GLOBAL ECONOMIC OUTLOOK

Q1 2016

CAPITAL ECONOMICS

Market turmoil not justified by economic reality

- China's economy likely to rebound, not collapse
- Advanced economies should grow at a steady pace...
- US Fed will still raise rates faster than markets expect...
- Oil price to recover but remain below $50pb this year
- ...while inflation is set to stay lower for longer
- ...but the ECB and BoJ will probably ease policy further

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Cover image by Bobby Gunthorpe

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Executive Summary

- Despite the prevailing gloom about the world economy, we think global growth will pick up from around 2½% last year to 3% in both 2016 and 2017, using our own estimates for China. Growth should be little changed in the US this year and will probably slow a bit in the euro-zone. However, we expect activity in China to rebound in response to last year's fiscal and monetary stimulus, while some other emerging economies should stabilise as commodity prices rebound. With inflation set to stay low for longer than previously expected, central banks will keep monetary policy ultra-loose.

- The outlook for the **US** economy is reasonably bright. Admittedly, export-oriented manufacturers have been hit hard by the 20% appreciation of the dollar over the past eighteen months and net trade will remain a drag on growth for some time yet. In addition, activity and investment in the mining sector have collapsed because of the slump in energy prices. But the much larger services sector is doing well. Employment growth is likely to remain strong, causing the unemployment rate to fall below 5%. This in turn should support consumption growth and prompt wage inflation to pick up later this year. Against that backdrop, the Fed is still likely to raise rates more rapidly than expected by the markets.

- The recovery in the **euro-zone** is likely to slow a little. Even if the oil price and the euro remain at their current levels, headline inflation will rise, dampening the growth of real incomes, while the boost to exports from the weaker exchange rate has already begun to wane. Moreover, although austerity has largely ended, there is little scope for fiscal stimulus. The combination of weak growth and below-target inflation is likely to persuade the ECB to step up the pace of its asset purchases again, perhaps as soon as Q2 this year.

- The Bank of **Japan** is also likely to ease policy further. The Japanese economy returned to growth at the end of last year, unemployment has fallen steadily and the inflation rate, excluding fresh food and energy, has risen. But we doubt that the pick-up in inflation will be sustained. Trade unions are entering spring wage talks with lower demands than last year. If pay settlements are as weak as we expect, the Bank of Japan is likely to boost QE again, perhaps as soon as April. This in turn should prompt a renewed slide in the yen.

- The **UK** economy faces a number of headwinds, including the prospect of renewed austerity and uncertainty ahead of the referendum on EU membership which may take place as soon as June. However, it should be able to withstand these pressures fairly well. Growth in employment is boosting incomes and households are less indebted and more confident than they were a few years ago. With inflation likely to rise slowly, we expect the Bank of England to raise rates by only 25bp this year and to tighten policy gradually thereafter.

- Having slowed abruptly in the second half of last year, **Canada**'s economy looks set to remain very weak this year. The collapse in energy prices has already taken a heavy toll on the mining sector and we anticipate a slump in housing investment too. That said, if oil prices rebound in line with our forecast, Canada's export revenues should recover.

- The economies of **Australia** and **New Zealand** have, so far, proved resilient in the face of weak commodity prices. Growth will probably be a little below 2½% in both countries for a second successive year. In Australia, lower investment in the mining sector will continue to be a big drag on activity for some time yet, and prospects for the housing market have deteriorated. But the recent improvement in the labour market points to steady growth of household consumption.

- Our in-house estimates indicate that GDP growth in **China** slowed sharply in early 2015 but has since been fairly stable. We expect activity to rebound this year in response to policy stimulus which has already been implemented. Fiscal policy has become more expansionary and credit growth has picked up since monetary policy was eased last year. With growth prospects improving and the current account surplus likely to remain high, a major slide in the renminbi seems unlikely. That said, the currency could weaken further against the dollar as the authorities are now managing it against a trade-weighted basket.

- After several years of slow growth, **India**'s economy has been boosted by low oil prices and looser monetary policy. External vulnerabilities have also diminished. However, with little room for further policy stimulus, growth is unlikely to accelerate much in the coming years. Longer-term prospects depend on progress in tackling the country's structural problems. This is likely to be painfully slow due to lack of political consensus.

- Economic activity in the rest of **emerging Asia** should gain more momentum this year. The countries which are best placed to benefit from the rebound which we anticipate in China are **Hong Kong**, **Korea**, **Singapore** and **Taiwan**. In contrast, the persistence of low commodity prices will hold back the recoveries in **Indonesia** and **Malaysia**, while **Thailand** is still struggling due to political instability.

- Prospects for **emerging Europe** are mixed. The countries of central Europe, including Poland and the Czech Republic, are benefiting from rising incomes and employment, helped by the moderate growth in Germany. In contrast, the outlook for **Russia** remains bleak. The best that can be hoped for this year is that the economy comes out of recession, but even that is far from certain. **Turkey** also faces big challenges. Its large current account deficit, weakening exchange rate and high inflation will force its central bank to raise interest rates further, dampening demand.

- **Latin America** is likely to do no more than stagnate this year. **Brazil** will probably remain in recession as both fiscal and monetary policy will be tightened further and the current policy paralysis is likely to continue. However, provided we are right in forecasting a recovery in commodity prices, other economies in Latin America should fare better. The election of a more reform-friendly government in **Argentina** has improved long-run prospects, but its economy first needs stabilising.

- The slump in oil prices has clouded the outlook for oil producers in the **Middle East**. Indeed, **Saudi Arabia** has already slashed energy subsidies and is planning large public spending cuts. In contrast, prospects for the net oil consumers in **North Africa** have brightened.

- Finally, weak growth in the three largest economies in **sub-Saharan Africa** will drag down the entire region. **Nigeria** and **Angola** are struggling to adjust to lower oil prices while **South Africa**'s economy is being held back by entrenched structural problems, power shortages and low export prices.

Main Forecasts

Table 1: Real GDP (% Annual Change at PPP Exchange Rates)

	World Share[1]	Average 2002–2011	2012	2013	2014	2015e	Forecasts 2016	2017
World (Official China data)	*100*	4.1	3.4	3.3	3.4	2.9	3.2	3.3
World (CE China estimate)	*100*	3.9	3.2	3.1	3.1	2.4	3.1	3.2
Advanced Economies	*42.9*	1.8	1.2	1.1	1.8	1.8	1.9	1.7
US	*15.9*	1.7	2.2	1.5	2.4	2.4	2.5	2.0
Euro-zone	*12.0*	1.1	-0.8	-0.3	0.9	1.5	1.2	1.5
- Germany	*3.4*	1.1	0.6	0.4	1.6	1.4	1.0	1.7
- France	*2.4*	1.2	0.2	0.7	0.2	1.1	1.0	1.5
- Italy	*2.0*	0.2	-2.8	-1.7	-0.4	0.7	1.0	0.5
Japan	*4.4*	0.7	1.7	1.6	-0.1	0.7	1.5	0.5
UK	*2.4*	1.7	0.7	1.7	2.9	2.2	2.2	2.7
Canada	*1.5*	2.0	1.9	2.0	2.5	1.2	1.0	1.5
Australia	*1.0*	3.1	3.6	2.1	2.6	2.3	2.3	3.0
Emerging Economies[3]	*57.1*	6.4	5.0	4.6	4.2	3.0	4.3	4.5
Emerging Asia[3]	*33.1*	7.8	5.9	5.9	5.6	4.4	5.7	5.5
- China (Official data)	*16.6*	10.6	*7.7*	*7.7*	7.3	6.9	6.8	6.5
- China (CE estimate)[2]	*16.6*	10.1	7.0	6.5	5.8	4.3	6.5	6.0
- India	*6.8*	*7.7*	5.1	4.7	5.2	5.5	6.0	6.5
- S. Korea	*1.6*	4.4	2.3	2.9	3.3	2.6	3.0	2.5
Emerging Europe	*7.3*	4.6	2.2	1.9	1.4	-0.5	1.8	2.0
- Russia	*3.3*	4.8	3.4	1.3	0.6	-3.5	0.3	0.5
- Turkey	*1.4*	5.5	2.1	4.2	2.9	3.0	1.5	2.5
Latin America	*8.4*	3.8	3.1	2.9	0.9	-0.5	0.3	2.5
- Brazil	*3.0*	3.9	1.8	2.7	0.1	-3.5	-2.3	2.0
- Mexico	*2.0*	2.3	4.0	1.4	2.1	2.5	3.0	3.5
MENA	*4.7*	5.5	4.6	3.0	3.4	3.0	2.0	2.3
- Saudi Arabia	*1.5*	6.1	5.4	2.7	3.5	3.4	1.5	1.0
- Egypt	*0.9*	4.8	2.2	1.5	4.3	3.5	3.0	4.0
Sub-Saharan Africa	*2.4*	6.3	4.2	4.9	4.9	2.9	3.8	4.5
- Nigeria	*1.0*	8.5	4.3	5.5	6.2	2.5	3.2	4.0
- South Africa	*0.7*	3.5	2.2	2.2	1.5	1.3	1.3	1.8

(1) % of world GDP in 2014 PPP terms. (2) Estimates based on our China Activity Proxy (CAP). (3) We use CAP-derived GDP estimates for China in aggregates for emerging Asia, emerging economies, and the world.

Main Forecasts (Continued)

TABLE 2: OTHER MAIN FORECASTS

Inflation and world trade are year average, market forecasts are end period

	Latest (20th Jan.)	Average 2002-2011	2012	2013	2014	2015	Forecasts 2016	2017
Inflation								
World	2.0	2.8	3.0	2.6	2.5	1.8	2.1	2.7
G7	0.4	1.9	1.9	1.3	1.5	0.3	0.9	2.2
US	0.5	2.4	2.1	1.5	1.6	0.1	1.1	2.6
Euro-zone	0.2	2.1	2.5	1.3	0.4	0.0	0.5	1.5
Japan	0.3	-0.2	0.0	0.4	2.8	0.8	0.5	2.5
UK	0.1	2.4	2.8	2.6	1.5	0.0	1.1	1.7
China	1.6	2.6	2.6	2.6	2.0	1.4	2.5	2.5
World Trade (1)	0.5	5.7	2.9	3.3	3.3	1.5	3.0	3.0
Exchange Rates								
US$ / €	1.09	1.31	1.32	1.38	1.21	1.09	1.00	1.00
Yen / US$	117	102	86	105	120	120	130	140
US$ / £	1.42	1.72	1.63	1.66	1.56	1.47	1.40	1.50
Interest Rates								
US (2)	0-0.25	1.9	0-0.25	0-0.25	0-0.25	0.25-0.5	1.5-1.75	2.75-3.00
Euro-zone (3)	0.05	2.2	0.75	0.25	0.05	0.05	0.05	0.05
Japan (4)	0-0.1	0.2	0-0.1	0-0.1	0-0.1	0-0.1	0-0.1	0-0.1
UK	0.5	3.1	0.5	0.5	0.5	0.5	0.75	1.25
Bond Yields (5)								
US	2.0	3.7	1.8	3.0	2.2	2.3	3.0	3.5
Germany	0.5	3.5	1.3	1.9	0.5	0.6	0.8	1.3
Japan	0.2	1.3	0.8	0.7	0.3	0.3	0.5	0.5
UK	1.6	4.0	1.8	3.0	1.8	2.0	2.5	3.0
Commodities								
Oil (6)	28	63	110	111	56	36	45	60
Gold (7)	1096	813	1,662	1,208	1,186	1,062	1,250	1,250

(1) Volume of trade in goods , (2) Federal Funds target rate, (3) ECB refi (middle) rate, (4) Bank of Japan overnight rate, (5) 10 year gov't bond yields, (6) Brent ($ per barrel), (7) $ per ounce.

Global Overview

Market turmoil not justified by economic reality

- Prospects for growth in advanced economies remain reasonably bright. We expect aggregate GDP to expand at about the same pace this year as in 2014 and 2015. In contrast, growth in emerging markets, which has slowed sharply since 2010 (see Chart 1) is likely to pick up slightly.
- This would lift growth of the world economy as a whole to around 3% or so this year, which is consistent with the latest global composite business surveys. (See Chart 2.)
- Household consumption in advanced economies should expand at a steady pace in the coming year or two. Admittedly, the windfall from lower energy prices, which has boosted household spending in Europe, will be smaller than it was last year – even if oil prices remain at their current low levels.
- However, employment should continue rising at a decent pace. Tightening labour markets have not yet led to faster growth of average wages but surveys suggest that wage growth will pick up soon in the US, though not in the euro-zone or Japan.
- Fiscal policy should no longer be a major drag on growth. (See Chart 3.) Indeed, austerity is likely to be relaxed a bit in southern euro-zone economies, and Germany will need to boost government spending to support the influx of refugees.
- We expect the oil price to rebound strongly in the coming years because the long-run cost of production is typically at least $50 per barrel in non-OPEC countries. (See Chart 4.) Supply cuts are likely to accelerate in the US in the coming months and this should eventually bring supply and demand back into balance. (See Chart 5.) Nonetheless, oil prices will remain a long way below their average of over $100pb between 2010 and 2014.
- Headline inflation in advanced economies will increase later this year than previously expected, before rising more sharply during 2017. (See Chart 6.) Lower inflation this year should encourage most central banks to keep policy ultra-loose, with the ECB and Bank of Japan likely to ease policy further in the coming months.
- In most economies, there seems to be little threat of deflation given that core inflation and inflation expectations have remained firmly positive. And in the US, where the labour market is relatively strong and wage inflation is likely to pick up, we expect the Fed to raise rates faster than anticipated by the markets over the next two years. (See Chart 7.)
- Our in-house estimates suggest that China's growth rate has been much lower than indicated by official figures for several years, but that it has been stable for the past twelve months. Indeed, GDP growth actually picked up in the final quarter of last year after stripping out the effects of the volatility in the equity market. (See Chart 8.) We expect activity there to strengthen this year as credit growth picks up. In these circumstances, the authorities will be able to keep the renminbi broadly stable in trade-weighted terms.
- Our forecast for a gradual recovery in commodity prices suggests that the worst may now be over for a number of other emerging economies. That said, Russia's economy is likely to do no better than stabilise in 2016, and Brazil is facing another year of recession, compounded by its mounting political and fiscal problems.

