Germany

The minimum wage weighs on employment, but boosts growth

Activity remained sluggish in Q3 2014 in Germany (+0.1%, up from -0.1%): household consumption was dynamic but investment fell back again. In Q4, activity should barely accelerate (+0.2%): households should consume at a slower rate and investment is unlikely to pick up. In early 2015, purchasing power should accelerate due in particular to the introduction of the minimum wage; this should boost consumption (+0.7%) and activity (+0.5%). In Q2, with the effects of these temporary factors fading, activity should slow down a little (+0.4%).

At the end of 2014, the short-term outlook is gloomy

In Q3 2014, German growth disappointed (+0.1%, up from -0.1%), partly due to the effect of the unusual school holiday schedule *(box 1)*, but also probably due to the effect of the crisis in confidence linked to the conflict in Ukraine. Since the summer, the business climate has declined slightly, particularly in industry, which suggests that investment may not get going again before the end of the year. Capital goods expenditure should stagnate, while construction expenditure should increase only slightly given the recent decline in orders in this sector. In Q4, the main stimulus to activity should once again be household consumption, which is nevertheless expected to slow down (+0.2%) after a dynamic Q3 (+0.7%). Foreign trade should be neutral on growth. All in all, activity should barely accelerate in Q4 (+0.2%), which should bring annual growth to +1.5% in 2014.

The introduction of the minimum wage should boost growth in the beginning of the year

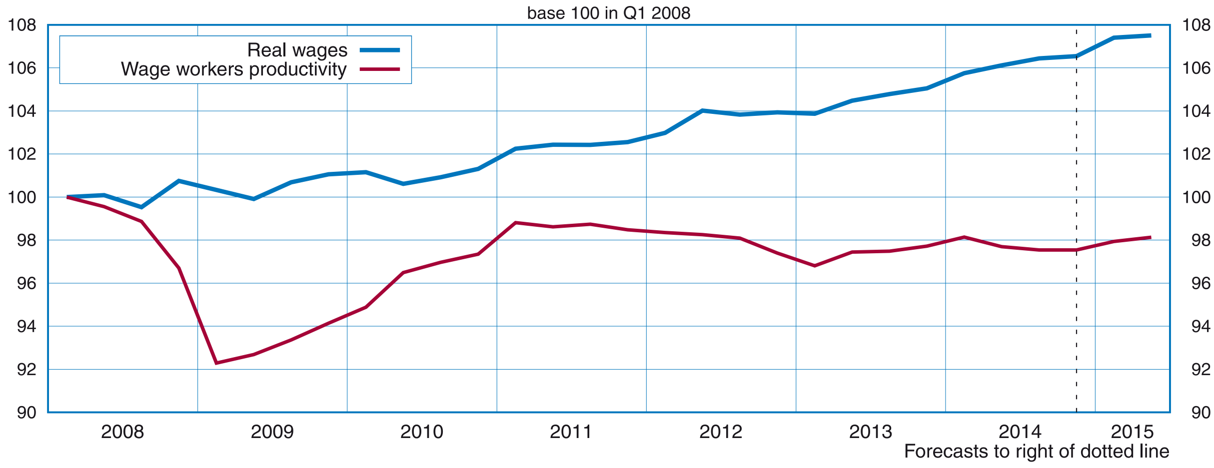
From 1 January 2015, German employees will be paid at least €8.50 gross per hour worked *(box 2)*. The average per capita wage should automatically increase by 1.1% from Q1 2015, and real wages should continue to increase more quickly than productivity *(Graph)*, while jobs may be lost in low-wage sectors. All in all, household income should benefit considerably from the introduction of the minimum wage, as well as the combined effects of lowered social contributions and higher retirement benefits from 2015 onward: it should increase by 1.1% in Q1 2015.

Prospects should brighten in H1 2015

The dynamism of household income should be translated in a substantial rise in private consumption in Q1 (+0.7%). At the same time, investment in equipment should accelerate (+0.8%), given the necessity to reinvest after a period of adjustment, but only tentatively, as companies' margins should be reduced by the acceleration in payroll. Imports should increase strongly, driven by internal demand, and the contribution of foreign trade to growth should be slightly negative. All in all, activity should accelerate sharply in Q1 (+0.5%).

In Q2 2015, the effects of temporary factors should fade, and activity should slow down slightly (+0.4%), mainly due to household consumption, which should however remain dynamic (+0.5%). The annual growth overhang at the end of H1 should be +0.9%.■

Since 2008, real wages have been increasing more quickly than productivity



Source: Destatis

Box 1 - Germany - Variations in industrial production and school holidays in Q3 2014

The monthly variations of the industrial production index (IPI) in July and August were affected by the unusual school holiday schedule in the summer of 2014. The IPI gain in July led to an overestimation of growth in Q3.

The school holidays were later than usual in many Länder, stimulating industrial production in July (+1.0%) and limiting production in August (-2.3%).

