale and retail trade contracted in the first quarter as the VAT increase dented demand whilst, at the same time, industrial output disappointed. Manufacturing output contracted by 1.0 per cent in May after a 4.7 per cent expansion in April. Weather-related European weak demand for natural resources also depressed activity. The recent OPEC+ meeting, which concluded on 2 July, ratified the production constraints on oil, taking these into 2020. However, the budgeted increase associated with the 'national project' in public sector investment spending is likely to feed through as the year passes, and so give a boost to output growth in 2020 relative to this year.

Consumer price inflation has been below the 4 per cent target rate during 2018 but increased to above 5 per cent in the first quarter of this year as the effect of the VAT increase passed through. The broad-based deceleration in growth and benign oil prices appear in the recent inflation data, with inflation weakening from 5.1 per cent in May to 4.7 per cent in June. After raising rates from 7.25 per cent to 7.50 per cent in September last year and again in December to 7.75 per cent (where it held them until the June meeting), the central bank has taken this opportunity to loosen monetary policy a little, by reducing the policy rate to 7.5 per cent. Our forecast is that inflation will be around 4¾ per cent this year and 3¾ per cent next. To the extent that the central bank looks through the temporary nature of the VAT effect, any further weakening in activity is likely to be met with monetary loosening.

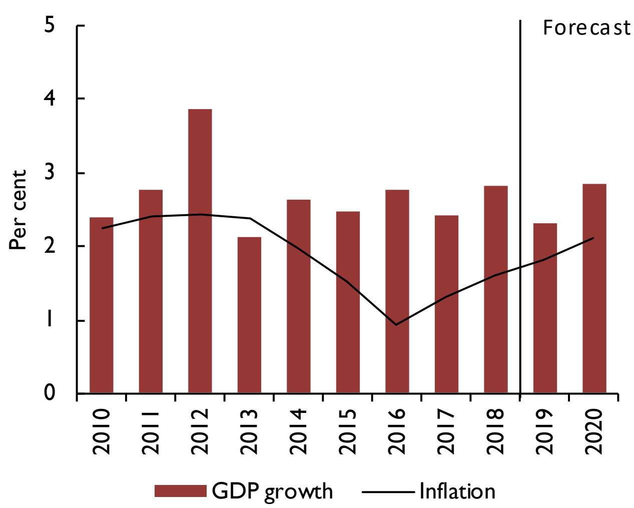
Australia

The Australian economy lost momentum in the second half of last year in line with other economies but, even after allowing for that weakness, the economy expanded by 2.8 per cent in 2018, which is broadly in line with its estimated potential. The weakness in late 2018, however, persisted in the first quarter of this year, with growth at just 0.4 per cent in the quarter. As a result, we forecast GDP growth falling to 2¼ per cent in 2019 before strengthening a little to around 2¾ per cent in 2020.

The most proximate reason for the slowdown is the escalation in the trade dispute between the US and China. The escalation has driven corporate risk premia higher and, at the same time, market expectations for policy rates have turned from tightening to easing in several advanced economies, including Australia.

Since our May forecast, there are increasing signs of rising spare capacity in the labour market. To start with, the unemployment rate nudged up from around 5 per cent at the start of this year to 5.2 per cent in May. Details in the labour market data show that the rise in unemployment is because of higher participation rather than a fall in employment. Employment rose over this period at a robust rate and is expected to continue rising in the near term, albeit at a moderate pace. At the same time, wage growth has remained muted, with private sector wage inflation at 2.4 per cent in the twelve months to the first quarter of this year.

Figure 23. Australia: GDP growth and inflation



Source: NiGEM database and NIESR forecast.
Note: Inflation is based on consumer expenditure deflator.

At 1.5 per cent, annual inflation continues to remain below the target rate of 2–3 per cent. The relatively low inflation outturns registered recently are consistent with subdued rates of wage inflation. There is a risk of dislodged inflation expectations if inflation outturns remain persistently below the target rate. All these factors encouraged the board of the Reserve Bank of Australia to lower the cash rate by 25 basis points to 1.25 per cent in early June.

While there are concerns about domestic risks from debt and house prices, the economic fundamentals remain sound and GDP growth will likely recover to a pace that is close to potential in 2020 and beyond. Monetary policy remains accommodative and the government has injected a fiscal stimulus in the April budget that includes income tax cuts, additional spending on health and a one-off payment to pensioners, single mothers and others. At the same time, the 2 trillion yuan fiscal stimulus announced by the Chinese government is likely to raise GDP in Australia by around 0.2 percentage points (Kara and Liadze, 2019).

In terms of risks, the most important domestic risk relates to household debt and the housing market, with house prices now falling in some areas. The adjustment to house prices has been orderly so far and our forecast assumes that the correction remains orderly. On the external front, trade tensions and commodity prices are the major risk issues. Trade tensions between China and the US have had an adverse impact on Australian exports and investment intentions. An early resolution of the uncertainty presents an upside risk to our forecast, whereas an escalation in tensions will have a negative impact on economic prospects.