Global Charts

Chart 1: GDP (% y/y)

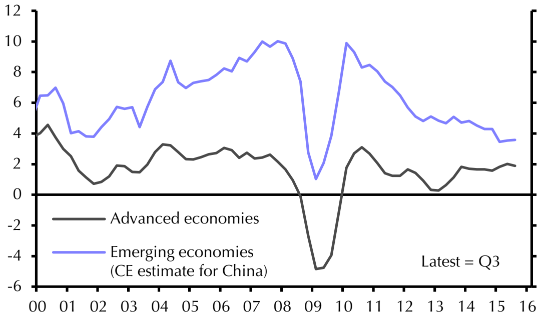


Chart 2: Global Composite PMI & World GDP

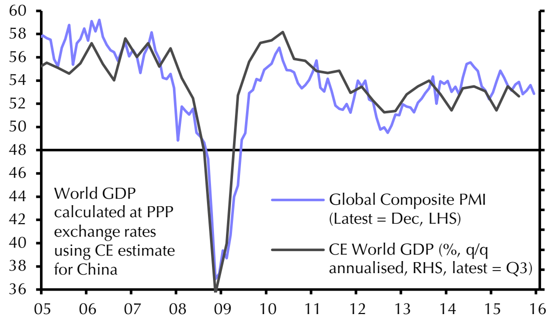


Chart 3: Change in Cyclically-Adjusted Budget Balance (Advanced Economies, % of GDP)

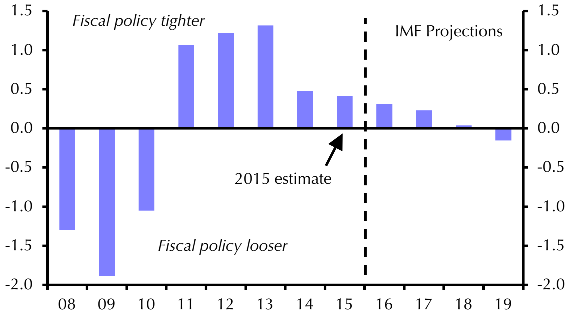


Chart 4: Estimates of Oil Production Costs (US$ Per Barrel)

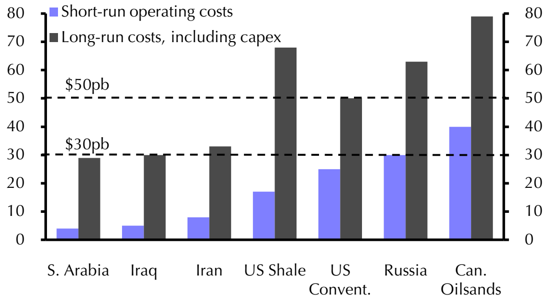


Chart 5: Global Oil Production & Consumption (Mn Bpd)

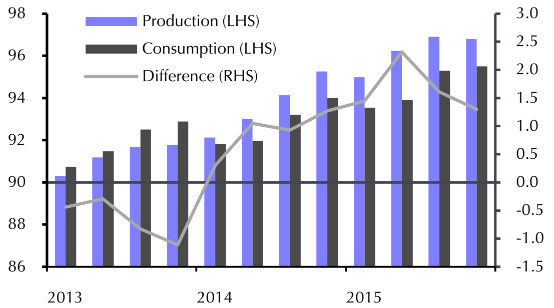


Chart 6: OECD CPI Energy & Oil Price (% y/y)

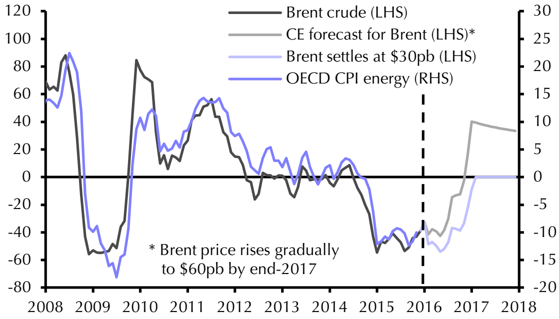


Chart 7: Key Policy Rates (%)

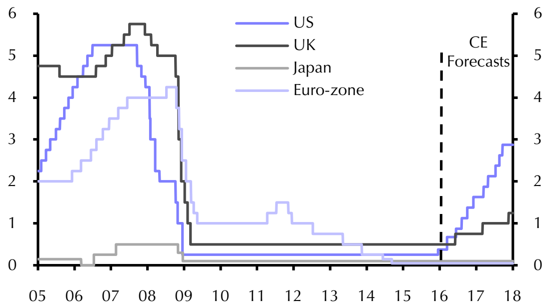
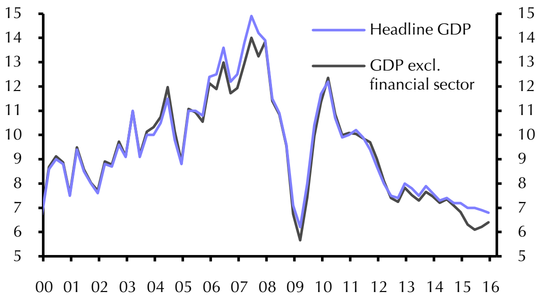


Chart 8: China GDP Growth (% y/y)



Sources – Thomson Datastream, Markit, IMF, CE

United States

Domestic fundamentals remain solid

- We expect GDP growth of 2.5% this year, as solid domestic demand more than offsets the drag from external trade. Beyond that, however, we anticipate that higher interest rates will trigger a slowdown to 2.0% in 2017.
- Our calculations indicate that fourth-quarter GDP growth was only 1.0% annualised. But there have been a number of temporary slowdowns and even quarterly contractions during this recovery, which all proved to be temporary blips. (See Chart 1.) We see no reason why this time will be any different.
- Admittedly, the ISM manufacturing index has fallen below the 50 mark, but the non-manufacturing index is still at a relatively healthy level. (See Chart 2.) Export-orientated manufacturing has been hit hard by the 20% surge in the dollar over the past 18 months.
- Real exports peaked a year ago, while imports have continued to trend higher, with net external demand subtracting about 0.5% points from GDP growth last year. (See Chart 3.) The drag will be similar in 2016.
- The slump in oil prices resulted in a big collapse in drilling activity and investment but, up to now, actual oil production has held up quite well. (See Chart 4.) The drag on investment will fade in 2016, although domestic oil production will finally begin to decline more significantly.
- Consumption growth will probably slow a little in 2016, but should remain close to 3%, driven by improvements in the labour market. Employment growth has been unusually strong in recent years and, with labour market slack disappearing, we anticipate a pick-up in wage growth soon. (See Charts 5 & 6.)
- Lower commodity prices will keep headline inflation below 2% this year, but rising domestic price pressures will push core inflation higher. (See Chart 7.)
- In that environment, we expect the Fed to increase interest rates a little more aggressively than the markets do, with the fed funds rate at slightly more than 1.5% by end-2016 and nearly 3% by end-2017. (See Chart 8.)

TABLE 3: UNITED STATES

% change on a year earlier

	Average 04 - 13	2014	2015e	Forecasts 2016	Forecasts 2017
GDP	1.7	2.4	2.4	2.5	2.0
Private cons'ptn	1.7	2.7	3.2	2.7	2.2
Total fixed invest.	1.1	4.1	4.0	3.8	3.5
Gov't cons'ptn	0.4	-0.4	0.2	2.0	1.2
Stockbuilding(1)	0.1	0.0	0.0	0.0	0.0
Dom'stic demand	1.5	2.5	3.2	2.9	2.2
Exports	5.5	3.4	1.8	0.5	2.0
Imports	3.3	3.8	5.6	2.1	2.3
Consumer prices	2.3	1.6	0.1	1.1	2.6
Real disp. income	1.9	2.7	3.6	2.5	2.5
H'hold sav. ratio(2)	4.9	4.8	5.3	5.0	5.2
Employment	0.6	1.6	1.7	1.3	1.3
Unemployment(3)	6.7	6.2	5.3	4.7	4.5
Interest rate(4)	2.3	0.1	0.4	1.6	2.9
Fed gov't bal.(1)	-4.6	-2.8	-2.5	-2.4	-2.3
Current account(1)	-4.2	-2.2	-2.5	-2.5	-2.5

(1) As a % of GDP
(2) As a % of disposable income
(3) Unemployment rate, end of period
(4) Fed funds rate at end of period

United States Charts

Chart 1: Real GDP (% q/q Annualised)

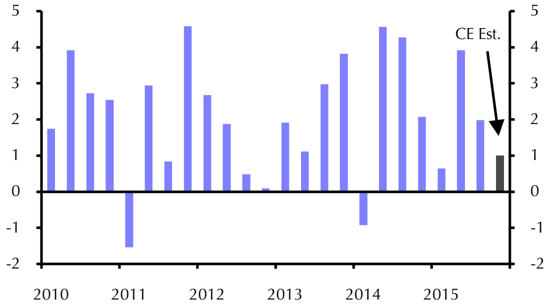


Chart 2: ISM Activity Indices

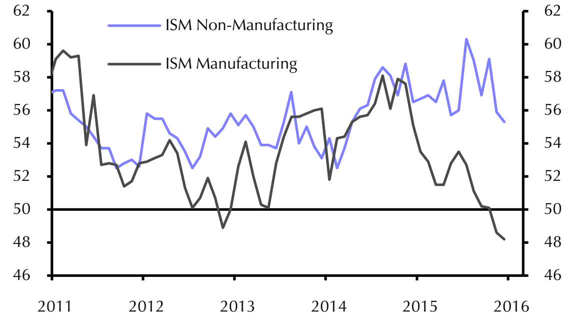


Chart 3: Real Exports & Imports (Jan. 2012 = 100)

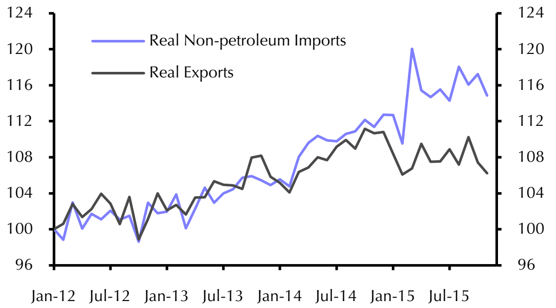


Chart 4: US Oil Rig Count & Production

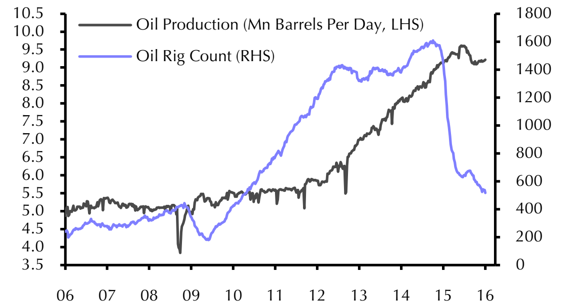


Chart 5: Change in Non-Farm Payroll Employment (000s)

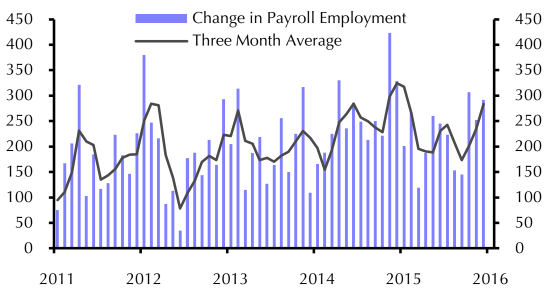


Chart 6: Wages (% y/y)

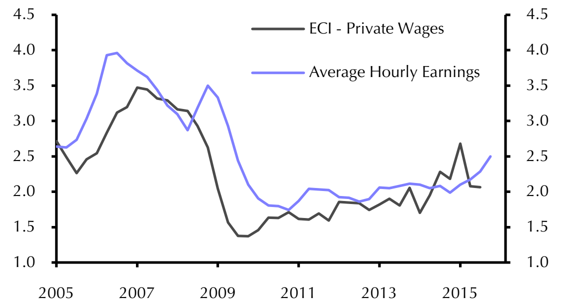


Chart 7: CPI Inflation (%)

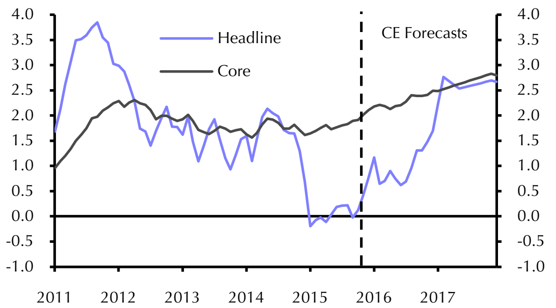
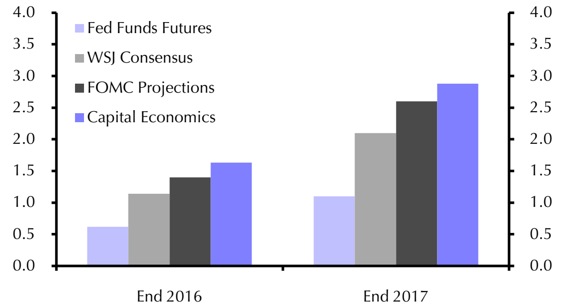


Chart 8: Fed Funds Rate Projections (%)



Sources – Thomson Datastream, CE

CAPITAL ECONOMICS

Euro-zone

Growth to slow as consumer recovery loses steam

- In contrast to most forecasters, we expect the euro-zone's fragile economic recovery to lose pace in 2016 as the consumer upturn runs out of steam.
- Survey indicators suggest that the euro-zone economy gained some momentum at the end of last year. The composite PMI points to a quarterly expansion in Q4 of about 0.4% after Q3's 0.3%, while the EC's measure of economic sentiment points to annual growth of 2% or more. (See Charts 1 & 2.)
- But the hard data have painted a significantly less upbeat picture. In particular, there are signs that the recovery in household spending – which accounted for nearly all of the pick-up in GDP growth last year – is running out of steam. Indeed, monthly retail sales data suggest that household spending may have fallen in Q4 for the first time since early 2013. (See Chart 3.)
- What's more, spending growth could slow further in 2016 as the boost to real incomes from lower inflation goes into reverse. As Chart 4 shows, even if oil prices and the euro hold steady, headline inflation is likely to rise to 1% or so by the end of the year.
- At the same time, the boost to the growth of exports from the previous decline in the euro already appears to be fading. (See Chart 5.) And while the euro-zone's direct trade links to China are limited (see Chart 6), the uncertain global environment could offset the beneficial impact of any further euro declines.
- One potentially more positive influence is the stance of fiscal policy across the region, which is set to loosen marginally according to EC projections. (See Chart 7.) But the cumulative impact of the previous austerity could continue to weigh on growth for some time yet.
- Accordingly, we think that consensus and official forecasts that the recovery will gather more pace this year will prove too optimistic. Indeed, we expect growth to slow to just to above 1% in 2016 before picking back up again moderately next year. (See Chart 8.)
- Against this background, the pressure on the ECB to step up its policy support further is likely to build and we have pencilled in an acceleration of its asset purchases, perhaps accompanied by another interest rate cut, in the second quarter of the year.

