Ibbotson Associates Economic Commentary

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Key views

- Monetary policy in the United States, on one side, and eurozone and Japan, on the other, will diverge in 2015, and probably in 2016. But the Federal Reserve may start raising rates later than the consensus expects. Tightening may also be smaller in 2015 than the market thinks.
- Despite the sharp appreciation of the U.S. dollar, further rises are probable.
- Cheaper oil has lowered the market's projections of inflation in the short term. Growth expectations, on the other hand, have risen for most mature economies. A rebound in the price of oil is likely in 2015, but new supply from unconventional oil sources has depressed the long-term baseline price.
- Fear not deflation. Headline inflation will shortly turn negative in many advanced economies, prompting some economists to worry about a deflationary spiral. The latter, however, is unlikely in economies with fiat money and excess bank reserves.
- Grexit is more likely than ever. Markets appear too complacent.

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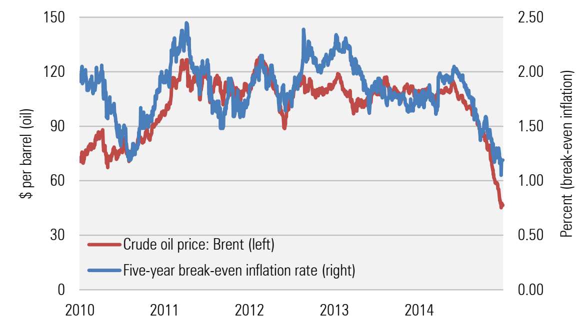

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Global themes

The consensus can be dead wrong. In 2014 most economists, including myself, expected a bear market for bonds. Instead, long-term yields fell across major currencies. Troubled European sovereigns were no exception. Italy closed 2014 borrowing five-year money for less than 1%, down from 2.7% a year earlier.

To be fair to Mr. Consensus, a few of his (clichéd) forecasts were right. The Federal Reserve tapered asset purchases and eventually shelved quantitative easing. The dollar rose. It was a year of sluggish growth, globally. China stayed on course for a soft landing. Fiscal headwinds did ease. Japanese headline inflation accelerated, even if only thanks to the consumption tax. Commodity prices didn't rise. Globally, inflation was lower than it's been in decades. The eurozone's recovery was indeed slow and uneven—Spain, however, surprised on the upside, and Italy and France disappointed.

But the mainstream was caught out on many fronts, besides interest rates. The Bank of Japan launched another wave of asset purchases. The Bank of England didn't raise interest rates, despite signals to the contrary in 2013. U.S. unemployment fell below 6%, and oil prices below $60. Russia took a bite off Ukraine. The Fragile Five made it to December. Brazil, however, lost "its" World Cup in a crushing defeat to Germany. (Reigning champion Spain, to my chagrin, didn't make it past the preliminary phase.)

What will be the surprises of 2015? Since I'm not a particularly sharp shooter—despite the occasional hit—I made a New Year's Resolution: "Thou Shalt Not Forecast." Instead, this Commentary discusses this year's themes, pointing along the way the scenarios the consensus takes for granted, and the ones that are not taken seriously enough. Enjoy.

Monetary policy: Divergence, yes, but how much?

Financial markets are convinced that the Federal Reserve will begin raising interest rates in 2015, lifting the policy rate to 1.25% by 2017. Most forecasters, according to Consensus Economics and Wall Street Journal polls, say the round of hikes will start either on April 29 or June 17. The yield on the 10-year note, according to the Wall Street Journal survey, is forecast at 3.1% in December 2015, and 3.75% one year later.

The previous tightening phase, 11 years ago, may be a guide to what's coming. In January 2004, the central bank stopped repeating that it would keep policy loose for a "considerable period." Instead, the Fed judged it could be "patient" in removing policy accommodation—just like they said on December 2014. The March 2004 announcement made no changes to the key phrases. One meeting later, in May, the central bank inched forward, saying, "the Committee believes that policy accommodation can be removed at a pace that is likely to be measured." If sticking to the script, this time they would change the language in March. At the very next meeting, in June 2004, the Fed raised the target rate. When extrapolated to 2015, the first hike would then come in April.