To correct the monthly variations of the IPI (SA-WDA) for the effect of the school holidays, the following model was used:

where:

$$ipi\_ecart = \underset{-1,98}{-4{,}1 * 10^{-5}} * (vac\_juillet + vac\_aout + vac\_sept)$$

* ipi_ecart represents the IPI as a deviation from its trend. The trend was extracted by use of a Hodrick-Prescott filter.

* vac_juillet+vac_aout+vac_sept is the number of school holiday days for the three summer months as a deviation from the average. This series was obtained after weighting by the number of inhabitants in the Länder affected by the school holidays (source: schulferien.org).

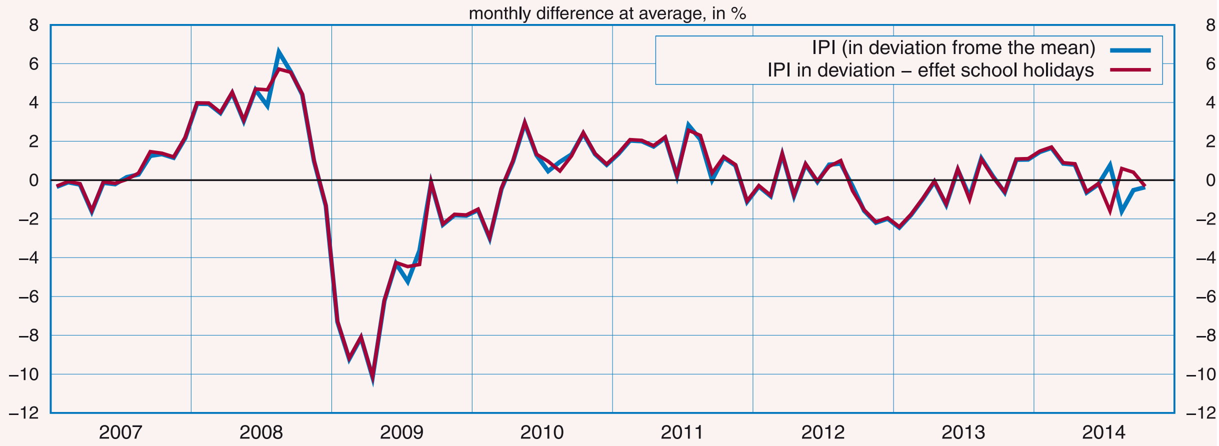
By definition, the estimation of the model differs from the observed series only for the months of July, August and September (*Graph*).

Excluding the impact of the school holidays, the IPI would have fallen back in July, before increasing slightly in August and September (the IPI trend being constant and close to 0 for the last months, the ipi_ecart variable can generally be interpreted as the IPI).

In Q3 2014, the overall effect of the school holidays on the IPI would be negative (-0.2 point), because there were more holidays then than in other years.

But ultimately, the underlying growth of the IPI was weak in Q3, and especially in July (*table*).■

IPI corrected for the school holidays effect



Sources: Destatis, INSEE calculation

Effects of school holidays on the IPI

	July	August	September
Observed changes of IPI	1.0	-2.3	1.1
Change of IPI outside school holidays	-1.4	2.2	-0.2
Effects of school holidays	2.4	-4.5	1.3

Sources: Destatis, INSEE calculations

Box 2 - Introduction of a minimum wage in Germany

In Germany, from January 2015, it will no longer be possible to pay employees less than €8.50 gross per hour worked[1]. This new minimum threshold should then be revised regularly.

In this issue of *Conjoncture* in France, the impact of introducing the minimum wage has been based on forecasts by the main German economic analysis institutes[2].

Hourly wages likely to rise significantly

In 2014, 5.3 million salaried workers were paid under €8.50/hour, or 14% of all employees. Nevertheless, given the exceptions provided by the law, 4 million employees are likely to be affected by the introduction of the minimum wage from 1st January 2015, or 10% of all employees. On average, for those concerned, the hourly wage should increase by 2 euros per hour. This corresponds to an increase in the average hourly wage of around 1.1%[3]. This will take effect immediately, from Q1 2015.

(1) There are a few exceptions, especially for employees aged under 18, and those covered by a branch agreement that contains a minimum wage of less than €8.50/hour.(3) 10% of employees have a wage rise of 30% (from €6.50 to €8.50), and their hourly wage currently represents €6.50/€17.30 = 38% of the average hourly wage in Germany. The direct impact is therefore 10%*30%*31%=1.1%.