TABLE 4: EURO-ZONE

% change on a year earlier

	Average 04 - 13	2014	2015e	Forecasts 2016	Forecasts 2017
GDP	0.9	0.9	1.5	1.2	1.5
Private cons'ptn	0.5	0.8	1.6	1.0	1.5
Total fixed invest.	1.3	1.3	2.2	1.5	2.0
Gov't cons'ptn	-0.1	1.5	1.5	1.0	0.0
Stockbuilding[(1)]	0.0	0.0	-0.2	0.0	0.0
Dom'stic demand	0.5	0.9	1.4	1.3	1.5
Exports	4.0	4.1	4.8	2.3	2.1
Imports	3.3	4.5	5.1	2.5	2.0
Consumer prices	2.0	0.4	0.0	0.5	1.5
Producer prices	2.1	0.0	-2.6	-1.0	0.5
Employment	0.3	0.6	1.1	0.5	0.6
Unemployment[(2)]	9.5	11.6	10.9	10.5	10.0
Interest Rate[(3)]	1.8	0.05	0.05	0.05	0.05
Gen'l gov't bal.[(1)]	-3.2	-2.4	-2.3	-2.1	-1.9
Current account[(1)]	-0.6	2.1	1.7	1.7	1.9

(1) As a % of GDP
(2) Unemployment rate
(3) ECB refinancing rate at end of period

Euro-zone Charts

Chart 1: Composite PMI & GDP

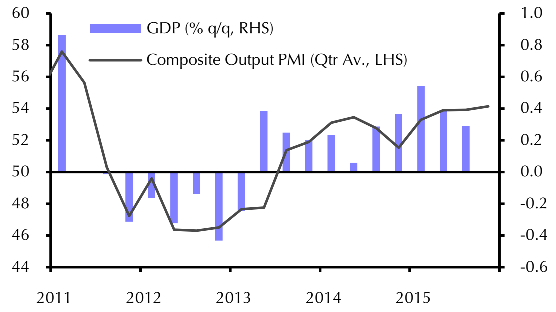


Chart 2: EC Economic Sentiment & Euro-zone GDP

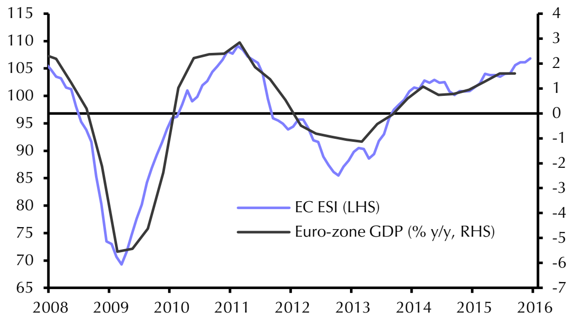


Chart 3: Retail Sales & Household Spending

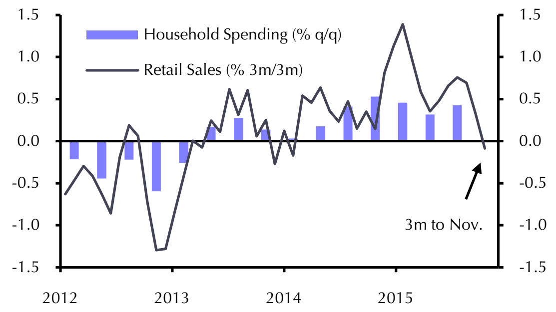


Chart 4: Consumer Price Inflation

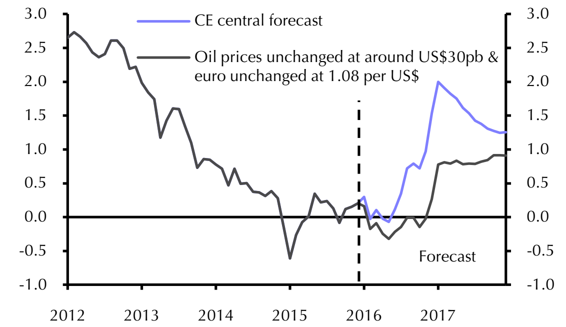


Chart 5: Trade-Weighted Euro & Euro-zone Exports

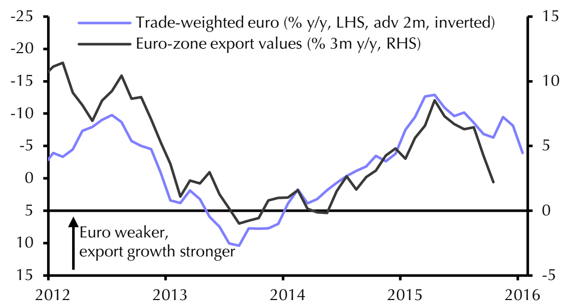


Chart 6: Exports by Destination (% of total, 2014)

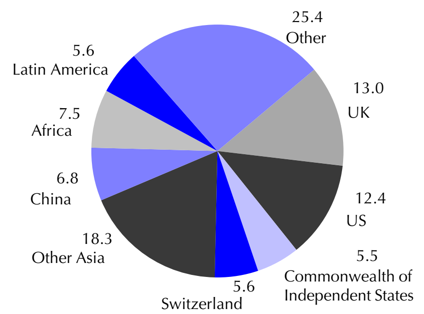


Chart 7: Change in Euro-zone Cyclically Adjusted Budget Position (% of GDP)

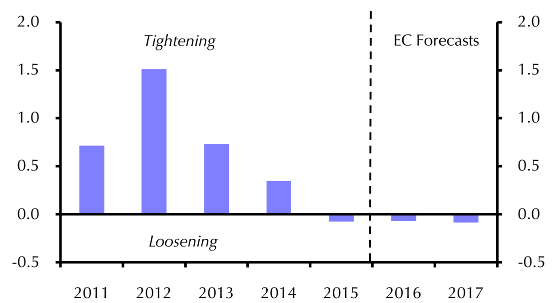
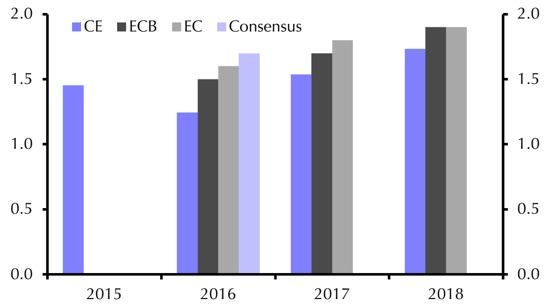


Chart 8: GDP Growth Forecasts (% y/y)



Sources – EC, ECB, Markit, Thomson Datastream, CE

Japan

Spring wage negotiations may force BoJ's hand

- Domestic demand should pick up speed ahead of next year's sales tax hike. However, sluggish wage growth and falling inflation expectations suggest that the Bank of Japan still has more work to do to reach its inflation target.
- The economy has returned to growth following a slowdown in summer, and both the manufacturing PMI as well as firms' output projections suggest that growth picked up at the start of the new year. (See Chart 1.)
- Domestic demand is set to strengthen ahead of the sales tax hike scheduled for April next year as consumers bring forward spending. However, activity will surely slump once the tax has been raised. (See Chart 2.)
- The labour market has continued to tighten steadily and the survey point to a further decline in unemployment. (See Chart 3.) Indeed, we expect the jobless rate to fall below 3% in the coming months.
- The Bank of Japan has traditionally focused on inflation excluding fresh food, which remains around zero. However, policymakers have recently shifted their attention to a new price gauge that strips out both energy prices and fresh food. On that basis, inflation has climbed to a fresh high lately. (See Chart 4.)
- With economic activity set to strengthen, the output gap should narrow ahead of the sales tax hike. On past form, though, underlying inflation is unlikely to rise any further from current levels. (See Chart 5.)
- Wage growth should edge higher as the labour market continues to tighten. But we expect it to reach a modest 1% by the end of this year (see Chart 6), which would be broadly in line with long-term productivity growth. As such, the labour market is unlikely to create major cost pressures.
- Survey-based inflation expectations have weakened (see Chart 7), but the Bank is placing more emphasis on the upcoming spring wage negotiations (Shunto). Unfortunately, trade unions are entering the talks with lower pay demands than last year in response to subdued price gains.
- First results of the Shunto should become available by March. If pay hikes are subdued as we expect, the Bank of Japan may step up the pace of easing at its end-April meeting. This should result in a renewed weakening of the yen, and together with a rebound in crude oil prices, should boost inflation by early next year. (See Chart 8.)

TABLE 5: JAPAN

% change on a year earlier

	Average 04- 13	2014	2015e	Forecasts 2016	2017
GDP	0.8	-0.1	0.7	1.5	0.5
Private cons'ptn	1.0	-0.9	-1.0	1.0	0.5
Private investm't	0.3	1.6	0.5	3.0	1.0
Public demand	0.4	0.3	0.7	0.5	0.5
Dom'stic demand	0.7	-0.4	0.2	1.0	0.5
Exports	4.4	8.3	3.2	3.0	3.0
Imports	2.9	7.3	0.4	0.5	1.0
Consumer prices	-0.1	2.8	0.8	0.5	2.5
(Excl. tax hikes)	-0.1	1.2	0.3	0.5	1.5
Unemployment(1)	4.4	3.6	3.4	3.1	2.8
Interest rate(2)	0.1	0.1	0-0.1	0-0.1	0-0.1
Monetary Base(3)	108	276	356	440	530
Gen'l gov't bal.(4)	-6.7	-7.3	-5.5	-5.0	-4.5
Current account(4)	3.0	0.5	3.5	2.5	1.0

(1) Unemployment rate
(2) Overnight call rate at end of period
(3) Yen Trillion at end of period
(4) As a % of GDP

Japan Charts

Chart 1: Industrial Production & Manufacturing PMI

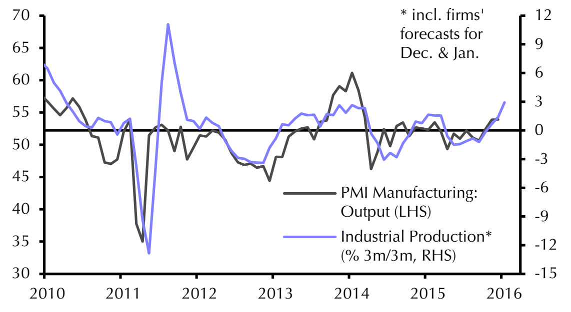


Chart 2: GDP

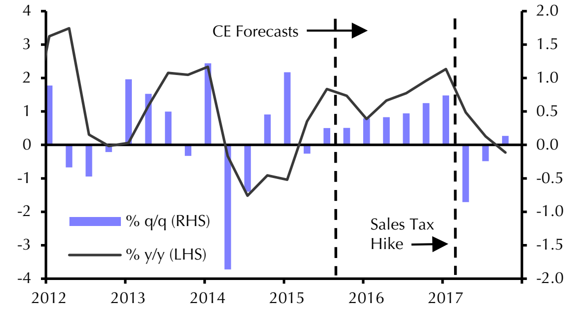


Chart 3: Tankan Employment & Unemployment Rate

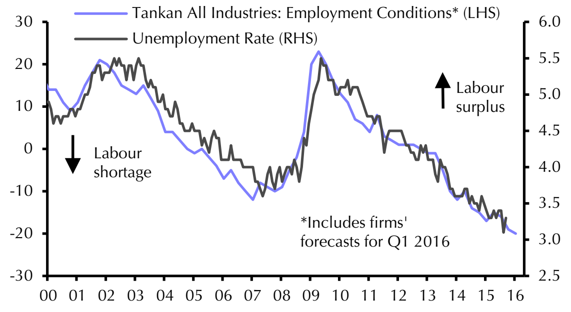


Chart 4: Consumer Prices (Excl. Tax, % y/y)

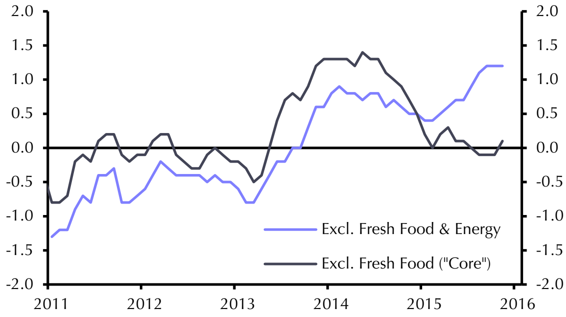


Chart 5: Output Gap & Consumer Prices

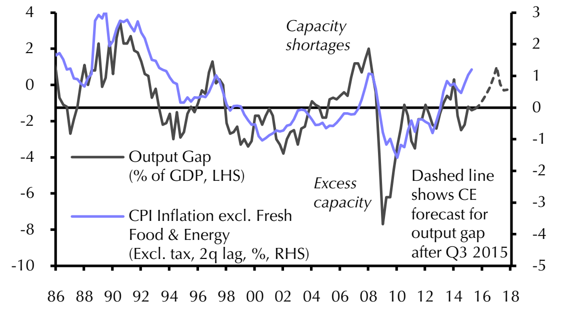


Chart 6: Unemployment Rate & Labour Cash Earnings

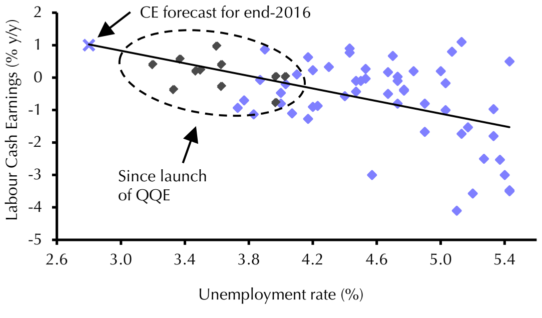


Chart 7: Tankan Inflation Expectations (Annual %-Change Over Coming 5 Years)

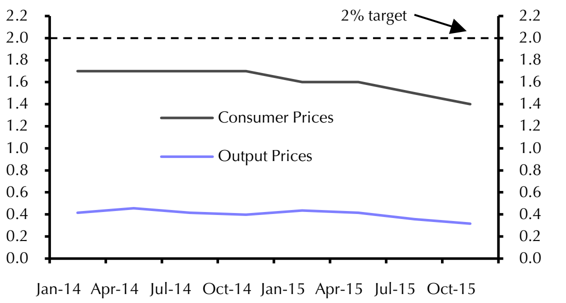
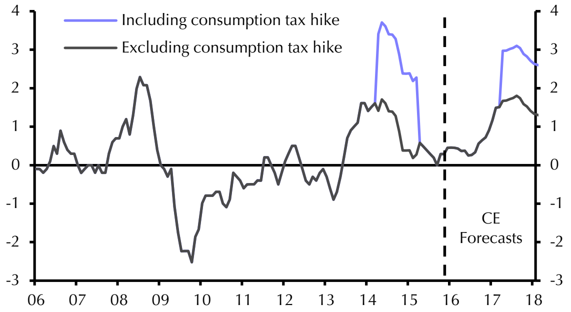


Chart 8: Consumer Prices (% y/y)



Sources – Thomson Datastream, CE

United Kingdom

Economy to weather threats fairly well

- A number of factors threaten to undermine the recovery in 2016. However, we think that the economy should weather these relatively well and expect growth of just over 2% again this year. With inflation building only slowly, interest rates will rise only gradually.
- The boost to household incomes from low inflation should fade as inflation picks up to around 1% by spring, thanks to previous falls in energy prices dropping out of the annual comparison. But inflation should only rise fairly slowly thereafter, and remain below its 2% target until 2018. (See Chart 1.) This means that the support to real incomes should decline only gradually. (See Chart 2.)
- While uncertainty ahead of the EU referendum and the resumption of the fiscal squeeze are further threats to growth in 2016 (see Chart 3), we think that the UK economy is well-placed to contend with them. So we expect the economy to continue growing at a similar pace to last year. (See Chart 4.) The unemployment rate will probably nudge down a bit further to around 5%. (See Chart 5.)
- However, growth is likely to be fairly unbalanced, with little contribution from the manufacturing and external sectors. (See Chart 6.) Regional divergences could widen, too, as the fiscal squeeze takes its toll on the devolved and northern regions.
- We are more optimistic about the outlook further ahead, particularly owing to our view that there is significant scope for productivity growth to recover. And as we believe that there is still some slack left in the labour market, wage growth relative to productivity should be contained, keeping growth of firms' unit labour costs subdued. (See Chart 7.)
- Meanwhile, the indirect disinflationary effect of the falls in energy prices seen over the last year will also still be feeding through, as will the impact of the falls in import prices seen recently. Accordingly, we expect the MPC to raise interest rates only gradually – albeit not as slowly as markets expect. Our forecast is for rates to end 2016 at only 0.75% and 2017 at 1.25%. (See Chart 8.)