An April liftoff is justified, some analysts say, because the economy grew 5% in the third quarter, and the unemployment rate is near the central bank's long-term range.

I believe there's far too much consensus around how early the tightening will begin, and how far it will go. About timing, it's easy to imagine why the first hike would be delayed. Headline inflation dropped like a rock in December. Unless oil bounces back, base effects may keep CPI inflation under 1% through the summer. Besides, wage growth nosedived in December, after rising above 2% a year since August 2013.

If we get to the April meeting with inflation brushing zero, slow wage growth, and flat core inflation, the Fed may feel "patient" a little longer.

The hikes may not take rates as high as markets think either. The neutral interest rate –at which the economy hits the natural unemployment rate—is a good guideline to medium-term monetary policy. That neutral rate has fallen over the decades. Today it appears to be lower than the Fed's own long-term projections (3.75%). Tomorrow it might go lower.

Secular currents, I'm afraid, run that way. Low labor force participation, feeble wage growth, a rising share of middle-aged workers, low productivity growth, etc. all lower the equilibrium interest rate. When the markets wake up to the fact that the economy can't deliver its potential with policy rates north of 3%, bond prices will have to adjust.

Or not. I find surprising that long-term yields have fallen, now below 2%, despite overwhelming agreement that policy rates are about to take off. Perhaps the bond market has already priced in a neutral interest rate below 3%. Add to that a softer global outlook, on cyclical grounds, and U.S. treasuries don't look too overvalued.

The European Central Bank is dealing with an entirely different breed of cat. The eurozone's economy struggles to take off. Deflation is at the gates. The chances of a hike are virtually zero in both 2015 and 2016. In fact, the new asset

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purchase program eases monetary conditions through September of next year.

The ECB will buy, from March 2015, €60 billion of assets a month (including the €10 billion under current programs). National sovereign debt and securities issued by European Union institutions are eligible, but corporate debt is off limits.

Across sovereigns, purchases will be proportional to each country's share of capital in the ECB. For instance Germany, the largest owner, has a 25.6% weight; Spain, 12.6%. Finally, the ECB will limit the portfolio to one third of a country's outstanding issuance.

The program elicits mixed feelings. On one hand, the total purchase will be at least 50% larger than the market anticipated.

On the other hand, as markets had grumbled, risk sharing comes with a cap. If the national banks incurred losses on the assets purchased, only 20% will be shared across the Eurosystem. The remaining 80% loss would be borne by the national banks (read "taxpayers"). A priori, partial loss-sharing limits the program's appeal to Italy, Portugal or Spain, who have much weaker fiscal fundamentals than Germany.

Regardless of whether you think that Draghi's policy solves any real world problems, you probably welcome it. What Draghi just delivered is an extended Valium prescription. A long commitment to easy monetary policy does wonders for asset prices: it reduces volatility, lowers borrowing costs, keeps default rates low, and supports equity valuations higher than otherwise.

The divergence theme, then, is alive and well. The surprise may come from Washington. If the Federal Reserve turns dovish, as I suspect, it may let us keep the punchbowl a while longer.

U.S. dollar: Room for further rises

A 15% rise since last summer, on a trade-weighted basis, has left some investors fretting that the greenback is expensive.

A longer bull market is very much in the cards. A 15% run-up is a molehill next to what happened in the early 1980s (54% appreciation) or the late 1990s (40%). Besides, adjusting for inflation differentials, a dollar is still cheaper, compared to a basket of euros, yens, and pounds, than it was in 1997-2003 or 1981-1986.