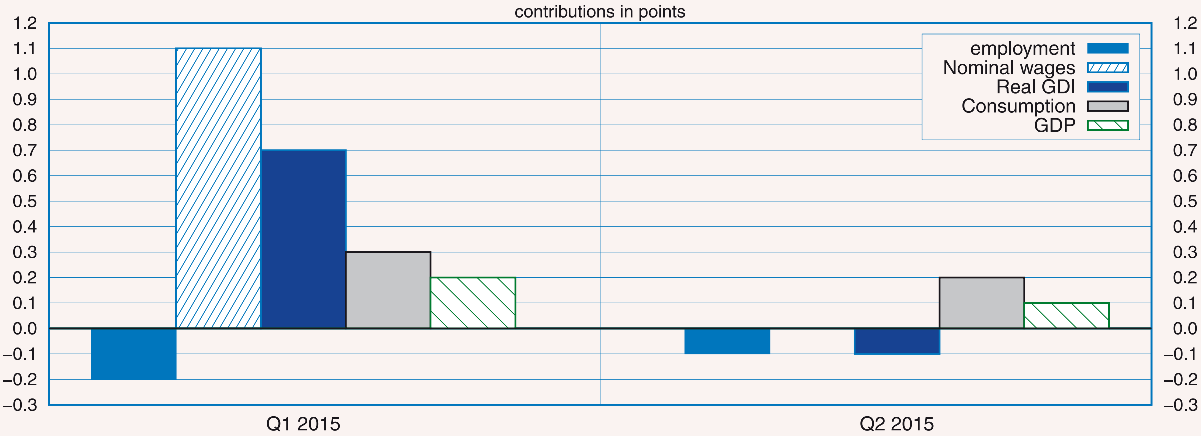
A negative impact is nevertheless expected on employment

The economic literature suggests that employment is likely to be adjusted downwards with the increase in labour costs, although the scale of the adjustments varies according to the different estimates. The chosen scenario involves a decrease in the hourly volume of work in the low-wage sectors of around 4% (0.3% across the economy as a whole). As jobs in these sectors are often part-time or minijobs, the effect on employment per capita is likely to be lower: -0.4% for the economy as a whole, or 200,000 jobs. Given the time-lag required for employment to adjust to labour costs, this effect on employment will probably be gradual and spread over several quarters in 2015 (-0.2 points in Q1 2014 then -0.1 points for the following quarters in relation to "spontaneous" employment forecasts).

A positive effect on activity

In all, the introduction of the minimum wage should result in a substantial increase in payroll in Q1 2015 (+0.9%). However, in the short term, households are unlikely to spend all of the extra income; they will probably save some, before adjusting consumption behaviour to their new income. For this reason the minimum wage is likely to have an upward impact on consumption in Q2 2015 *(Graph)*.■

Impact of introducing the minimum wage



The introduction of the minimum wage is likely to contribute -0.2 points to employment variations in Q1 2015.
Source: Germeinschaftsdiagnose

Italy

Stuck in the doldrums

Activity declined by 0.1% in Q3 2014, after -0.2% in Q2: technically, Italy is once again in slight recession, aftera stability in Q1 2014. GDP should stabilise in Q4. 2014 should therefore be the third consecutive year of declining activity (-0.4%). This sluggishness is likely to continue in H1 2015 and the mid-year growth overhang for 2015 should again be negative (-0.1%). The balance between the moderate dynamism of private consumption and foreign trade on the one hand, and the persistent decline in investment on the other, should mark the quarters to come.

The business climate deteriorated in the summer

After a slight improvement at the beginning of the year (which was not translated in the activity figures), the business climate in Italy deteriorated. The business tendency surveys suggest that activity will stagnate in Q4 2014. This stagnation in activity should continue on into Q2 2015.

Investment falls back again

The decline in investment is the main factor behind the sluggishness of activity. On the one hand, investment in construction has fallen continually since 2008 (34% cumulative decline) and notably cost 0.4 growth points in 2014. Neither the persistently lacklustre household income nor the perspectives of business leaders suggest that this trend will be reversed in the short term (-1.0% per quarter through to mid-2015).

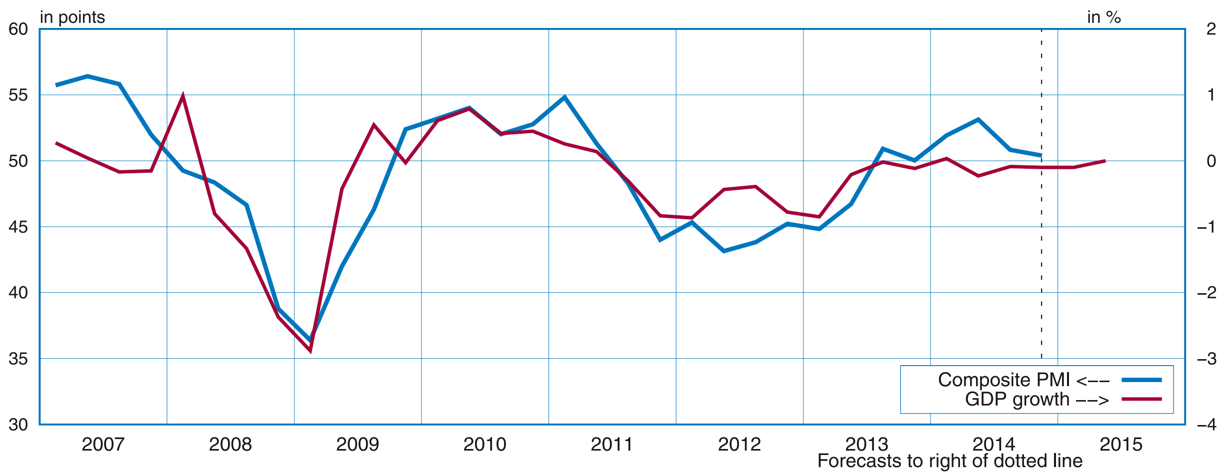
On the other hand, productive investment has been falling almost continually. Mediocre prospects for demand and the low production capacity utilisation rate prevent any recovery, while the corporate investment rate is at its lowest level since 1995 (when figures became available): 5.8% in Q2 2014 compared to 7.4% in 2007. The fall in investment in equipment should therefore continue between now and mid-2015, but should gradually ease, thanks to stronger foreign demand and the improvement in financing conditions: -0.5% in Q4 2014, -0.4% and -0.3% in Q1 and Q2 2015.