Table 6: United Kingdom

% change on a year earlier

	Average 04 - 13	2014	2015e	Forecasts 2016	2017
GDP	1.2	2.9	2.2	2.2	2.7
Private cons'ptn	1.1	2.7	3.0	2.5	2.5
Total fixed invest.	0.7	7.5	4.5	5.5	5.5
Gov't cons'ptn	1.4	1.9	1.7	1.0	0.5
Stockbuilding(1)	0.0	1.0	0.4	0.2	0.2
Dom'stic demand	1.1	3.2	2.5	2.5	2.5
Exports	3.1	1.8	5.4	3.5	5.0
Imports	2.5	2.8	5.9	4.0	4.0
Consumer prices	2.7	1.5	0.0	1.1	1.7
RPIX(2)	3.3	2.4	1.0	1.8	2.3
Producer prices	2.5	1.3	-1.6	0.3	2.0
Real disp income	1.0	-0.2	3.3	1.5	2.0
H'hld sav. ratio(3)	7.7	4.9	4.6	4.5	4.5
Employment	0.5	2.3	1.5	1.0	0.5
Unemployment(4)	6.6	6.2	5.4	5.1	5.0
Interest rate(5)	2.4	0.50	0.50	0.75	1.25
PSNB(1)	5.7	4.9	4.1	2.7	1.2
Current account(1)	-2.7	-5.1	-4.2	-3.4	-2.7

(1) As a % of GDP
(2) Retail Price Index excluding mortgage interest payments
(3) As a % of disposable income
(4) Unemployment rate
(5) Bank of England repo rate at end of period

United Kingdom Charts

Chart 1: CPI Inflation (%)

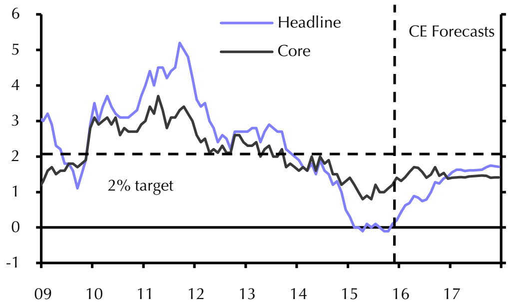


Chart 2: Energy Price Effect on H'hold Incomes (ppts)

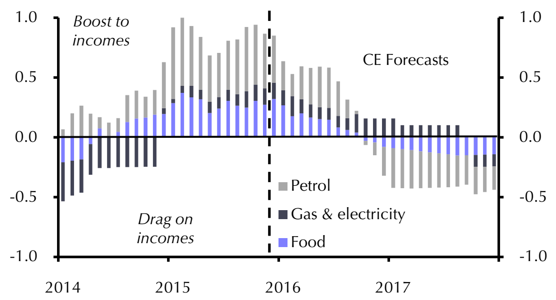


Chart 3: Cumulative Change in Structural Budget (% of GDP, IMF Forecasts)*

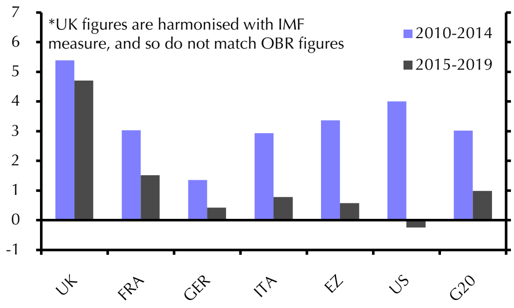


Chart 4: Real GDP (% y/y)

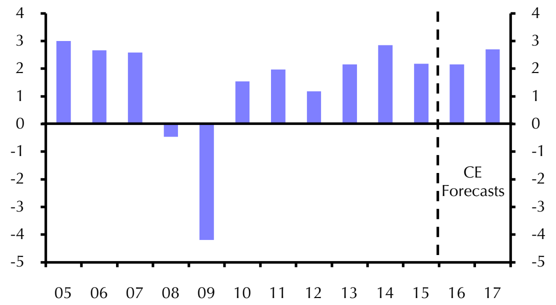


Chart 5: ILO Unemployment Rate (%)

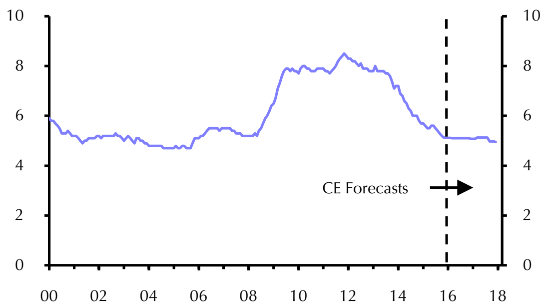


Chart 6: Contributions to Quarterly Real GDP Growth (ppts)

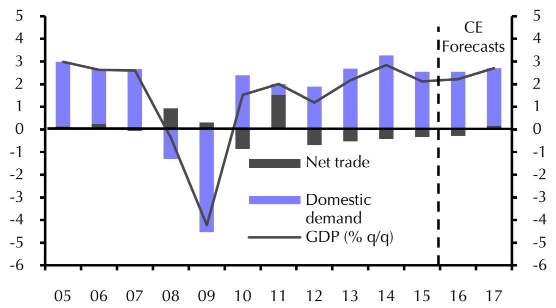


Chart 7: Productivity & Unit Wage Costs (%y/y)

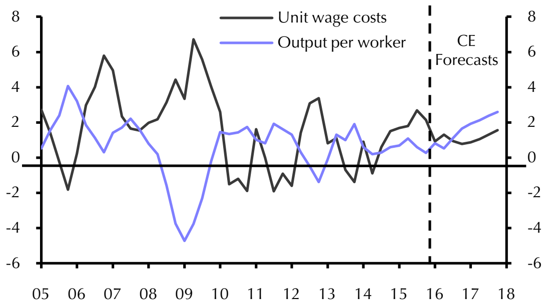
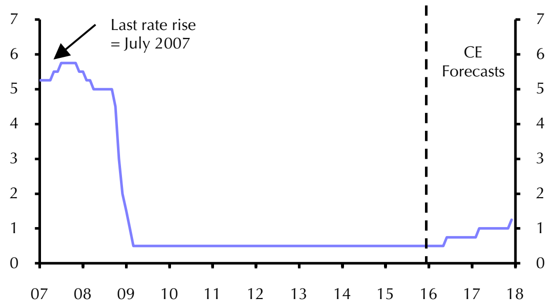


Chart 8: Bank Rate (%)



Sources – Thomson Datastream, BoE, CE

Canada

Growth prospects souring on collapse in oil prices

- Canada's dismal economic performance last year may just the beginning. Falling investment triggered by the collapse in oil prices will remain a severe drag on growth, while exporters see only moderate benefits from the lower Canadian dollar. Meanwhile, housing imbalances threaten broader growth prospects.
- Overall, after GDP growth of 1.2% in 2015, we expect only 1.0% growth in 2016, before a recovery hopefully begins in 2017.
- US economic growth together with a lower Canadian dollar should be enough to lift export growth this year and sustain moderate growth next year. (See Chart 1.)
- However, the collapse in oil prices will see further declines in business investment. (See Chart 2.) And before the economy has a chance to recover, we expect a painful downturn in housing investment. (See Chart 3.)
- Sluggish domestic demand is likely to persist, largely because of grim employment prospects. (See Chart 4.) The unemployment rate is likely to be rising by the end of the year.
- The depreciation of the Canadian dollar should keep core CPI inflation at the mid-point of the Bank of Canada's 1% to 3% target range, where it has been for well over a year now. (See Chart 5.) Headline inflation looks set to remain below 2%, reflecting the renewed slump in energy prices.
- But as the disinflationary pressures from growing slack in the economy intensify and the temporary exchange rate pass-through effects fade later this year, the Bank of Canada's estimate of underlying inflation will decline further. (See Chart 6.)
- The Bank of Canada will probably cut interest rates for a third time and hold thereafter, provided that the Federal government delivers its promised fiscal stimulus plan.
- Government of Canada bond yields have fallen this past year, but we envisage them rising with US Treasury yields later this year and throughout 2017. (See Chart 7.)
- After plunging below US$0.70 early this year, we expect the Canadian dollar to rebound to US$0.75 by year- end because we anticipate a recovery in oil prices. (See Chart 8.)

TABLE 7: CANADA

% change on a year earlier

	Ave. 04- 13	2014	2015e	Forecasts 2016	Forecasts 2017
GDP	1.9	2.5	1.2	1.0	1.5
Private cons'ptn	2.9	2.6	1.9	2.0	2.5
Total fixed invest	3.8	0.7	-3.1	-6.5	-2.5
Gov't cons'ptn	1.9	0.3	1.0	0.5	0.5
Stockbuilding(1)	0.1	-0.3	-0.3	0.0	0.0
Dom'stic demand	2.9	1.3	0.2	0.0	0.5
Exports	0.9	5.3	2.8	5.0	5.0
Imports	4.0	1.8	0.1	1.0	3.5
Consumer prices	1.8	1.9	1.1	1.4	1.6
Real disp income	3.3	1.1	2.4	2.0	2.5
H'hld sav. ratio(2)	3.5	4.2	4.6	4.6	4.6
Employment	1.2	0.6	0.9	0.5	0.5
Unemployment(3)	7.1	6.9	6.9	7.2	7.5
Interest rate(4)	2.1	1.00	0.50	0.25	0.50
Gen'l govt bal.(1)	0.1	-0.2	-1.2	-1.5	-1.0
Current account(1)	-1.0	-2.3	-3.6	-2.5	-1.6

(1) As a % of GDP
(2) As a % of disposable income
(3) Unemployment rate
(4) Bank of Canada overnight target rate at end of period

Canada Charts

Chart 1: US GDP & Canada's Exports (% y/y)

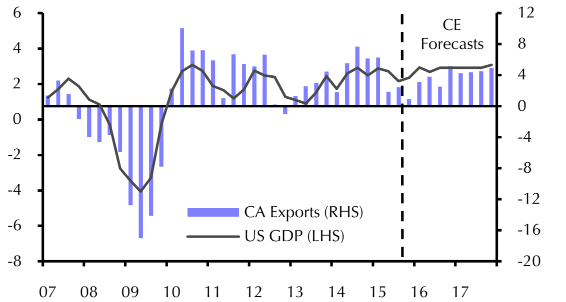


Chart 2: Business Investment (% of GDP)

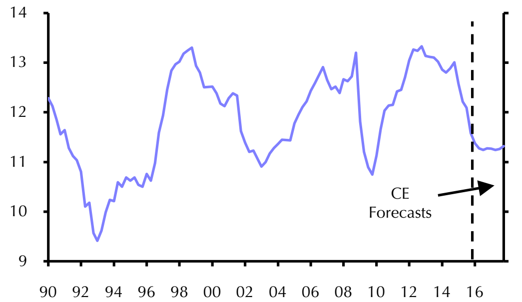


Chart 3: Residential Housing Investment (% of GDP)

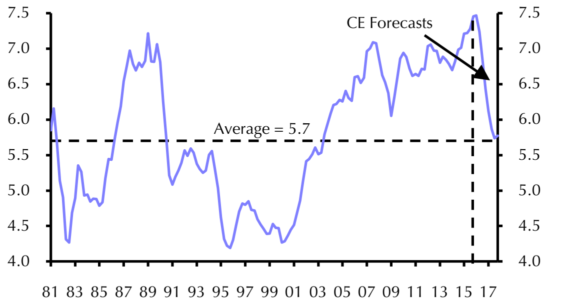


Chart 4: Business Hiring Intentions & Payroll Jobs

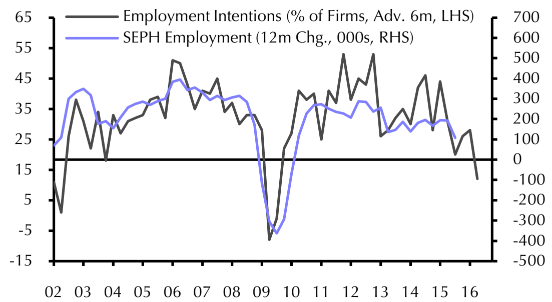


Chart 5: CPI Inflation (%)

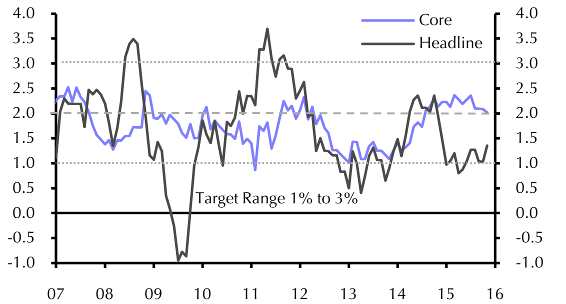


Chart 6: Output Gap & Underlying Inflation Indicator

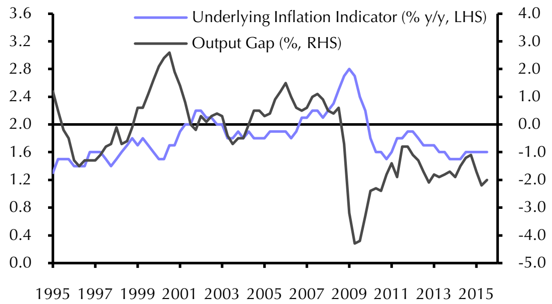


Chart 7: Bank of Canada Policy Rate & Government of Canada Bond Yields (%)

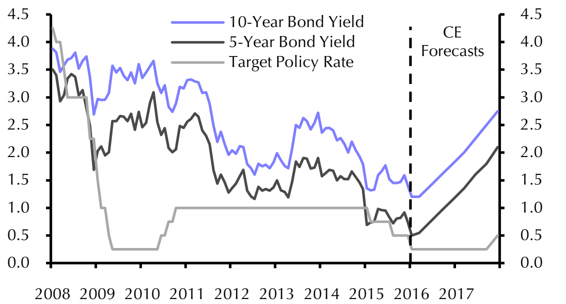
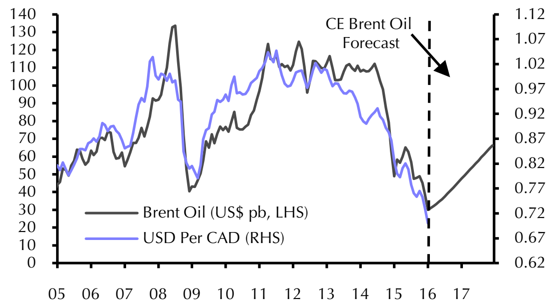


Chart 8: Brent Oil Price & Canadian Dollar



Sources – Thomson Datastream, Bloomberg, CE

Australia & New Zealand

Another year of below-potential growth

- The recent revival in Australia and New Zealand is not likely to be sustained this year. Although we have revised up our forecasts for GDP growth, we expect it to remain below 2½ in both countries. (See Chart 1.) With low underlying inflation set to become a bigger concern, both central banks are likely to cut interest rates by more than is widely expected.

- The resilience of both economies to the huge fall in the prices of their key commodity exports is impressive. Both bounced back from a weak second quarter to grow by nearly 1.0% q/q in the third quarter. (See Chart 2.)

- There has been a sharp improvement in Australia's labour market, which means that consumption growth should be stronger than previously expected. Largely because of this, we have revised up our forecast for growth in 2016 from 2.0% to 2.3%.

- Some of the boost to consumption growth from the stronger labour market will be offset by the impact of the recent weakness in the housing market. (See Chart 3.)

- Meanwhile, the benefits of the weaker dollar will be offset by a drag on growth from further falls in investment. (See Chart 4.) Mining investment will continue to be a large drag on GDP growth and the latest worsening in the terms of trade (export prices relative to import prices) will contribute to non-mining investment remaining subdued.

- The near-term outlook for New Zealand has also improved, with consumer and business surveys rebounding. (See Chart 5.) There are some signs that the weaker dollar is starting to support export growth too.

- That said, the full impact from the fall in dairy prices has yet to be felt. The unemployment rate will soon rise above 6.0% and our activity proxy suggests that the recent rebound in GDP growth is already fading. (See Chart 6.) So although we have revised up our forecast for GDP growth in 2016, we do not expect it to be any stronger than in 2015.