A threesome of euro issues is behind the rich dollar: deflation in Europe, central bank reserves, and Greece. Prolonged disinflation, and now technical deflation, forced the European Central Bank to start quantitative easing. Draghi has said he will keep buying assets "until we see a sustained adjustment in the path of inflation." What 'sustained' means, or how large an 'adjustment' would satisfy Draghi remains TBD. My impression, nonetheless, is that the ECB overestimates how much core inflation the economy can bear. Sure, oil prices and currency vagaries can bring price increases above 2%, for a few months. In the medium term, however, adverse demographics drive a downward trend. The German slant of fiscal-monetary policy doesn't help either.

If committed to an inflation rate "close to 2%", as the ECB's mandate states, we will wait for a long time. To be sure, Draghi didn't tie quantitative easing to an inflation threshold. And Germany would rumble way before core inflation reached 2%. Still, the upshot is that interest rates in Frankfurt would remain glued to zero beyond 2016—far longer than in Washington.

Another factor behind the strong dollar has been that central banks reduced their reserves in euros. Since June 2014, when the ECB introduced negative rates, foreign central banks must pay to hold euro reserves. Those reserves have fallen, as entities park their money in dollars or Swiss francs. That won't change soon.

The fallout from Syriza's victory in Greece could get much worse. Despite the media hype, the currency market hasn't fully priced Grexit and its ramifications. Portugal, Spain, and Italy might raise doubts in the markets this year.

What might restrain the dollar? I think the carry trade, with euro as the funding currency, will be risky. Interest rate differentials between dollar and euro are thin. If rates increase less than anticipated in Washington, or the liftoff is delayed, traders will get bruised. Another negative (for the dollar) would be that Greece's future clears up quickly, especially if that meant stronger support from Germany to stay in the eurozone.

On the whole, I see more pluses than minuses for the dollar. The bull market can go on.

Oil: Great things don't last, but sub-$100 oil might

From February 2011 until June 2014, Brent traded below $90 on exactly three days. This past July, only two of 49 forecasters polled by The Wall Street Journal expected oil to fall below $90 by year-end. An ever-growing population, plus ever-shrinking oil reserves, supposedly made $50 oil a

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nostalgia item, like one-dollar movie tickets. Or so we thought. In the last trimester of 2014 the price sank to $55.

In the short term lower prices benefit oil-importing countries, a category which happens to include the five largest economies in the world: United States, European Union, China, Japan, and India. Altogether, they account for two thirds of the world's Gross Domestic Product (in nominal terms, at market exchange rates), and half the population.

A $10 fall in the price of oil is a transfer $325 billion a year from oil producers to consumers. If the average price in 2015 were $70, $30 lower than in 2014, the gift would amount to 1.2% of world GDP.

When oil prices change, one minus one doesn't equal zero. The winners are, largely, households in rich countries. They are many and spendthrift. The losers are few: the governments of oily countries, and producing companies. They're also less constrained by current income than consumers, so it'll be a while before they cut investment, dividends, etc. Overall, then, cheaper oil lifts global spending--for now.

The crude rule of thumb is that U.S. demand increases 0.1% for every $10 drop in the price of oil. European consumers, hurting with high unemployment, get a much needed lift.

However, there's a catch. Consumer prices track the cost of black gold in the short term. Persistently low oil prices mean that U.S. inflation might fall below zero shortly. The eurozone in December was already in technical deflation.

For oil exporters, the effects of cheaper oil are (no surprise) negative. Income, profits, and fiscal revenue will all go down, but to different degrees, depending on how hooked the economy is on oil. For example, energy makes up 70% of Russia's exports, 25% of its output, and 50% of government revenues. Cheap oil, consequently, is wreaking havoc in there. By contrast, Norway's net exports of oil and gas amount to just 10% of GDP, and 29% of the government's receipts. Its massive sovereign wealth fund (almost $1 trillion) should help soften the blow.

According to data from the International Monetary Fund and the Financial Times, most major producers outside North America run a fiscal deficit if the price goes below $100. Some of them –Algeria, Iraq, Iran, Libya, Nigeria, and Venezuela--don't balance their budgets unless the stuff is trading above $100 (Russia is in that group as well). Cheaper oil will mean less revenue, tighter budgets, and currency depreciation—wherever the exchange rate is not fixed. In addition, if inflation expectations are not well anchored, higher inflation is likely.