NOTES

1 At 2011 PPP weights.
2 'Patient' was the description used by Jerome Powell, Chairman of the Federal Reserve in a speech on 8 March. The 19 June FOMC meeting statement noted that "In light of these uncertainties and muted inflation pressures, the Committee will closely monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion".
3 As detailed by the ECB President in his speech 'Monetary policy in the Euro Area' on 27 March 2019 at Frankfurt-am-Main. The ECB press release from the 6 June meeting noted that "The Governing Council now expects the key ECB interest rates to remain at their present levels at least through the first half of 2020, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to levels that are below, but close to, 2% over the medium term".
4 The Vix index is seen as a barometer of investor sentiment and market volatility and is a measure of market expectations of uncertain volatility implied by S&P 500 index option prices.

https://doi.org/10.1177/002795011924900106 Published online by Cambridge University Press

5 Bloomberg reported on 3 July 2019 that "[President] Trump tweeted that Europe and China are playing a 'big currency manipulation game'", https://www.bloomberg.com/news/articles/2019-07-03/be-prepared-for-anything-as-trump-slams-europe-china-on-tax.
6 See National Bureau of Economic Research at https://www.nber.org/cycles/main.html.
7 Rapport économique, social et financier (2018) at https://www.tresor.economic.gouv.fr/Articles/2017/10/03/publication-du-rapport-economique-social-et-financier-plf-pour-2018.
8 Reported in Japan Times, 15 October 2018.

REFERENCES

Aksoy, Y., Basso, H.S. and Smith, R.P. (2017), 'Medium-run implications of changing demographic structures for the macro-economy', *National Institute Economic Review*, 241, August.

Carreras, O. and Kirby, S. (2016), 'Is the global trade slowdown a risk to our forecast outlook?', *National Institute Economic Review*, February, 235, F14–15.

Carreras, O. and Ramina, M. (2017), 'The risk from increased trade protectionism', NiGEM Observations, No. 11.

Constantinescu, C., Mattoo, A. and Ruta, M. (2014), 'Slow trade', *Finance & Development*, 51(4).

Hantzsche, A. and Liadze, I. (2018), 'The war on trade: beggar thy neighbour – beggar thyself?', *National Institute Economic Review*, May, F46–7.

Hurst, I. and Liadze, I. (2019), 'Fiscal stimulus in China to boost global growth', *National Institute Economic Review*, May, F53.

Kara, A. and Liadze, I. (2019), 'The textbook response: using Chinese fiscal policy to offset US tariffs', NIESR blog, 2 May.

Lennard, J. (2018), 'The great synchronisation', *National Institute Economic Review*, 244, May, F40.

Lenoel, C. (2017), 'Simulation of French 5-year fiscal plan', *National Institute Economic Review*, 242, November, F55–7.

— (2018), 'Predicting recessions in the United States with the yield curve', *National Institute Economic Review*, May, F42–3.

—(2019), 'Is the US yield curve signalling that a recession is on the way?', *National Institute Economic Review*, May, F42–3.

Liadze, I. (2018), 'Trade wars – the saga continues', *National Institute Economic Review*, November, F38–9.

Liadze, I. and Hacche, G. (2017a), 'The macroeconomic implications of increasing tariffs on US imports', NiGEM Observations, No 12.

—(2017b), 'US monetary policy and its impact on emerging market economies', *National Institute Economic Review*, 240, May, F62–3.

Liadze, I. and Naisbitt, B. (2018), 'Global spillover effects of US monetary tightening', *National Institute Economic Review*, 246, November, F42–3.

Liadze, I. and Piggott, R. (2019), Japan consumption tax increase', *National Institute Economic Review*, 247, February, F65.

Naisbitt, B. (2018a), 'The re-emergence of concerns about debt', *National Institute Economic Review*, May, F44.

—(2018b),'The risks of rising global indebtedness', *National Institute Economic Review*, August, F4–9.

—(2019a) 'The risks from rising real house prices', *National Institute Economic Review*, February, 247, F55–57.

—(2019b), 'Will the 2010s be viewed as a period of global growth and stability?', NIESR blog, 30 April.

Rincon-Aznar and de Guevara, F. (2019), 'Structural reforms in Spain, a long and winding road', NIESR blog, 11 July

Rincon-Aznar, A., de Guevara, F., Forth, J., Maudos, J., Molla, S., Perez-Garcia, F., Llano, C. and Perez-Balsalobre, S. (2019), 'Structural Reforms in Spain', Brussels: European Commission.

Rudebusch, G. (2016) 'Will the economic recovery die of old age', *Federal Reserve Bank of San Francisco Economic Letter*, 2016-03, February.

Shin, H.S. (2019), 'What is behind the recent slowdown?', Presentation at the 'Public Finance Dialogue' workshop, German Federal Ministry of Finance and Centre for European Policy Research, May 2019.