Household consumption holding firm

Conversely, household consumption is holding firm (+0.1% per quarter on average since mid-2013), thanks to the lowering of the savings ratio. With the stabilisation of employment and the monthly 80 euro reduction in the tax burden that came into force in the spring of 2014, consumption should continue to grow at the same rate through to mid-2015, without households having to lower their savings ratio again.

Lastly, foreign trade should contribute positively to activity growth, as has been the case since the beginning of 2014 (+0.1 points per quarter), thanks in particular to the favourable effects of the Euro's recent depreciation: indeed, exports should accelerate (+0.8% in Q4 2014, then +0.7% per quarter until mid-2015), while imports remain less dynamic (+0.4% in Q4 2014, then +0.4% and +0.5% in Q1 and Q2 2015), due to rather sluggish domestic demand.■

GDP and composite PMI index of activity



Sources: Markit, Eurostat

Spain

The vigorous recovery gathers pace

The Spanish economy confirmed its recovery in Q3 2014, with activity progressing strongly (+0.5%) for the fifth successive quarter. Over the forecasting period, as still-favourable business tendency surveys suggest, Spanish growth should continue: +0.6% in Q4, then +0.5% per quarter in H1 2015. This vigorous activity is above all driven by the recently regained dynamism of domestic demand - particularly in private consumption and corporate investment - after six years of decline. All in all, after two years of falling GDP (-2.1% in 2012 and -1.2% in 2013), GDP should increase again in 2014 (+1.4%) and the growth overhang for 2015 after H1 should settle at +1.7%.

Private consumption still the main driving force of growth

Since H2 2013, household consumption has been rising again in Spain, in line with the relatively high levels of the business tendency surveys. For H1 2015, this vigour should be confirmed (+0.6% per quarter on average), thanks to a strong rise in employment, a halt to the shrinking of wages, and a gradual fall in precautionary savings enabled by the fall in unemployment begun in mid-2013 and which should continue on into mid-2015.

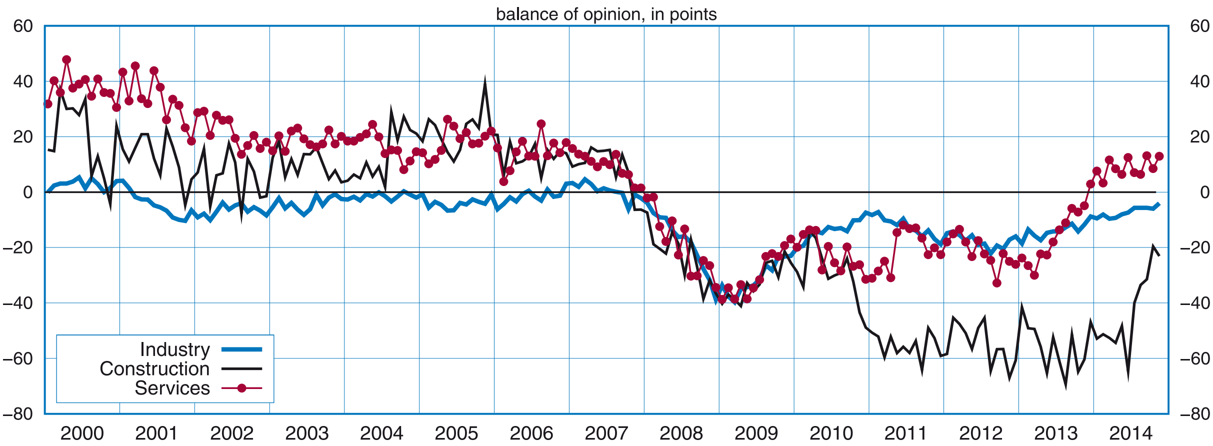
Investment also boosting activity

At the same time, the recent rise in building permits and the improved confidence shown in surveys of construction entrepreneurs *(Graph)* suggest the end of the property market adjustment. This should allow a smaller contraction of investment in construction in late 2014, then a slight rise in early 2015. This improvement should mark the end of seven years of decline, during which the share of construction in GDP fell by more than half, dropping from 22% in mid-2007 to 9% in mid-2014.