Why are prices falling? The most important reason is that there is a plentiful supply. As oil prices increased in the mid-2000s, energy companies found it profitable to extract oil from shale formations. Crude production in the U.S. alone jumped from about five million barrels a day (mbd) in 2008 to nine million now, out of a total of 75 million. The United States is on track to overtake Saudi Arabia as the world's top producer. Including ethanol and other liquid fuels, the U.S. is already number one. Crude production in Canada has increased by about 0.7mbd since 2008, thanks to tar sands.

Until recently the extra oil from North America had a muted effect. The boom coincided with disruptions in the supply from Libya, Iraq, and Iran. That took about 3 million barrels of daily production off the market. But in 2014 things changed. Libya's output, for instance, according to OPEC's Monthly Oil Market Report, increased by 400,000 barrels a day since the summer. That led to OPEC's total production rising to 30.3 mbd in the third quarter of 2014 from 29.8 mbd in the first quarter.

In November, as excess oil kept piling up, Saudi Arabia announced it wouldn't scale back production. As the only major producer with spare capacity, it can steer world prices, while everybody else acts as a price-taker.

The Saudis might be trying to defend their market share. A recent interview with the Saudi oil minister supports this view: "It is not in the interest of OPEC producers to cut their production, whatever the price is," said Ali al-Naimi in a recent interview with Middle East Economic Survey. "Whether it goes down to $20, $40, $50, $60, it is irrelevant." He added that we may never see a $100 price again. For now he's certainly crushing it.

Wall Street estimates that most shale projects in the U.S. turn a profit at $60 a barrel. That means many wells are losing money as I write this column. Companies should pull back on drilling, putting a floor under oil prices, at least in theory.

Not the case, though, in practice. Oil companies sign contracts that give them the right to drill on a plot of land for a certain period. If they don't drill, they must compensate the lessor, and the right to drill expires. In the short term, after the contract is awarded, drilling makes sense even below the "breakeven price."

Production, then, won't necessarily slowdown in the coming weeks, even if new drilling does. Canadian oil sand projects can turn a profit for even longer years. Tar sands are more like mining than oil drilling: they require large initial investments, after which they can keep producing oil for years, at low marginal cost.

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For several reasons, even over the long run prices might not recover all the way to $100 a barrel, for several reasons. First, technology is lowering the cost of squeezing tight oil out of the ground. Second, disruptions in the Middle East will return, eventually. In fact, one could argue that low oil prices might lead to more disruptions, if OPEC producers have to cut public expenditures and trigger social unrest. Third, at $60 a barrel Saudi Arabia would run a fiscal deficit of 14% in 2015, according to Moody's. How long can Riyadh afford it?

The supply surge is one story. But on the other (proverbial) hand, analysts worry that the price of oil has fallen because of weaker demand. Instead of raising disposable income for consumers, cheaper oil is a harbinger of slower growth. But where's the evidence of this slowdown?

Copper, nickel, and iron ore have all dropped over the past six months. The same is true of wheat, sugar, cotton, and soybeans. That price declines are so widespread strongly suggests that global forces, not just commodity-specific effects, are at play.

A different explanation, however, for decreasing commodities prices is that U.S. real interest rates are expected to go up. The Fed is now patiently awaiting the right time to start tightening. Past bouts of rising real rates have coincided with sinking commodities prices.

Others point at forecast surveys to explain lower oil prices. Forecasters have been marking down GDP projections, bringing down the world's expected growth 0.3 points in 2015. In particular, economists have in mind the structural slowdown in China, the lackluster recovery in the eurozone, a Russian rumble, and the failure that is Abenomics. Pessimism is further amplified because negative scenarios get a lot of press.