- Another year of below-potential growth in both economies will more than offset the boost to core inflation from their weaker currencies. (See Chart 7.) This will prompt the RBA and RBNZ to cut rates further. If we are right in expecting the RBA to cut rates from 2.0% to 1.5% and the RBNZ to cut them from 2.5% to 2.0%, then the Australian and New Zealand dollars should weaken further. (See Chart 8.)

TABLE 8: AUSTRALIA & NEW ZEALAND

% change on a year earlier

	Average 04 - 13	2014	2015e	Forecasts 2016	2017
Australia					
GDP	2.9	2.6	2.3	2.3	3.0
Unemployment(1)	5.0	6.1	6.1	5.9	5.5
Consumer prices	2.7	2.5	1.5	1.5	2.0
RBA cash rate	4.85	2.50	2.00	1.50	2.50
Gen'l gov't bal(2)	-1.1	-2.4	-2.6	-2.3	-1.8
Current account(2)	-4.8	-3.0	-4.4	-1.4	-1.0
New Zealand					
GDP	2.1	3.7	2.3	2.3	3.5
Unemployment(1)	5.2	5.8	6.0	6.1	5.3
Consumer prices	2.6	1.2	0.4	1.0	2.0
RBNZ cash rate	4.87	3.50	2.50	2.00	3.50
Gen'l gov't bal(2)	-0.2	-1.2	0.2	-0.2	0.0
Current account(2)	-4.8	-3.1	-3.8	-6.9	-4.6

(1) Unemployment rate
(2) As a % of GDP

Australia & New Zealand Charts

Chart 1: GDP (% y/y)

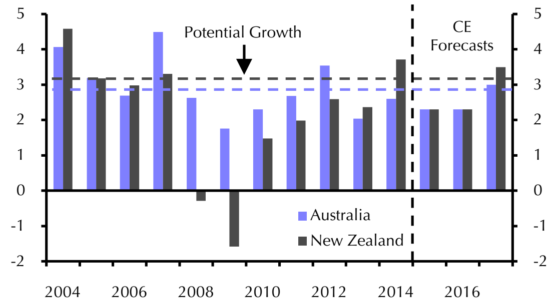


Chart 2: GDP (% q/q)

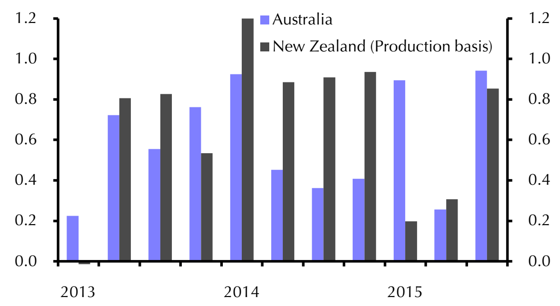


Chart 3: Australia Home Sales & House Prices (% y/y)

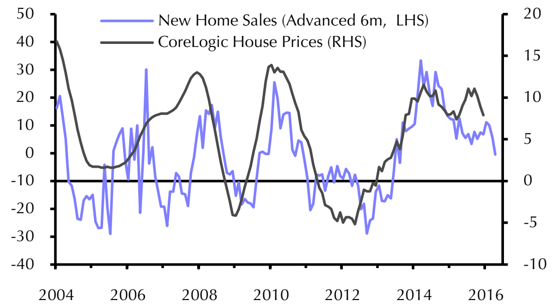


Chart 4: Contribution to % y/y Australian GDP Growth (ppts)

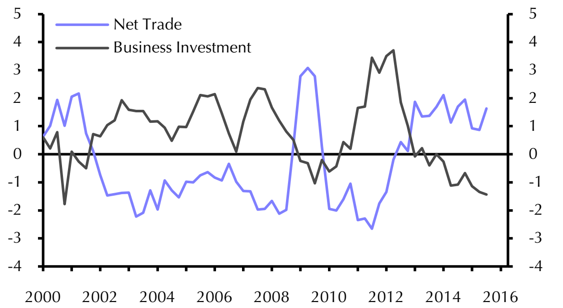


Chart 5: New Zealand Consumption & Confidence

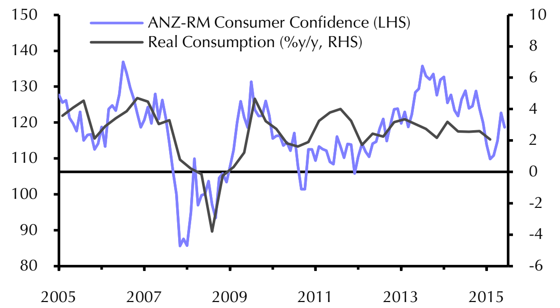


Chart 6: Capital Economics NZ Activity Proxy & GDP (% y/y)

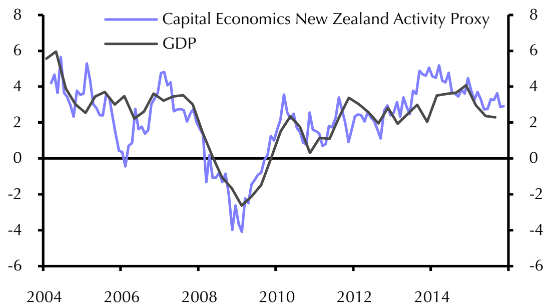


Chart 7: Core CPI Inflation (%)

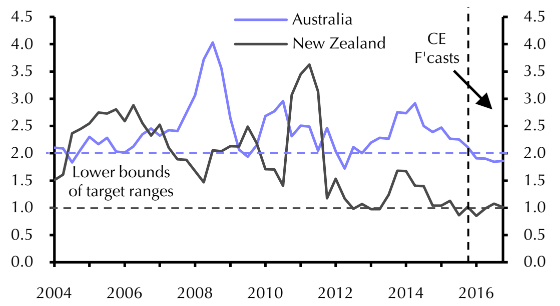
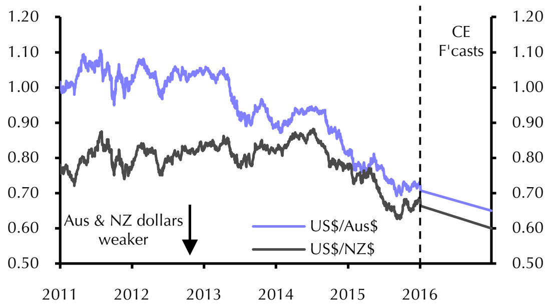


Chart 8: Exchange Rates



Sources – Thomson Datastream, Bloomberg, CE

China

Policy-driven rebound ahead

- Sentiment about China's economic prospects remains downbeat but we expect continued policy support to drive a recovery in growth over the coming months.
- Confidence in the China growth story was badly dented in 2015. Policy missteps played a part but in terms of economic developments, this was largely due to investors belatedly catching up with trends that had been underway for some time.
- Our China Activity Proxy, which we think is a better gauge of the strength of the economy than the official GDP figures, shows that growth has been slowing over several years.
- There was a sharper downturn in early 2015 but for most of last year conditions appeared relatively stable (see Chart 1) with resilience in services and consumer spending helping offset weakness in industry and investment.
- The deceleration in growth since 2010 is largely a structural decline after years of unsustainable investment and credit-driven growth. That structural shift has further to run over the coming years. But in the near-term we believe – contrary to the consensus – that a cyclical recovery is likely.
- Fiscal policy was inadvertently tightened a year ago as a ban on borrowing by local government financing vehicles came into effect. It has now been loosened substantially. (See Chart 2.) A tax cut on purchases of small cars late last year has already had a major effect (see Chart 3) and the government has pledged further tax reductions this year. Benchmark interest rates have been lowered six times so far and we expect more cuts this year. Credit is accelerating. (See Charts 4 & 5.)
- The usual volatility in data around Chinese New Year will cloud the picture and there is a good chance that the official GDP figures show no improvement at all. After all, they failed to reflect the early-2015 slowdown. However, we expect more reliable indicators of actual activity to show solid signs of a pick-up in growth by Q2.
- Even if the economy turns a corner, further volatility is likely in China's equity markets, which continue to be driven by speculation rather than fundamentals. (See Chart 6.)
- Meanwhile, the People's Bank has given strong hints that it will in future manage the renminbi's value relative to a currency basket rather than against the US dollar.
- One implication is that if the dollar strengthens against other major currencies, as it did in 2015 and as we expect in 2016, the renminbi will depreciate against the dollar. (See Chart 7.) But with China continuing to run a large current account surplus (see Chart 8), and sentiment towards the economy likely to improve if our forecasts are correct, we believe that a major slide in the renminbi is unlikely.

TABLE 9: CHINA

% change on a year earlier

	Ave. 04–13	2014	2015e	Forecasts 2016	2017
GDP (CE est.)[1]	9.9	5.8	4.3	6.5	6.0
GDP (Official)	10.2	7.3	6.9	6.8	6.5
Consumer prices	3.1	2.0	1.4	2.5	2.5
Current account[2]	5.3	2.1	2.6	2.5	2.5

(1) Derived from our China Activity Proxy; (2) As a % of GDP

China Charts

Chart 1: China Activity Proxy & GDP

Chart 2: Government Spending (RMB, % y/y)

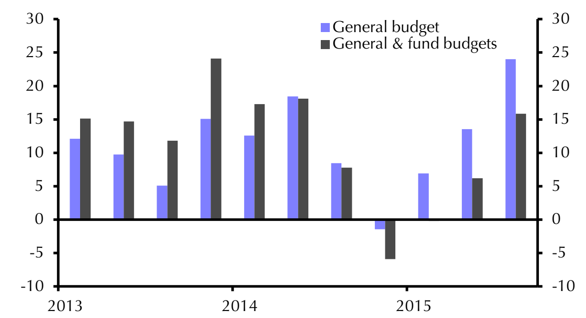


Chart 3: Car Sales & Production (3m ave., % y/y)

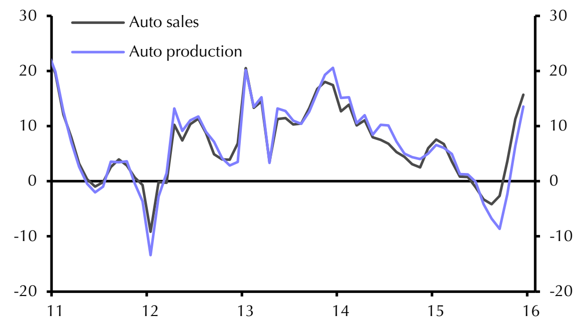


Chart 4: Policy Rates (%)

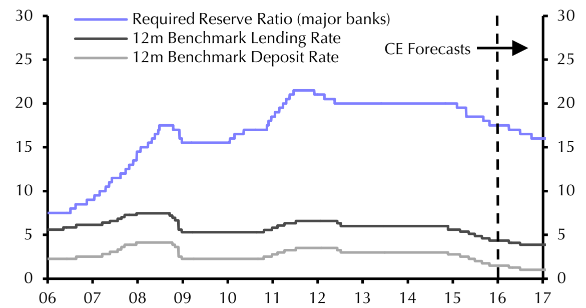


Chart 5: Outstanding Credit (RMB, % y/y)

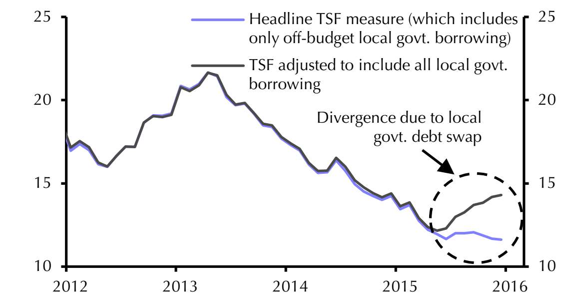


Chart 6: Shanghai Composite

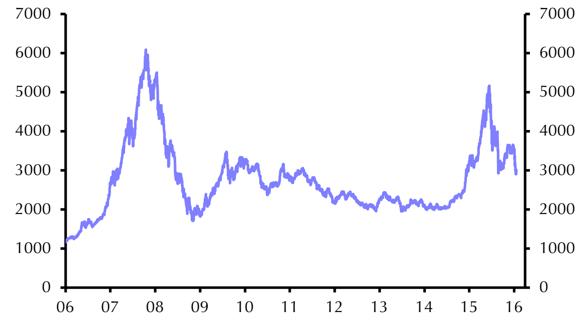


Chart 7: Renminbi Exchange Rates

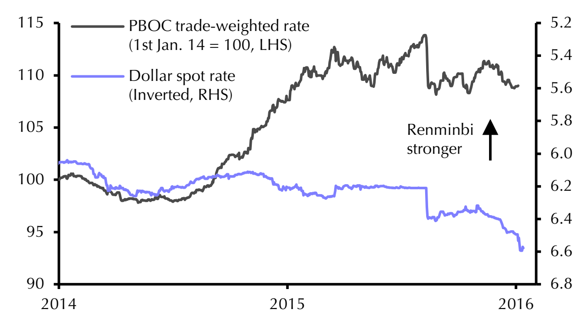
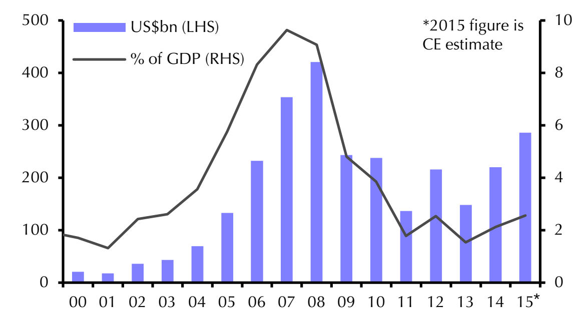


Chart 8: Current Account Balance



Sources – Thomson Datastream, CEIC, Bloomberg, Capital Economics

India

Cyclical pick-up in growth likely, but reform progress slow

- The latest GDP data show that India's economy grew by an impressive 7.4% y/y in Q3 of 2015. (See Chart 1.) In reality, the economy is, at best, gradually recovering after years of tepid growth. And without substantial structural reform, growth will remain below the rates seen from 2004 to 2011.
- There have been some signs of a pick-up in activity. Industrial production has strengthened over the past few months and the slowdown in bank lending growth appears to have bottomed out. (See Charts 2 & 3.)
- Looking ahead, the 125bp of cuts to the Reserve Bank of India's (RBI's) repo rate last year, coupled with the fact that global commodity prices remain weak, mean that the near-term outlook for consumer spending and industrial production is relatively upbeat.
- Meanwhile, the current account deficit has narrowed, largely thanks to the drop in commodity prices. (See Chart 4.) This reduction in external vulnerabilities should help to keep the rupee relatively stable against the US dollar. We are forecasting the rupee to weaken only slightly to 68/$ by end-2017, compared to 66/$ at the start of 2016.
- But there are some clouds on the horizon. First, inflation has been accelerating in recent months (see Chart 5) which has reduced the scope for further easing. Price pressures are likely to build further following the Pay Commission's recommendation for a hike in public sector wages of up to 23% this year.
- This will add to the RBI's already tough challenge in meeting its medium-term inflation targets of 5% by the end of FY16/17, and 4±2% by the end of FY17/18. Given this, we think that the repo rate will remain on hold at 6.75% throughout 2016. (See Chart 6.)
- Second, there is little room for fiscal stimulus. Indeed, rather than let the budget position worsen, a more likely scenario is that the finance ministry offsets the public sector pay increases by scaling back capital expenditure. When the next budget is unveiled, in February, we expect the government to stick to its target of trimming its deficit to 3.0% of GDP in FY17/18. (See Chart 7.)
- Prospects for lifting trend growth depend largely on how successful the government is in implementing structural reforms. Recent developments have not been encouraging.
- The government's attempts to push through reform of domestic tax policy and land acquisition laws have been rebuffed in parliament. This is likely to set the tone for the coming years. These constraints are key reasons for the lack of development of a robust manufacturing sector (see Chart 8) which, ultimately, means that economic growth is likely to fall short of its immense potential over the medium term.