Through to mid-2015, capital goods investment should continue to grow quickly (about +2% per quarter), as it has done since the beginning of 2013. This progression is due to the need for reinvestment after a period of adjustment, the possibilities opened up by the high level of corporate margin, and increased production capacity utilisation.

Exports, sustained by the regained competitiveness of the Spanish economy and the recent depreciation of the Euro, should remain buoyant while imports should slow down slightly. All in all, the contribution of foreign trade to growth should be zero in the forecast, whereas it had been negative since mid-2013.■

business climate per sector
Last point: November 2014



Source : INE

United Kingdom

Slight loss of momentum

Although the United Kingdom has been going through a vigorous economic recovery phase since early 2013, activity slowed in Q3 2014 (+0.7% after +0.9%). The level of confidence in business tendency surveys remains high, but lower than the levels observed since late 2013. So growth should slow again in Q4 (+0.5%). In particular, the dynamism of household expenditure should be moderated by the slower fall in precautionary savings and by the reduction of wealth effects linked to the slowdown in property prices. In addition, foreign trade should continue to dampen activity. In H1 2015, growth should be maintained (+0.5% per quarter) and the annual growth overhang for 2015 should reach +18% by the middle of the year.

The business climate falls back

In Q3 2014, British growth reached +0.7%, after +0.9% in Q2. This slight slowdown is attributable primarily to services (+0.7% after +1.0%) and, to a lesser degree, to manufacturing (+0.4% after +0.5%). The deterioration of the business climate since August, followed by a modest recovery in November (*Graph*) suggests activity should slow down again in Q4 2014 (+0.5%), as a result of the lesser buoyancy of public and private consumption. On the supply side, the slowdown is likely to stem primarily from services and construction activities. In H1 2015 activity is expected to maintain the same growth rate (+0.5% per quarter), sustained by still solid, although less dynamic, domestic demand.

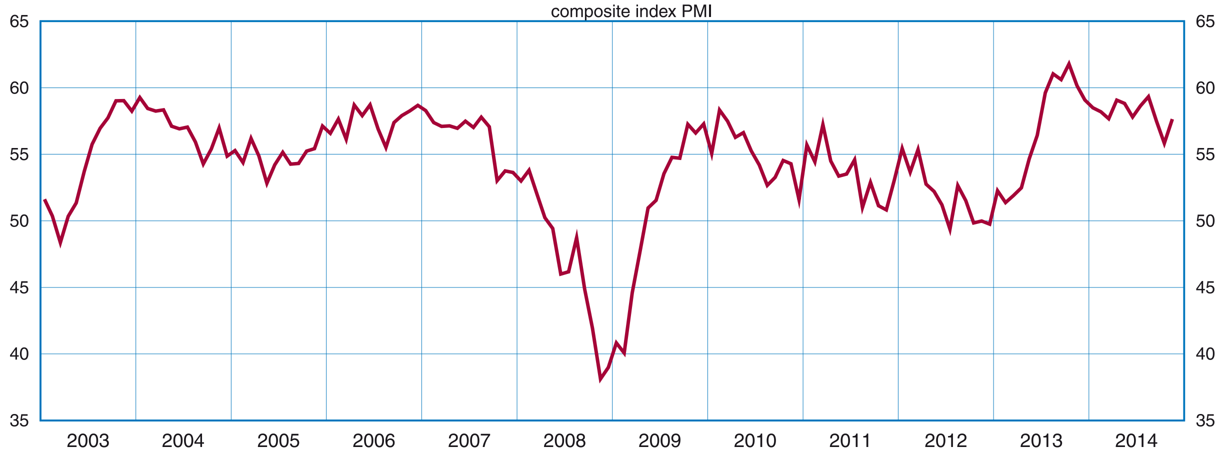
Domestic demand slowing down

British households, which remain confident despite a recent decline, are expected to spend at a slightly reduced pace (consumption and residential investment) over the forecasting period, in comparison with the trend of recent quarters: +0.7% in Q4, then +0.5% per quarter in H1 2015. Unemployment should continue to fall, but more slowly, which should slow the fall in precautionary savings. In addition, the property market became significantly quieter (slowdown in prices, fall in the number of transactions and credit granted), which should limit wealth effects. Nevertheless, the dynamism of payroll employment and weaker inflation should support household purchasing power.