But real-time gauges of activity, such as the composite Purchasing Managers Index, don't show a major decline. The problem with the demand hypothesis is that it's mostly in the realm of the "expected," not the "actual." Oil supply has actually gone up, but whether China will slow down in 2015 remains to be seen. Pin your global outlook, if you wish, to the herd's. But remember: Mr. Consensus forecasted that oil would now be trading at $100.

To be sure, the supply and demand interpretations are not at odds. Oil prices may be responding to a recent surge in supply. Cheaper oil is raising growth now, but it's not enough to offset macroeconomic forces that are expected to depress demand in the medium term. If the pessimism is overdone, plus oil supply stays up, prices could recover.

Inflation: Deflation fears are overdone

Cheaper oil is crushing inflation. As price rises were already meager in advanced economies, inflation is likely to turn negative—deeply so in places like Switzerland, Sweden or Greece. For 2015 as a whole, average forecasts have fallen by at least half a percentage point for all Western countries. Is falling inflation a challenge? The mainstream has it that deflation, like cholesterol, comes in two varieties: "good" and "bad." The first type stems from a positive supply shock, such as higher productivity or, today, the lower cost of a key commodity. Bad deflation comes about when demand is persistently behind potential.

Teasing the two apart is tough: "good" and "bad" deflations can coexist. Nevertheless, the conventional view asserts that European and Japanese deflations are mostly of the "bad" kind. The U.S. and the U.K., on the other side, are largely in the grip of "good" deflation.

Other distinctions are useful. Small, expected price declines aren't as bad as big, unexpected deflations. If prices fall 3% a year, real debt rises at a snail's pace. Defaults don't happen overnight. Productivity growth means that nominal wages and profits can still rise—albeit slowly—even if prices don't.

Perhaps, but some economists worry about the deflation spiral. Lower inflation means that real interest rates are rising. With zero nominal interest rates, the central bank can't fight back. If real rates fall, consumers and businesses postpone consumption and investment. Demand weakens, which causes output to fall. This depresses inflation further, feeding a vicious loop.

This deflationary vortex, with paper money, seems impossible. If the central bank stops paying interest on reserves, or starts charging for them, money will chase goods, or the currency will depreciate, or both. Either way, prices rebound. Even under the gold standard, big deflations were rare, on both sides of the Atlantic. Real GDP wouldn't fall over protracted periods of falling prices. The only period when a big deflation coincided with shrinking output was the Great Depression. But that was a rapid deleveraging under the gold standard.

Deflation, don't get me wrong, isn't a crackpot's nightmare. Population aging and its companion, a higher saving rate, are slowly but surely pushing all mature economies towards lower inflation. However, that's a slow disease (which can be cured), not a quick spiral.

Prices, however, are rising less than central banks would like. It's not clear that Yellen, Draghi, and company have can

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lift inflation, although they believe so. And that's my concern: that interest rates stay too low for too long.

Greece: Germany gambles

When Greece's crisis broke out, at the end of 2009, debt as a share to GDP was 127%. Athens was rescued by official lenders which, in return, demanded sharp cuts to public spending. Partly because of fiscal austerity, economic activity shrunk—19% since 2010. The average Greek is now 22% poorer than in 2008.

Despite the pain, the debt ratio swelled to 175%. In absolute terms, the government owed €330 billion in 2010; €316 billion in 2014. Debt is barely declining.

Suppose that Athens managed, forever, to balance the budget before interest payments. Assume, also, that Greece grew 2.5% a year, and kept inflation at 2%. And assume it could keep the average cost of debt at 4.2%, today's rate thanks to the bailout. Under those (rosy) conditions, a hundred years from now Greece's government would still have obligations worth 130% of GDP.

No wonder that Alexis Tsipras, who campaigned to restructure debts and renegotiate the austerity terms, is now prime minister.

During the campaign Tsipras also said he wanted to stay in the euro. But compromise with the troika may prove impossible. Germany, the sine qua non party, has been clear that debts must be repaid. Grexit is closer than ever.