TABLE 10: INDIA

% change on a year earlier

	Ave. 04–13	2014	2015e	Forecasts 2016f	2017f
GDP (old base)	7.9	5.2	5.5	6.0	6.5
GDP (new base)	-	7.5	-	-	-
Consumer prices	8.0	7.2	5.0	5.0	5.5
Gen'l gov't bal[1]	-4.6	-4.6	-4.0	-3.9	-3.6
Current account[2]	-2.2	-1.4	-1.5	-2.0	-2.0

(1) Fiscal years, % of GDP (2) % of GDP

India Charts

Chart 1: GDP (% y/y)

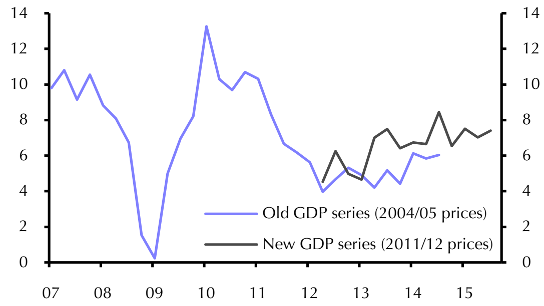


Chart 2: Industrial Production (3m ave. % y/y)

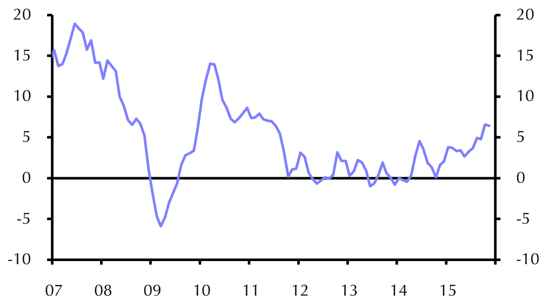


Chart 3: Bank Lending to Private Sector (3m ave. % y/y)

Chart 4: Current Account Balance (% of GDP, 4Q Avg.)

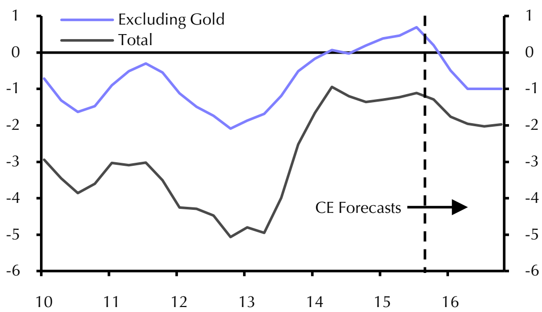


Chart 5: Consumer Prices (% y/y)

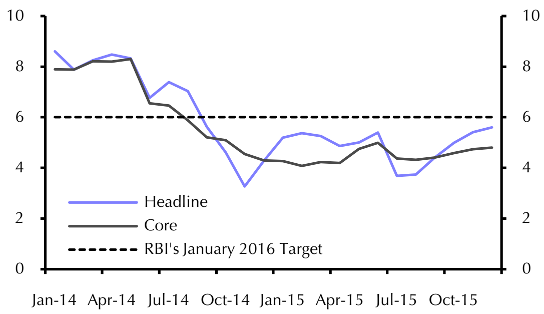


Chart 6: RBI Policy Rates (%)

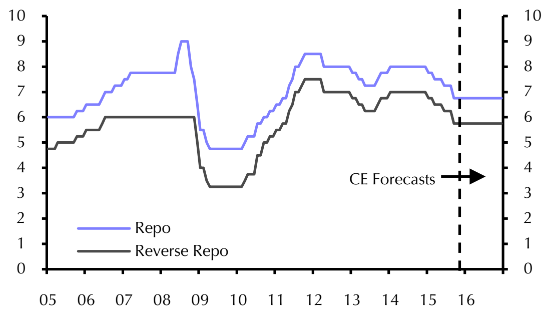


Chart 7: Central Government Fiscal Deficit (% of GDP)

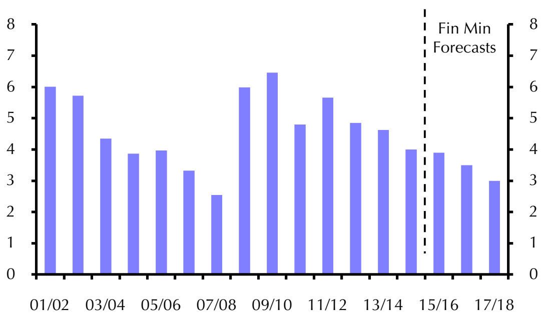
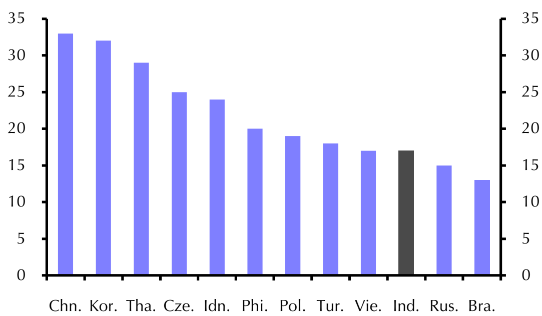


Chart 8: Manufacturing Sector (% of GDP, Latest)



Sources – Thomson Datastream, CEIC, Bloomberg, CE

Other Emerging Asia

Better year ahead

- Most countries in Emerging Asia are likely to record stronger growth this year than last year. (See Charts 1 & 2.) Exports should pick up on the back of an expected recovery in the region's main trading partners, including China. (See Chart 3.) Meanwhile, low interest rates and depressed oil prices will provide support to domestic demand.
- The Newly Industrialised Economies (Hong Kong, Korea, Singapore and Taiwan) are particularly well placed to benefit from a recovery in China. However, better prospects for exports come against a backdrop of growing domestic problems.
- Years of very loose monetary policy have contributed to a surge in credit growth, which has in turn led to a sharp rise in household debt in Korea and Singapore, and property price bubbles in Hong Kong and Taiwan. (See Chart 4.) Interest rates in Hong Kong and Singapore, which track US rates closely, look set to rise over the coming year. (See Chart 5.) The unwinding of credit bubbles and higher interest rates will act as a drag on growth.
- The outlook elsewhere is mixed. We expect Vietnam and Bangladesh, which are successfully developing competitive low-end manufacturing export sectors, to perform well.
- The Philippines also looks well-placed to grow strongly this year. But with none of the front-runners ahead of the country's presidential election in May inspiring much confidence, there is a risk that much of the good work of the current president, Benigno Aquino, could be undone.
- Prospects elsewhere are less positive. With commodity prices likely to remain depressed, growth in Malaysia and Indonesia looks set to stay relatively weak by past standards. Meanwhile, political uncertainty in Thailand, which is dragging on investment, will continue to hold back economic prospects.
- Inflation looks likely to rise in most of Asia in 2016 despite the recent fall in oil prices, as previous larger falls drop out of the annual comparison. (See Chart 6.) But with underlying price pressures still weak and few signs that countries are starting to run into capacity constraints, inflation should remain below or within the target range of all of the region's main central banks next year.
- As such, we don't think policy-makers will generally be raising interest rates. In most countries central banks will keep interest rates on hold in 2016, and Indonesia's central bank is likely to cut rates. (See Chart 7.)
- There is a risk that Malaysia, which has a high short-term debt burden, will get into trouble as monetary policy tightening in the US gathers momentum. But the rest of Emerging Asia looks reasonably well placed to weather any fallout. Foreign currency debt is low and current account positions have strengthened since the 2013 "taper tantrum". (See Chart 8.)

TABLE 11: SELECTED ASIA-PACIFIC

	World Share[1]	GDP 2014	GDP 2015e	GDP 2016f	GDP 2017f	Inflation 2014	Inflation 2015e	Inflation 2016f	Inflation 2017f
Emerging Asia[2]	10.6	4.3	4.0	4.5	4.5	3.1	1.7	2.8	3.0
Indonesia	2.5	5.0	4.7	5.0	5.0	6.4	6.5	4.5	4.5
South Korea	1.6	3.3	2.6	3.0	2.5	1.2	0.7	1.5	2.0
Thailand	1.0	0.7	2.6	3.0	2.5	1.9	-0.8	1.5	2.0
Philippines	0.7	6.1	5.7	6.5	6.5	4.2	1.5	2.5	3.5

(1) Share of world GDP in 2015 PPP terms. (2) Excl. China & India

Other Emerging Asia Charts

Chart 1: GDP (% y/y)

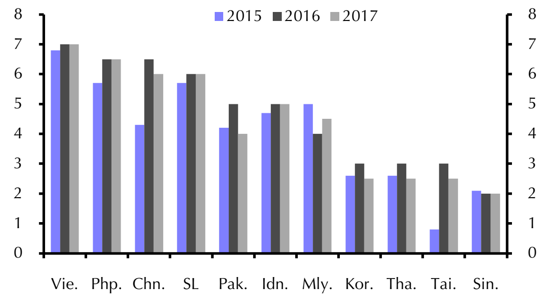


Chart 2: Emerging Asia (ex. China & India) GDP (% y/y)

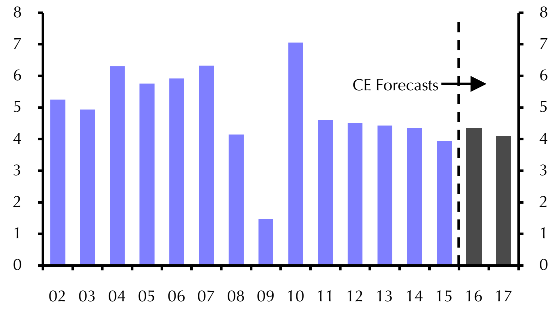


Chart 3: Emerging Asia Exports & Global GDP (% y/y)

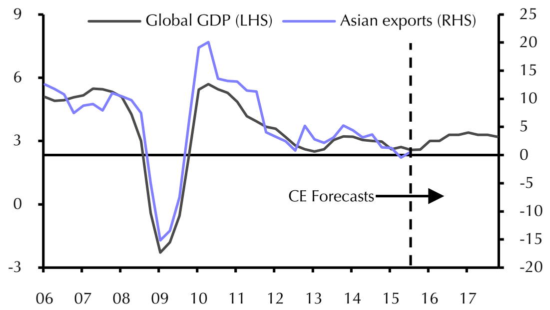


Chart 4: House Price to Income Ratio (Jan. 2001=100)

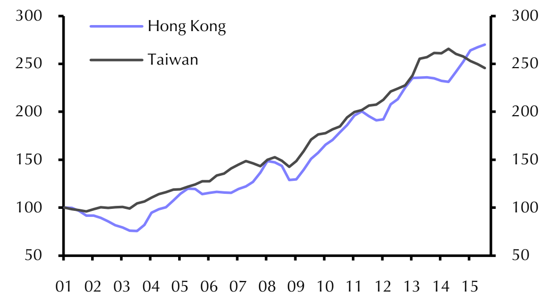


Chart 5: Interest Rates (%)

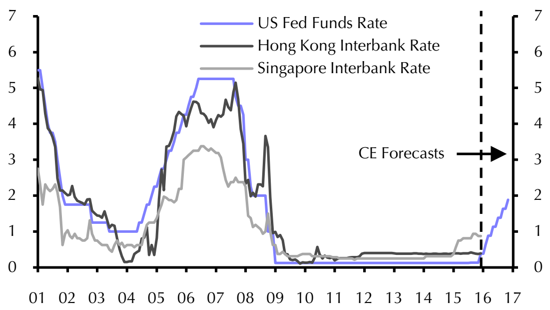


Chart 6: Oil Prices & Emerging Asia Energy CPI (% y/y)

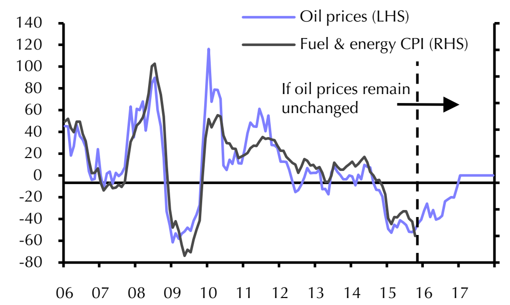


Chart 7: Interest Rate Forecasts (% change latest to end-2016)

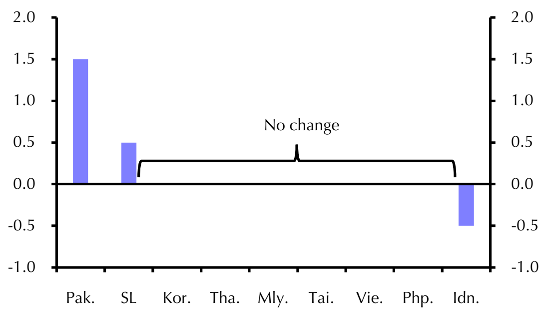
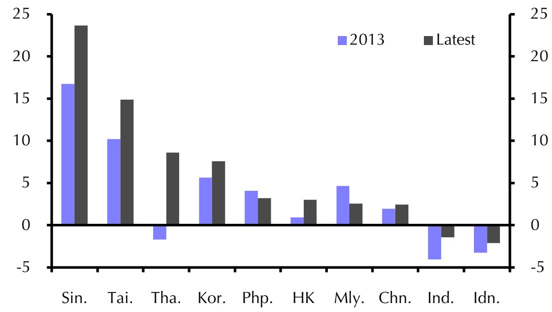


Chart 8: Current Account Balance (4Q Sum, % of GDP)



Sources – Thomson Datastream, CE

CAPITAL ECONOMICS

Emerging Europe

Russia still buffeted by slump in oil prices

- In aggregate, GDP growth in Emerging Europe is likely to return to growth in 2016. Central and South Eastern Europe should continue performing well and while Russia will lag behind, it should at least exit recession.
- GDP in Emerging Europe as a whole fell by 0.2% y/y in Q3 2015, following a drop of 0.7% y/y in Q2. (See Chart 1.) This came as the slump in the Russian economy eased a little, while the Central European economies, as well as Turkey, put in good performances.
- We expect the Russian economy to stabilise in the coming quarters. However, in contrast to previous recessions, this recovery is likely to be different and particularly sluggish. (See Chart 2.) The government will need to tighten fiscal policy, bank lending will stay weak and deep-seated structural problems are likely to constrain business investment. The latest fall in oil prices means the risks to our forecast lie firmly on the downside.
- Elsewhere, we think growth prospects for Turkey are weaker than most anticipate. A large current account deficit (see Chart 3) is likely to keep the lira under pressure. And persistently high inflation means that interest rates will need to be raised, acting as a drag on domestic demand.
- The strongest economies in the region will probably be in Central and South-Eastern Europe. Our forecast for Germany, the region's largest trading partner, points towards solid, if unspectacular export growth of 5-6% y/y. (See Chart 4.) Moreover, we think domestic demand should remain strong.
- Labour markets are improving, bank lending is strengthening, and low commodity prices will keep inflation subdued. (See Chart 5.) Weak inflation should support households' purchasing power and allow central banks to keep monetary policy loose. (See Chart 6.)
- A shift to populism in parts of the region is worrying. However, government budget positions are relatively strong, (see Chart 7) so an increase in public spending doesn't present an immediate problem. Indeed, looser fiscal policy should actually boost growth. We are more concerned about the medium-term implications of populist policymaking.
- All told, we expect the Russian economy to eke out positive, but meagre, growth. And growth in Turkey is likely to slow. But we think large parts of Central and South Eastern Europe should be able to record GDP growth of 3-4% this year and next. (See Chart 8.)