Foreign trade continues to limit growth

For the last two years, the increase in exports has remained modest and the UK's market share has diminished, partly due to the appreciation of the pound, which limits competitiveness, but also apparently due to non-price competitiveness losses. Consequently, through to mid-2015, exports should again increase less quickly than world trade. Sustained by the dynamism of domestic demand, on the other hand, imports should grow at a significant rate. All in all, the contribution of foreign trade to activity growth should be negative in each of the forecast quarters (-0.1 points per quarter).■

The business climate was down in the summer



Source: Markit

European national accounts have switched to the 2010 base

Since September 2014, the accounts of the different European countries have been released using the new “2010 base”. Changing base means reviewing the methods, classifications and statistical sources used in national accounting to reflect economic reality in the best possible way. The switch to the 2010 base gives the opportunity to carry out a certain number of conceptual adjustments, often linked with the change in the European System of Accounts (switch from “ESA 95" to ”ESA 2010"), and methodological adjustments, as happens every time a change of base is introduced.1 Incidentally, the reference year for prices is now 2010 (against 2005 previously).

As was the case for France, revisions to GDP and the main aggregates of demand (consumption, investment, foreign trade, etc.) are relatively small compared to the variability of the different series for the other European countries studied too (Germany, Spain, Italy, United Kingdom).

Annual GDP level has been increased by about 3% in each country

In the Eurozone (18 countries), nominal GDP in 2010 has been increased by 3.5%: in Germany and France, the increase is 3.2%, while in Italy it is 3.6% and in Spain 3.4%. This revaluation of the level of GDP generally affects quarterly variations only to a small extent. Nevertheless, the history of recent activity changed slightly: in particular, growth has been more vigorous in the United Kingdom and France since 2008, but less so in Germany and Spain *(Graph)*.

(1)The quarterly accounts have switched to the 2010 base, "*Conjoncture* in France, June 2014, for further details on the switch to the 2010 base in France.
(2)Jess N., Pramil J.and Roucher D. (2013) "In search of lost British productivity", Conjoncture in France, December 2013, INSEE.

These differences reflect not only the impact of conceptual changes linked with the new ESA, but also often the introduction of new recently acquired information.

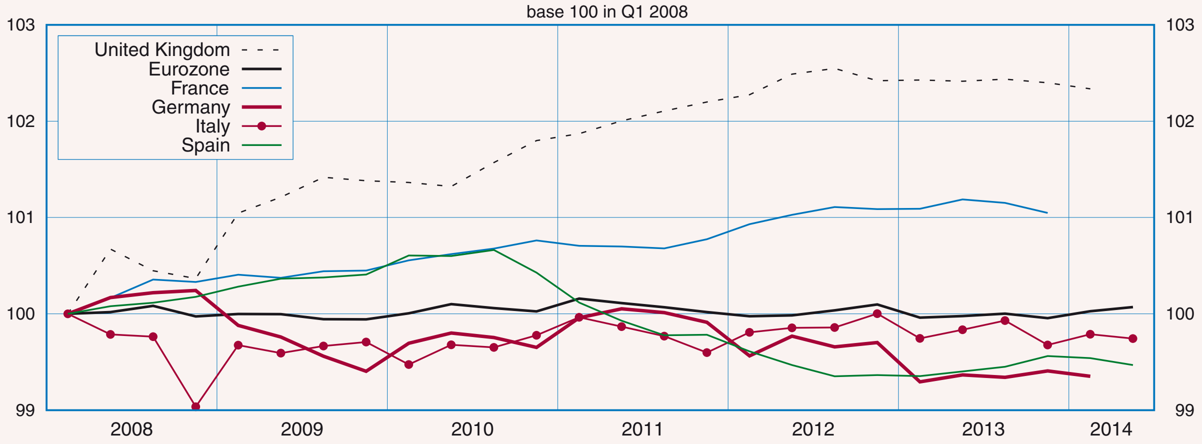
Investment is increased by the inclusion of R&D expenditure

In all the countries studied, investment expenditure has increased significantly (+16% for the Eurozone as a whole), most notably because the figures now take into account spending on research and development, which contribute most to the GDP revaluation. In Italy, GFCF has increased by only 6% between the two bases, and the upward revision of household consumption, to take the illegal economy into account, contributes almost the same amount to the increase in GDP.

The scale of the British productivity puzzle has lessened

Revisions to the British national accounts have reduced the scale of the fall in productivity observed in the United Kingdom.2 Productivity gains are still particularly low in the United Kingdom since the 2008 crisis; nevertheless, the deviation from the long-term trend has decreased slightly, standing at 15% against 20% previously. First, the trend followed by productivity gains was lower before the crisis: +0.9% average annual growth between 1970 and 2007 against +1.1% before the revisions. In addition, the slowdown in productivity was less marked during the recession (-1.4% against -2.5%) and the upturn more dynamic than before the revisions. In short, the productivity puzzle in the United Kingdom is still ongoing but the scale of the phenomenon has been revised downwards.■

GDP in volume terms: diference between the 2010 base and the 2005 base



Sources: Eurostat, INSEE calculations

United States

The recovery is solid, keeping the dollar strong

Activity remained buoyant in Q3 2014 (+1.0% after +1.1%), with the American economy confirming its recovery after a contraction at the beginning of the year due to harsh winter conditions. Part of the summer dynamism, however, is attributable to temporary factors (fall in imports, big rise in public defence expenditure to finance the military intervention in Iraq), so there should be a backlash, with activity slowing down in Q4 (+0.6%).In H1 2015, domestic demand should be slightly more dynamic and activity should accelerate again (+0.7% per quarter).