In the hypothetical doomsday scenario, after a few weeks of talks, the troika and Greece can't reach a deal. A bank run follows, but Europe's official lenders don't save the day. Athens is forced to restrict capital outflows. Liquidity dries up, and Greece's central bank issues domestic currency (new drachmas). Grexit becomes a fait accompli.

This chain of events pivots around Germany's position. Officials in Berlin and Brussels believe that bond markets won't turn against other peripheral countries. This sang-froid can be justified. When Athens called elections, in December, the currency didn't move, and stock markets barely flinched. Portugal's economy, and Ireland's, and Spain's, are on the mend. The European Stability Mechanism has now a standing facility to bail out members in need. Draghi's got QE. French and German banks aren't much exposed to Greece any more. Grexit might even be a plus, if removing a bad apple makes the rest of the barrel healthier.

Another cynical interpretation is that Germany wants Greece to leave, so that nobody else does. Grexit would cause a deep crisis in Greece, with frightful effects for businesses and banks. That would scare Italy or Spain not to vote for parties like Five Star Movement, or Podemos.

Or is Germany bluffing? Letting Greece out is a big gamble this year. Both Spain and Portugal are going to the polls in 2015. Besides, the European bailout safety net, in case of contagion, is not large enough to pull out big fish like Italy or Spain. In addition, Europe's version of quantitative easing, with its partial risk-sharing, has a decaf feel to it.

I find all this quite unsettling. So why aren't the markets in a panic? A doubtful explanation is the "weakest link" thesis I mentioned: a Greece-less eurozone is actually stronger.

More likely is that markets think that one side will give in. What if Tsipras backpedals on its promise to restructure the debt? Syriza has formed government in coalition with a smaller party: Independent Greeks (ANEL). In the best case scenario, the coalition would hold. There would be riots, and both parties would be politically dead. But Greece would crawl onwards for a few more years, inside the euro.

At worst, the coalition would break up. If Tsipras can't find a new partner—and, realistically, there's only one other party—new elections may have to be called.

Can Germany get off the high horse? Many economists in Brussels and Washington believe (correctly, I think) that Greece needs another restructuring. I suspect Germany would never accept a straight haircut. A maturity extension or zero-interest loans might be palatable to both Greeks and Germans, even if it means fiscal discipline for Athens. One can only hope.

My sense is that the market will shortly re-price the risk of default and exit, reflecting higher odds of Grexit. Beyond that, I don't think even the director of this drama knows what's coming next.

Country commentary

United States

The third quarter GDP release surprised on the upside, three times. The advance estimate of an upbeat 3.5% growth (quarter on quarter, annualized) got revised to an speedy 3.9%, then further upgraded to a blistering 5% pace, managing to best the second quarter's 4.6%. Consumption rose modestly, probably held back by slower housing activity and modest wage growth.

PMI surveys point to a slowdown in Q4, from the abnormally high rate of growth of Q3. Lower oil prices should provide a small push to the economy in the short

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term. Household spending should benefit, although investment in the energy sector will probably suffer. The overall impact in the short term is in the ballpark of 0.1% of GDP for every $10 fall of oil prices. Real spending growth already leaped to 0.7% a year in November, from 0.2% in October. Although month-to-month figures are too noisy to draw conclusions, cheaper gasoline should noticeably boost consumption growth in 2015:Q1, from 2014:Q4.

One-year-ahead growth forecasts have improved lately, thanks to solid gains in payrolls and better labor utilization rates. Involuntary temporary employment has narrowed, and the unemployment rate is now probably near its neutral rate.

Some will discount the rapid reduction of the jobless rate, as it's the result of massive drop of the participation rate. Recent work by researchers at the Federal Reserve, however, suggests that cyclical weakness is only depressing the participation rate by 0.25 to one percentage point. The remaining 2% to 2.75% drop, since 2007, is thus due to demographics. The ongoing aging of the workforce, the authors estimate, will subtract 2.5 points from the participation rate over the next ten years.

That reinforces the view that unemployment is near, if not below, the cyclically-adjusted rate. That means that the Fed should consider the unemployment portion of its mandate fulfilled. Inflation should now be the polestar of monetary policy.