TABLE 12: SELECTED EMERGING EUROPE

	World Share[1]	GDP (% y/y) 2014	2015e	2016f	2017f	Inflation (%) 2014	2015e	2016f	2017f
Emerging Europe	7.0	1.4	-0.5	1.8	2.0	6.0	10.0	6.0	5.0
Russia	3.1	0.6	-3.5	0.3	0.5	7.8	15.5	8.0	6.0
Turkey	1.4	2.9	3.0	1.5	2.5	8.9	7.6	8.8	8.3
Poland	0.9	3.4	3.5	3.5	4.0	0.0	-1.0	0.8	1.8
Czech Republic	0.3	2.0	4.3	3.0	3.5	0.4	0.5	1.3	2.0
Hungary	0.2	3.5	2.8	2.3	2.5	-0.2	0.0	1.5	2.3

(1) Share of world GDP in 2014 PPP terms.

Emerging Europe Charts

Chart 1: Emerging Europe GDP (% y/y)

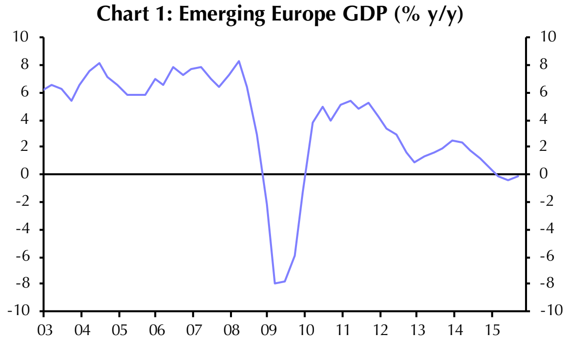


Chart 2: Russia GDP (% y/y)

Chart 3: Current Account Balance (% GDP, 2015e)

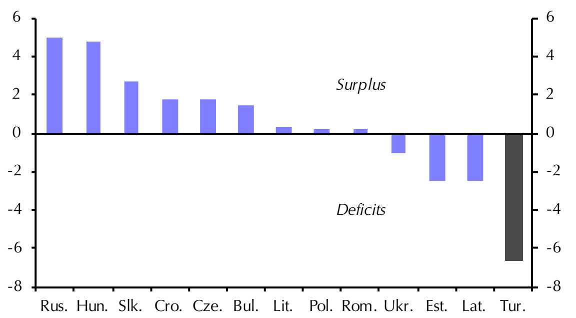


Chart 4: Central & South Eastern Europe Exports & Germany GDP (% y/y)

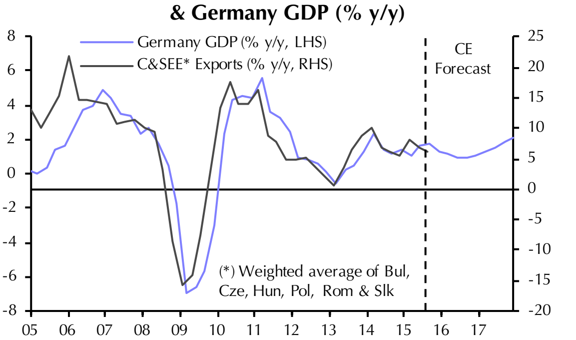


Chart 5: Consumer Prices (% y/y)

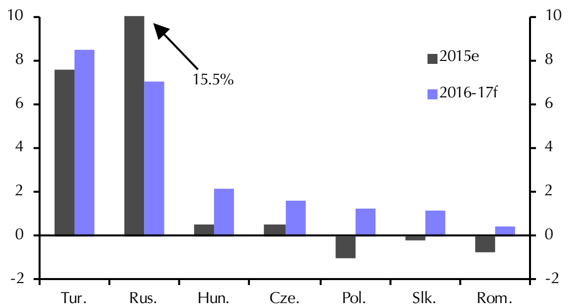


Chart 6: Policy Interest Rates (%)

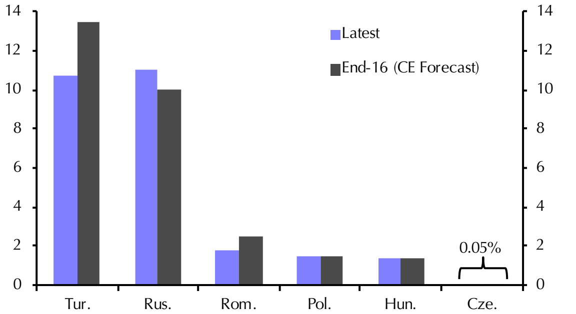


Chart 7: Government Budget Balance (% GDP, 2015e)

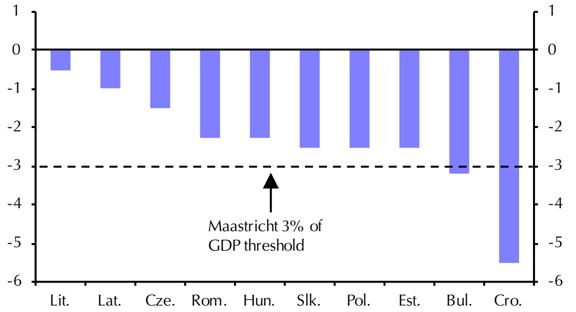
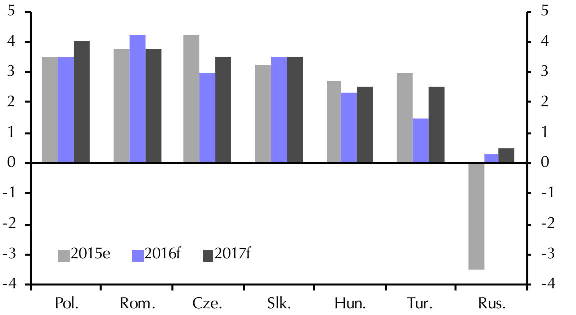


Chart 8: GDP (% y/y)



Sources – Thomson Datastream, CE

Latin America

Brazil recession to persist, weak recovery elsewhere

- Having contracted in 2015, we expect Latin America's economy to do little more than stagnate this year. Growth will probably pick up only slightly in 2017.
- Our GDP Tracker suggests that regional output contracted at a faster pace in Q4 than in Q3. (See Chart 1.) This was largely due to a further downturn in Brazil, which is now in the midst of its worst recession since the 1930s. Growth elsewhere picked up a little at the end of last year, but not sufficiently to offset problems in the region's largest economy.
- Overall, we expect a small pick-up in growth in 2016-17, driven mainly by external factors. For a start, we think the big falls in commodity prices are probably behind us. If so, Latin America should see a rebound in commodity exports. (See Chart 2.) Weaker currencies should continue to support export demand too. In addition, we are forecasting a recovery in economic growth in China which should lead higher export volumes.
- If these forecasts prove accurate, rising exports should help to narrow large current account deficits, particularly in Brazil, Colombia and Peru. (See Chart 3.)
- However, domestic weakness will be a constraint on the recovery. Unemployment is rising and credit conditions have tightened following a multi-year lending boom. (See Chart 4.)
- Meanwhile, there is little room for policy support. Fiscal policy is likely to be tightened in most countries. (See Chart 5.) Brazil's position is the most precarious. Indeed, if Brazil's government continues to miss its budget deficit targets there could eventually be a full-blown fiscal crisis.
- Policy-makers in Mexico and Colombia may also be forced to tighten fiscal policy further because oil revenues have slumped. In Argentina, the election of a more reform-friendly government has raised hopes of faster growth in the medium-term. But the authorities will first need to put the economy on an even keel, which will dampen demand.
- In most countries, inflation is likely to edge lower but remain above target. (See Chart 6.) Accordingly, interest rates look set to move up. In Brazil, further interest rate hikes are likely in the near term and monetary easing will be delayed until next year. (See Chart 7.)
- All told, growth in most countries looks set to pick up only slightly over the coming years. And in all cases except Mexico, it will remain substantially below its average rates of the past decade. (See Chart 8.)

TABLE 13: SELECTED LATIN AMERICA

	World Share (1)	GDP (% y/y) 2014	2015e	2016f	2017f	Inflation (%) 2014	2015e	2016f	2017f
Latin America	8.2	0.9	-0.5	0.3	2.5	5.4	6.3	6.0	4.5
Brazil	2.9	0.1	-3.5	-2.3	2.0	6.3	9.0	8.0	5.0
Mexico	2.0	2.1	2.5	3.0	3.5	4.0	2.8	3.3	3.0
Argentina (2)	0.9	-2.7	0.5	-1.5	3.0	35.0	35.0	40.0	10.0
Colombia	0.6	4.6	3.0	2.5	3.2	3.2	5.0	6.0	3.5
Chile	0.4	1.8	2.2	3.0	0.0	4.4	4.4	4.1	3.3

(1) Share of world GDP in 2014 PPP terms, (2) Forecasts are for Capital Economics proxies.

Latin America Charts

Chart 1: Latin America GDP & CE GDP Tracker

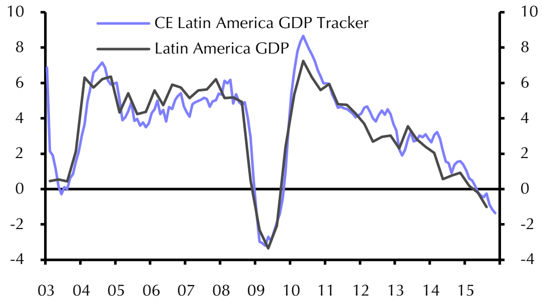


Chart 2: Latin America Commodity Exports & Prices

Chart 3: Current Account Balances (% of GDP)

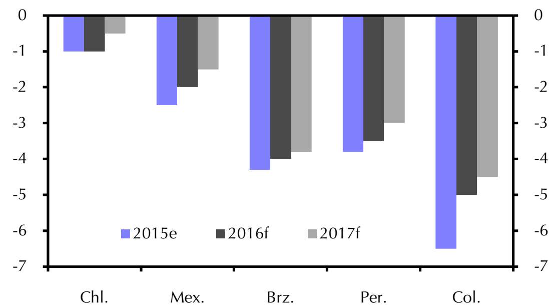


Chart 4: Latin America Real Private Sector Credit (% y/y)

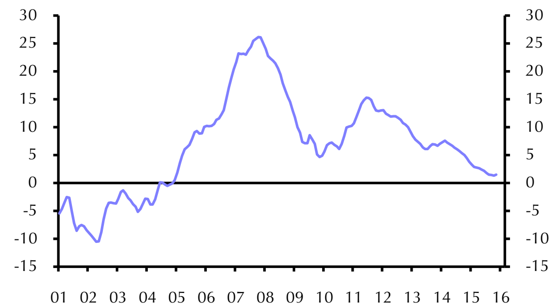


Chart 5: Public Sector Budget Deficits (% of GDP)

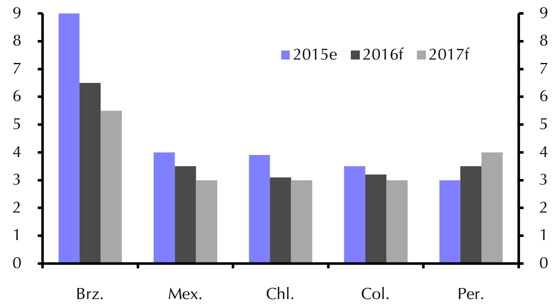


Chart 6: Consumer Prices (% y/y)

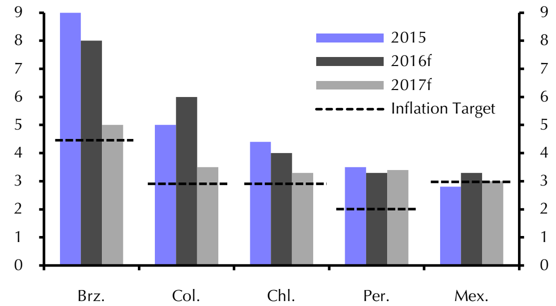


Chart 7: Policy Interest Rates (%)

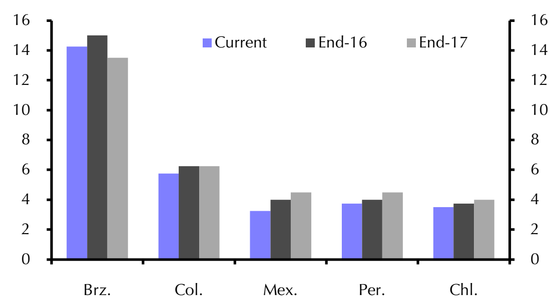
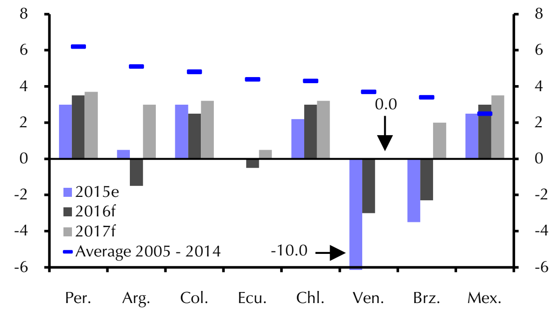


Chart 8: GDP (% y/y)



Sources – Thomson Datastream, Bloomberg, CE

Middle East and North Africa

Cheap oil hits home

- The Gulf economies have weathered the storm created by low oil prices well so far, but 2016 is likely to be the year in which they begin to weigh heavily on growth. In contrast, we expect the North African economies (Egypt, Morocco and Tunisia) to strengthen gradually.
- Unlike other major oil producers, growth in the Gulf held up well last year. Saudi Arabia's economy expanded by 3.4%, in line with the growth rates recorded in the previous couple of years. (See Chart 1.)
- The fresh leg down in oil prices, to around $30pb (see Chart 2), in recent months is unlikely to panic policymakers. Large savings and low debt levels mean that twin budget and current account deficits can be financed for many years to come. (See Chart 3.)
- Nonetheless, some policy adjustment will be required. We think it's unlikely that Saudi Arabia will resort to currency devaluation, although markets suggest that this risk has increased. (See Chart 4.) At the same time, calls from the rest of OPEC to cut oil output in order to shore up oil prices will probably be ignored. Instead, policymakers are starting to outline their plans to tighten fiscal policy. Several countries have already cut fuel subsidies, but we expect capital spending to take the brunt of the cuts.
- Tighter fiscal policy will hold back growth in non-oil sectors. Oil production will be kept high in order to squeeze out high-cost producers. But we're unlikely to see a repeat of the surge in oil output seen over the past year or so. With this in mind, we expect GDP growth to slow by more than the consensus expects in all six members of the Gulf Cooperation Council this year. (See Chart 5.)
- Outside the Gulf, Algeria was ill-prepared for a period of low oil prices and, as a result, a sharp fiscal squeeze is on the cards. The economy will do little more than stagnate this year. On top of this, political concerns are mounting. The conflicts in Syria and Iraq continue to cast a cloud over the outlook for Lebanon and Jordan. Tourist arrivals in Jordan are, not surprisingly, already at a decade low.
- In Morocco, Egypt and Tunisia, security concerns will take a toll on tourism sectors. (See Chart 6.) Meanwhile, the post-devaluation tightening of monetary policy in Egypt will dampen growth there. On a positive note, however, low oil prices coupled with tighter fiscal policy will support macro-stability. (See Chart 7.) And ongoing reforms mean that medium-term prospects are brightening. Hence, while 2016 will be tough, we expect growth to strengthen from 2017. (See Chart 8.)