The recovery is solid

Activity should slow down slightly in Q4 2014, in line with the message delivered by business tendency surveys: the business climate remains at a high level in all sectors, but has stabilised since the summer *(Graph)*. Activity should then gain momentum in H1 2015 (+0.7% per quarter), sustained by robust domestic demand.

Corporate investment remains robust

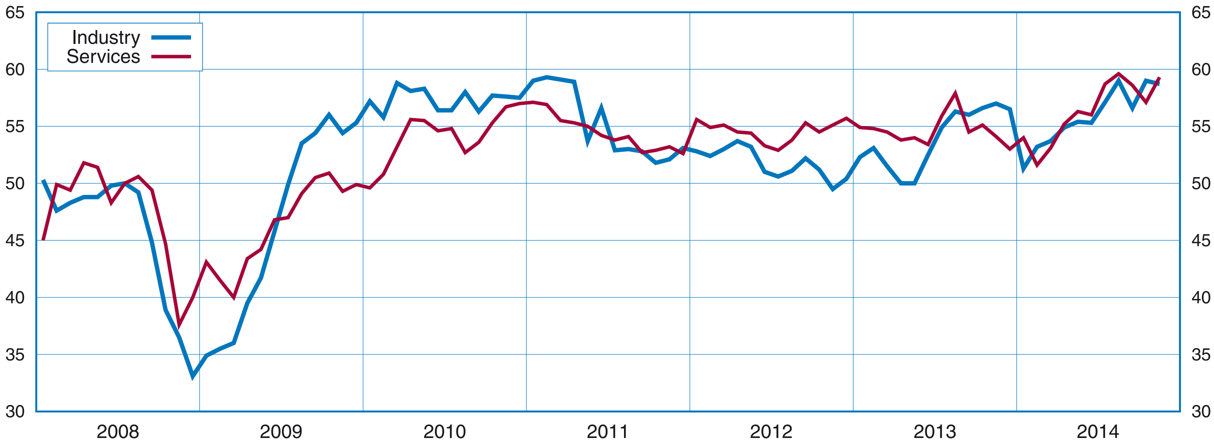
The good performance of activity and the rise in production capacity utilisation rates should encourage companies to continue their non-residential investments at a rate between 1% and 1.5% per quarter. On the other hand, residential investment is unlikely to rediscover its dynamism of 2012 and 2013, as suggested by the loss of momentum in property prices and the slowdown in housing starts during 2014.

The labour market continues to improve

Since January 2014, the American economy has created on average 241,000 jobs per month and the unemployment rate has regularly fallen back, down to 5.8% in October, its lowest level since July 2008. Wages, which accelerated considerably in real terms (+1.3% as an annual average in 2014 compared to +0.5% in 2013), should also remain on track in H1 2015. Consequently, growth in purchasing power should remain dynamic (+1.0% per quarter on average), and household consumption should benefit from this: after slowing slightly in Q3 (+0.5%), it should recover a little more momentum in Q4 (+0.6%) then in H1 2015 (+0.7% per quarter).

After a sharp recovery in Q2 2014 (+2.7%), exports slowed in Q3 (+1.2%). They are expected to be only slightly more dynamic (+1.4% then +1.3% per quarter), in the wake of weaker world demand and handicapped by the dollar's past appreciation. After the fall in Q3 (-0.2%), imports should recover in Q4 (+1.5%), then continue at a sustained rate of progress in H1 2015 (+1.3% per quarter), driven by dynamic domestic demand but slowed by the fall in imports of petroleum products. The contribution of foreign trade should be slightly negative over the coming quarters.■

The business climate remains strong in both industry and services



Source : ISM

Japan

The end of deflation remains uncertain

Japan is in recession again: activity shrank by 0.5% in Q3 2014, after -1.7% in Q2. This fall is largely due to widespread destocking among Japanese companies, but the sluggishness of domestic demand indicates that the VAT rise in April produced worse consequences than expected. Household consumption recovered only slightly (+0.4%) after falling in the spring (-5.2%), residential property investment continued to shrink substantially (-6.8% after -10.0%) and corporate investment fell back again (-0.4% after -4.7%). Through to Q2 2015, the effects of the VAT rise should fade and activity increase moderately (+0.4% per quarter on average).

Activity should grow again at the end of 2014

After a sharp deterioration in Q2, the business climate in manufacturing gradually picked up, stimulated by domestic orders and exports *(Graph)*. However, the business climate in services is gloomy. All in all, activity should grow moderately in Q4 (+0.4%).