Core inflation has stayed between 1.5% to 2%, despite a precipitous fall of headline inflation since October. Forward-looking gauges of inflation are mixed. On one hand, inflation expectations are near the lower bound of the historical range. Hourly earnings gains were also very low in December, from a year before. On the other hand, the jobless rate is low and falling, labor turnover has increased, and unemployment insurance claims are near historical lows. Bank credit is rising near 8%, annually, which is within the typical range.

In the short term the headline rate will almost surely drop near zero, if not below, reflecting past declines in the price of oil. The risk to the consensus position is that the Fed gets intimidated by low headline inflation. If so, the central bank could postpone the first interest rate hike to the third quarter—or beyond, if core inflation started sagging. As I write this, judging from the Federal Open Market Committee's dovish slant, I think it's a likely scenario in the short term.

Beyond the next couple of quarters, I would be surprised if wages and core inflation didn't pick up. Higher interest rates are only a matter of time.

Eurozone

Headline deflation got pushed under zero by the recent plunge of oil prices. December's preliminary estimate put the annual consumer price index change at -0.2%, sharply down from a 0.3% rise in November and a 0.4% advance in October. Lower prices gill give households a modest relief from high unemployment and low wage growth. On the other hand, businesses might put off investment and hiring decisions, at least until the inflation outlook is clearer.

Expected inflation, from the ECB's Survey of Professional Forecasters in 2014:Q4, has been sliding down since late 2013. One-, two- and five-year-ahead forecasts, back in Q4, were at 1.1%, 1.4%, and 1.8%. The Consensus Economics Survey from January 2015, however, suggests that one-year inflation expectations may have fallen to almost zero.

I expect Gross Domestic Product to have risen a mere 0.1% in the fourth quarter, based on the composite output index from the Purchasing Managers survey. That would make Q4 the weakest trimester in over a year, and support the case for quantitative easing by the ECB.

Retail sales withstood the Q4 slowdown well, rising by 0.6% in October and 0.5% in November.

In Germany, real-time forecasts of output improved a little in December, although still suggesting GDP growth of around 0.5% (not annualized). Both new manufacturing orders and new business for service providers fell in December. Industrial output has not bounced from the summer slowdown and continues to contract on an annual basis. Exports have also shrunk, month to month, in October and November, as growth in Europe and Asia stagnates. Consumption and unemployment, however, improved late in 2014, offsetting weakness in the external sector.

France rebounded from an output contraction in Q2, posting GDP growth of 0.3% in Q3. Still, the Purchasing Managers Index composite output index doesn't suggest further improvement in Q4. If anything, the private sector should grow more slowly. In December the government announced a reform package, as Italy and Spain did in recent times, that should lift growth. It's too early, however, to tell the scope and effectiveness of actual changes.

Including 2014, Italy has been in recession for three years in a row. There shouldn't be a fourth year of contraction, but the January consensus forecast of growth for 2015, 0.4%, is not too reassuring. Unemployment in Italy rose 13.4% in November, up to 12.5% a year before. High youth unemployment, stifling labor regulations, and perennial political instability prevent Italy from realizing its productivity potential.

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United Kingdom

The U.K. has been one of the best performers among rich countries in 2014. GDP spent the best part of 2014 growing more than 2.5% on an annual basis, the fastest pace since 2010. Unemployment has stayed at 6% since August.

In the fourth quarter the economy slowed to 2% (annualized), compared with 2.9% in the third. Growth remains robust by long-term standards. All the growth, however, came from services; industry and construction contracted. The energy sector has yet to reflect the impact from cheaper oil.

Lower oil prices forced headline inflation to a 14-year low of 0.5% in December, which will likely turn negative shortly. Core inflation actually edged higher to 1.3%, much to the relief of the Bank of England. As in the U.S., policymakers in the U.K. seem to operate under the hypothesis that British disinflation is of "the good kind" (i.e. driven by a supply shock), rather than the pernicious, demand-driven type.