Table 14: Selected Middle East and North Africa

	World Share (1)	GDP 2014	GDP 2015e	GDP 2016f	GDP 2017f	Inflation 2014	Inflation 2015e	Inflation 2016f	Inflation 2017f
Mid. East & N. Africa	4.7	3.4	3.0	2.0	2.3	4.3	4.0	4.5	3.8
Saudi Arabia	1.5	3.5	3.4	1.5	1.0	2.7	2.0	2.0	1.5
Egypt	0.9	4.3	3.5	3.0	4.0	10.1	10.5	10.0	9.0
UAE	0.6	4.6	4.0	2.5	2.5	2.3	4.0	3.5	3.0
Morocco	0.2	2.4	4.5	4.8	5.5	0.4	1.5	1.8	2.3

(1) Share of world GDP in 2014 PPP terms.

Middle East and North Africa Charts

Chart 1: Saudi Arabia GDP (% y/y)

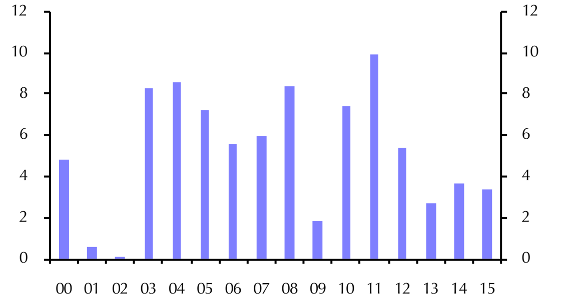


Chart 2: Oil Price (Brent, US$pb)

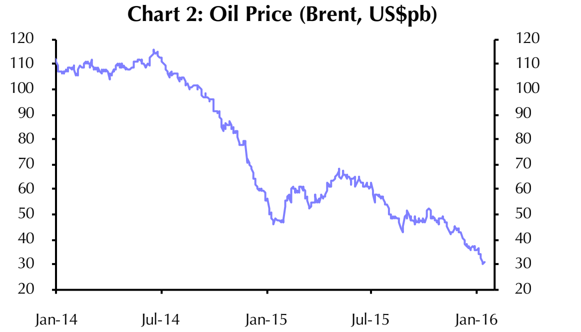


Chart 3: FX Reserves and Sovereign Wealth Fund Assets (% of GDP)

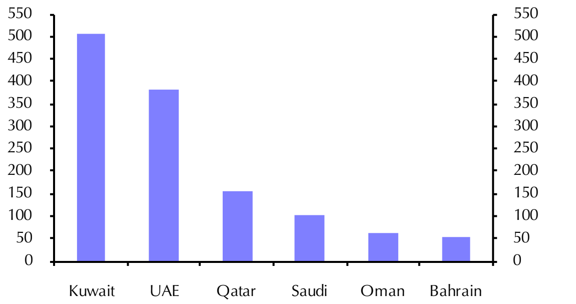


Chart 4: Difference between Saudi Riyal Spot and 1Y F'wd Rates (vs. US, %)

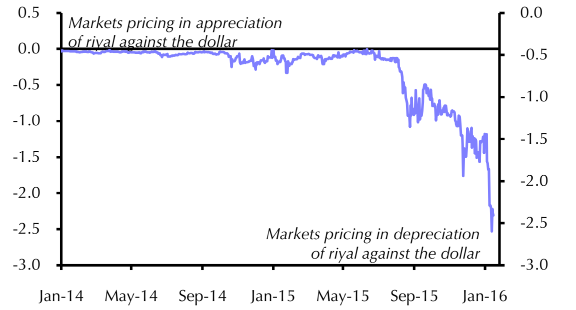


Chart 5: GDP (% y/y)

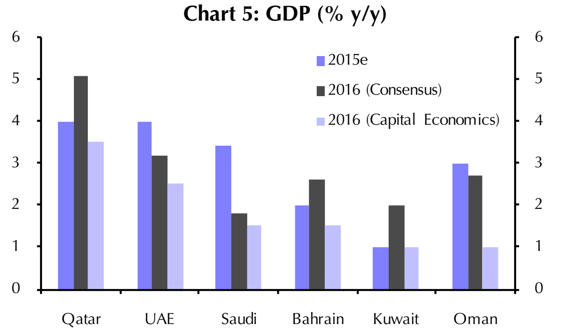


Chart 6: Tourist Arrivals (12m Sum, Jan. 2011 = 100)

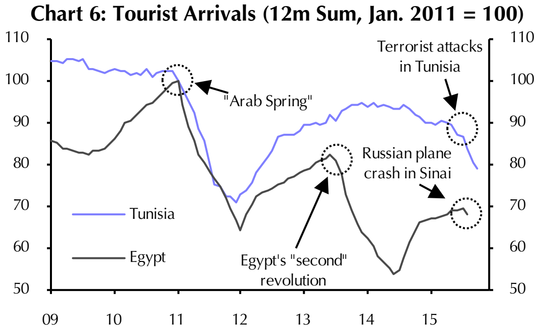


Chart 7: Current Account Balances (% of GDP)

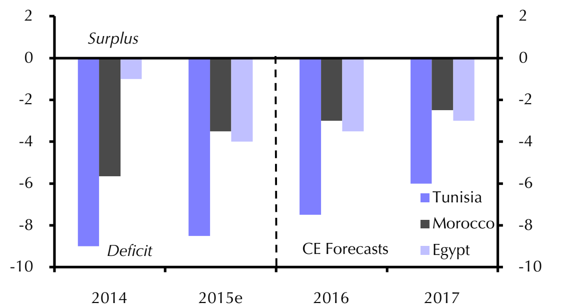
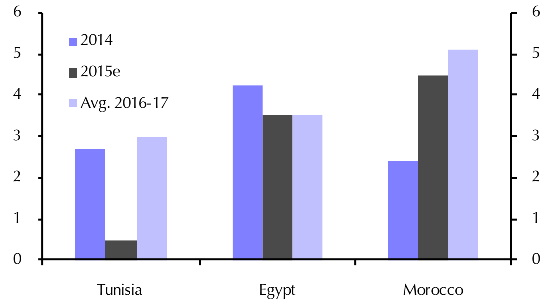


Chart 8: GDP (% y/y)



Sources – CEIC, Thomson Datastream, CE

Sub-Saharan Africa

Grim outlook for major economies

- Growth slowed markedly in 2015 due to poor performances in Sub-Saharan Africa's three largest economies – Nigeria, South Africa, and Angola. However, activity was stronger in the region's smaller markets, a theme which we believe will continue into 2016. (See Chart 1.)
- Low commodity prices continue to batter many of the region's economies, notably oil-rich Nigeria and Angola. Nonetheless, many African economies are actually net commodity importers and therefore benefit from lower prices. In Kenya, for example, falls in commodity prices have boosted income by about 3% of GDP. (See Chart 2.)
- But even commodity importers will continue to run wide current account deficits in 2016. (See Chart 3.) Supply-side constraints have prevented domestic production from keeping up with demand, driving large trade deficits.
- These structural deficits kept pressure on African currencies in 2015. (See Chart 4.) Most currencies are likely to continue to weaken this year 2016, albeit more gradually.
- The Nigerian naira will probably be an exception. The official naira exchange rate has been held steady by an increasingly complex system of FX controls in recent months. (See Chart 5.) We expect it to be devalued in 2016. This will cause an inflationary shock, but it will probably be less damaging in the long-run than the slow contraction of demand caused by the currency controls.
- Weak currencies have added to inflation, which is high throughout Africa. We expect inflation to pick up in during 2016. Uganda, where a weak currency coincides with loose fiscal policy, is likely to be particularly hard hit. (See Chart 6.)
- Poor infrastructure is, of course, a major constraint on growth across the region. This is even true of the region's most advanced economy, South Africa, where electricity output has been declining since 2012 as ageing generators require more and more maintenance. (See Chart 7.)
- While growth should pick up a little in 2016, we expect it to remain very weak compared to the previous decade or so. GDP growth should accelerate slightly in Nigeria and Angola if we are right in forecasting oil prices to stabilise.
- Growth should pick up more sharply in Ghana as the country recovers from its recent currency crisis and oil output rises. The region's second-largest economy, however, is a worrying exception. We expect GDP in South Africa to expand by a paltry 1.3%, which is below the consensus. (See Chart 8.)

TABLE 15: SELECTED SUB-SAHARAN AFRICAN ECONOMIES

	World Share[1]	GDP (% y/y) 2014	2015e	2016f	2017f	Inflation (%) 2014	2015e	2016f	2017f
Sub-Saharan Africa	3.0	4.9	2.9	3.8	4.5	7.0	7.4	8.3	7.4
Nigeria	1.0	6.2	2.5	3.2	4.0	8.1	9.0	9.5	9.0
South Africa	0.7	1.5	1.3	1.3	1.8	6.1	4.6	5.8	6.2
Angola	0.2	4.4	1.5	3.0	4.0	7.3	10.5	13.0	9.5
Kenya	0.1	5.4	6.0	6.7	6.7	6.9	6.5	6.8	6.3
Ghana	0.1	4.0	3.0	4.5	7.0	15.5	17.0	12.5	12.0

(1) Share of world GDP in 2014 PPP terms.

Sub-Saharan Africa Charts

Chart 1: Share of SSA GDP (%)

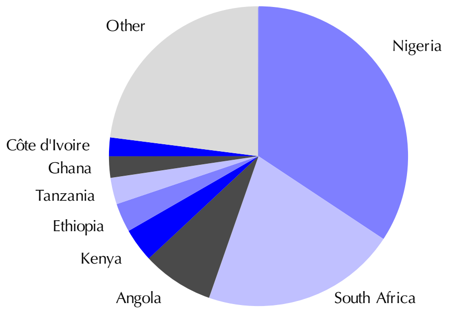


Chart 2: Change in Net Commodity Exports (2014 to latest, % of GDP)

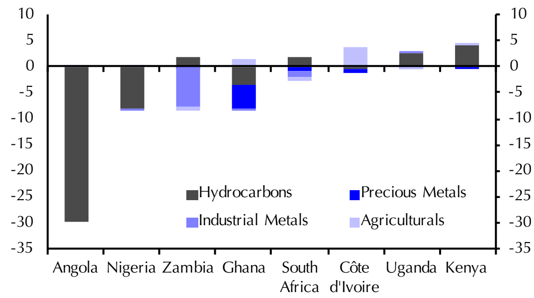


Chart 3: Current Account Balance (% of GDP)

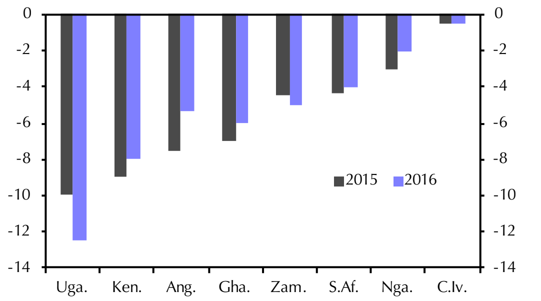


Chart 4: Currencies vs. US$ (Index, 1st 2015 = 100)

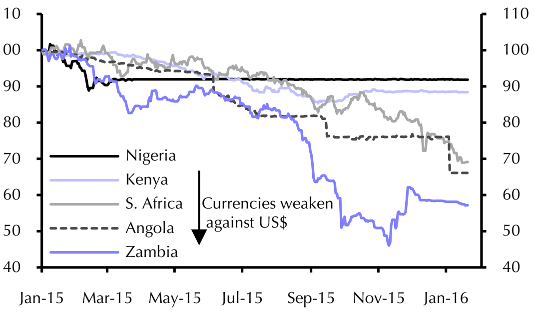


Chart 5: Naira per US$

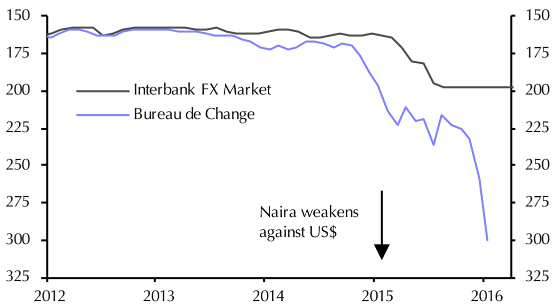


Chart 6: Consumer Prices (% y/y)

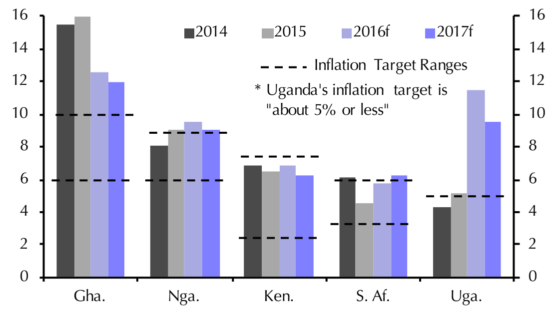


Chart 7: South Africa Electricity Output (12m Av. GWh, '000)

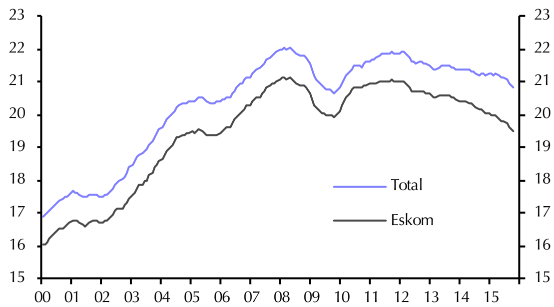
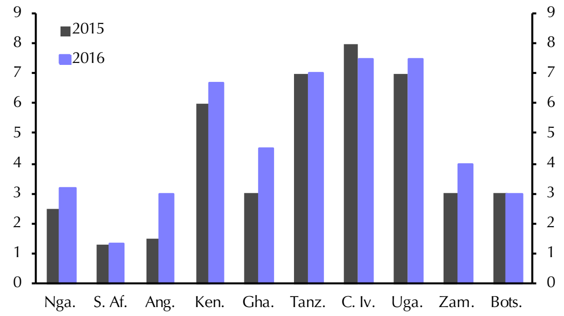


Chart 8: GDP (% y/y, Ordered by Size of Nominal GDP)



Sources – IMF, Thomson Datastrea, National Sources, CE

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About Roger Bootle, Executive Chairman

One of the City of London's best-known economists, Roger Bootle runs the consultancy, Capital Economics, one of the world's largest independent economics consultancies, which he founded in 1999. Roger is also a Specialist Adviser to the House of Commons Treasury Committee and an Honorary Fellow of the Institute of Actuaries. He was formerly Group Chief Economist of HSBC and, under the previous Conservative government, he was appointed one of the Chancellor's panel of Independent Economic Advisers, the so-called "Wise Men". In July 2012, it was announced that Roger and a team from Capital Economics had won the Wolfson Prize, the second biggest prize in Economics after the Nobel.

Roger Bootle studied at Oxford University and then became a Lecturer in Economics at St Anne's College, Oxford. Most of his subsequent career has been spent in the City of London.

Roger has written many articles and several books on monetary economics. His latest book, The Trouble with Europe, first published in May 2014, was published in paperback in April 2015, to wide acclaim. It follows The Trouble with Markets, which analyses the deep causes of the recent financial crisis and discusses the threats to capitalism arising from it. Like his previous book, Money for Nothing, which correctly anticipated the financial crisis, it has been widely praised. It followed the success of The Death of Inflation, published in 1996, which became a best-seller and was subsequently translated into nine languages. Roger is also joint author of the book Theory of Money, and author of Index-Linked Gilts.

Roger appears frequently on television and radio and is also a regular columnist for *The Daily Telegraph*. In The Comment Awards 2012 he was named Economics Commentator of the year.

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