Despite stable underlying inflation, the central bank hinted that it wouldn't raise interest rates soon. That's a significant change from just a few months ago, when the BoE was expected to move ahead of the Fed. Rates on overnight index swaps suggest the market now expects the first rate rise no earlier than March, and possibly later than June.

It seems likely the U.K. will accelerate in the first half of 2015 thanks to lower fuel prices. Households, and hence retail sales, will benefit the most.

Japan

Prime Minister Shinzo Abe won the December election, and his Liberal Democratic Party and its (much smaller) Komeito coalition partner kept their two-thirds majority. Despite a turnout of only over half the electorate, the incumbent's victory has been interpreted as an endorsement to Abenomics—a mix of monetary easing, fiscal stimulus, and structural reform.

On the tails of this victory, Abe announced an additional, ¥3.5tn fiscal package, aimed at lifting growth. That would be the third fiscal program since he launched his tripod of policies over two years ago. (The first two, in January 2013 and April 2014, were worth ¥10.3tn and ¥5.5tn.) In addition, in the short term the administration is likely to push ahead with initiatives such as corporate tax cuts and the restart of nuclear plants.

The spending program might raise the deficit but most economists are betting that Japan will grow faster in 2015 than in 2014, which will boost tax revenues. The forecast for the government balance in fiscal year 2015-16 has thus slipped down over the past month.

Falling oil prices continue to undo the inflationary effects of the cheaper yen. Core inflation, excluding the effect of the consumption tax rise in April, is just 0.7%. Wages and inflation expectations have failed to pick up, which doesn't bode well for inflation in 2015.

China

Two headwinds held back China during 2014. One was Beijing's attempt to rebalance the economy and contain a runaway shadow financial sector. The second one was the cooling off of the property sector. Both contributed to keep real GDP growth at 7.4% in 2014.

The home stretch of 2014 saw signs of weakness. Industrial production expanded 7.2% from a year before in November, less than the 7.7% posted in October. The average output Purchasing Manager Index fell from Q3 to Q4. The composite index declined quarter-to-quarter, for manufacturing; for services, however, it rose a little.

In 2015 I expect Beijing to announce a growth target between 6.5% and 7%—the consensus forecast of growth is 7%, so a lower goal should be a surprise.
Fixed investment spending has tempered, from annual rates of 25% in 2010 to close to 15% now. The latter is still too high, but policymakers believe in a gradual approach to rebalancing, so I don't expect a collapse. If necessary, the government will roll out new stimulus measures to support investment and keep overall growth close to 7%. A modest example of policy support was the cut, by the People's Bank of China, of its benchmark rates in November. That was the first such move since July 2012.

India

Another letdown in 2014, when the economy probably grew close to 5.5%, just one percentage point more than in 2012 and far below the near-10% pace achieved from 2005 to 2008, and in 2010-2011. While I don't think that pace is sustainable in the long term, a cyclical return to something closer to 7% should be possible.

The first quarter of 2015 should see a growth spurt, thanks to lower oil prices--India is one of the world's largest importers. Consumers will benefit from cheaper oil through lower retail prices. In addition, the Reserve Bank of India can afford to lower interest rates (as it did this month), because inflation has dropped.

Inflation dropped to a record low 4.4% in November and, although it bounced to 5% in December, it's still at multi-year lows. Wholesale price inflation is essentially zero, and

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could well turn negative in January. Provided that price pressures stay low, further cuts should bring the key repo rate down to at least 7%, if not lower.

The pace of reform seems to have picked up in late 2014. The Modi administration took advantage of cheaper oil to scrap diesel subsidies, while also increasing prices for natural gas. The change should improve the fiscal balance or re-route resources to more important uses, such as public infrastructure. The government also lifted limits on foreign investment in a few sectors, and sent a bill to parliament for the implement a national goods and services tax, replacing the panoply of state taxes. With no state elections until November, Modi should be able to pursue contentious reforms for the next few months.

About Ibbotson

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