Domestic demand should pick up slightly

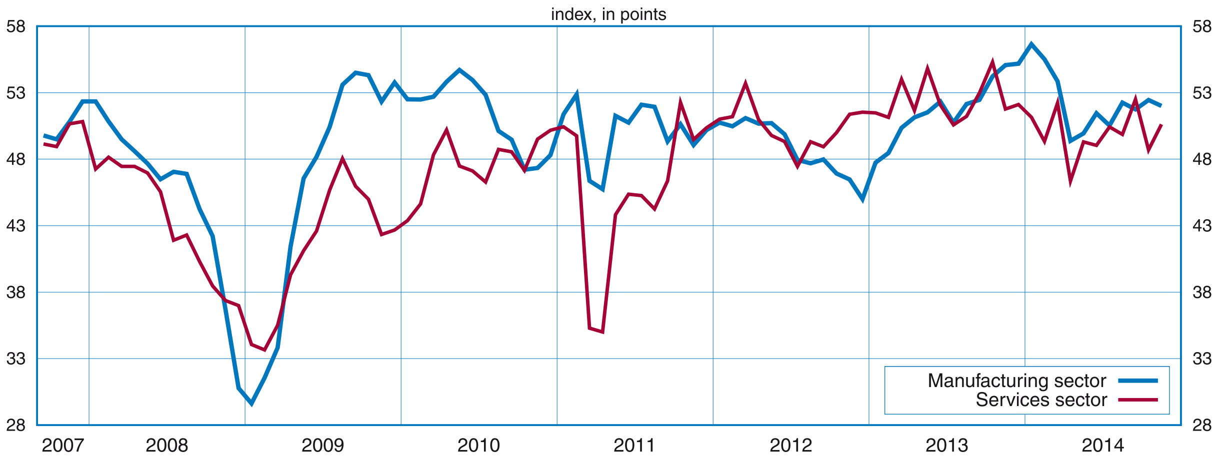
Household consumption expenditure picked up only slightly in Q3. The low level of household confidence suggests that the rise in consumption should remain fairly modest: +0.3% in Q4, then +0.4% per quarter in H1 2015. Corporate investment should stagnate in Q4 2014 then accelerate slightly in H1 2015, driven by slightly more dynamic activity. Property investment should slowly stabilise over the forecasting period: housing starts are late recovering from the shock of the VAT rise.

The business tendency surveys indicate that exports should be dynamic in Q4, in line with world demand. They should remain that way in H1 2015, sustained by the relative buoyancy of world trade and the past depreciation of the yen. Driven by domestic demand, imports should also regain a little vigour.

The end of deflation remains uncertain

The VAT rise in April 2014 led to a sharp acceleration in prices, with inflation reaching levels unmatched since 1991. It settled at +2.9% in October (without the VAT rise, the Bank of Japan estimates that the rise in prices would be only 1.0%). So this level is in large part due to a temporary stimulus, added to the strong depreciation of the yen. Indeed, wage growth remained tentative in Q3: the exit from deflation dynamic has not yet been completely engaged. The Bank of Japan therefore announced a new acceleration of the monetary base in November. In addition, faced with the scale of the effects caused by the rise in VAT this year, the government announced the postponement of the second VAT rise, initially planned for 2015, and has called an early general election in December. ■

The business climate in manufacturing holds firm



Source: Markit

Mixed first results for Abenomics

Since 1998, Japan has been in a deflationary spiral and is struggling to restore dynamic economic activity in a context of a massive rise in government debt. At the beginning of 2013, the government of S. Abe, soon after being elected, put in place a policy in several parts - or 'arrows' - designed to bring Japan out of this spiral: this policy is commonly known as "Abenomics". The objective is, on the one hand, to boost demand by means of a very accommodating policy mix intended to anchor expectations of inflation at a higher level, and on the other hand to increase Japan's potential growth through structural reforms.

"Abenomics" combines several types of proactive policies to escape deflation

This policy can be divided into three "arrows": a major fiscal stimulus, a massive monetary expansion, and the implementation of structural reforms to boost potential growth. In the short term, the objective is threefold: to generate a sharp rise in prices which would encourage corporate investment by lowering real interest rates and enable an exit from the deflation dynamic; to revive exports through a major depreciation of the yen; and to generate a fiscal multiplier effect.

A fiscal stimulus and a VAT shock

Since taking office, the government of S. Abe has chosen to implement a strongly expansionist fiscal policy, reactivating expenditure on infrastructure in particular. A fifth stimulus package since the earthquake in March 2011 was passed in February 2013 for around 2.2% of GDP. A sizeable part of this package was assigned to the reconstruction of areas devastated by the 2011 earthquake (0.4% of GDP) and to the replacement of obsolete infrastructures (0.8% of GDP). Social and medical-social services also benefited from supplementary funds constituting 0.7% of GDP.

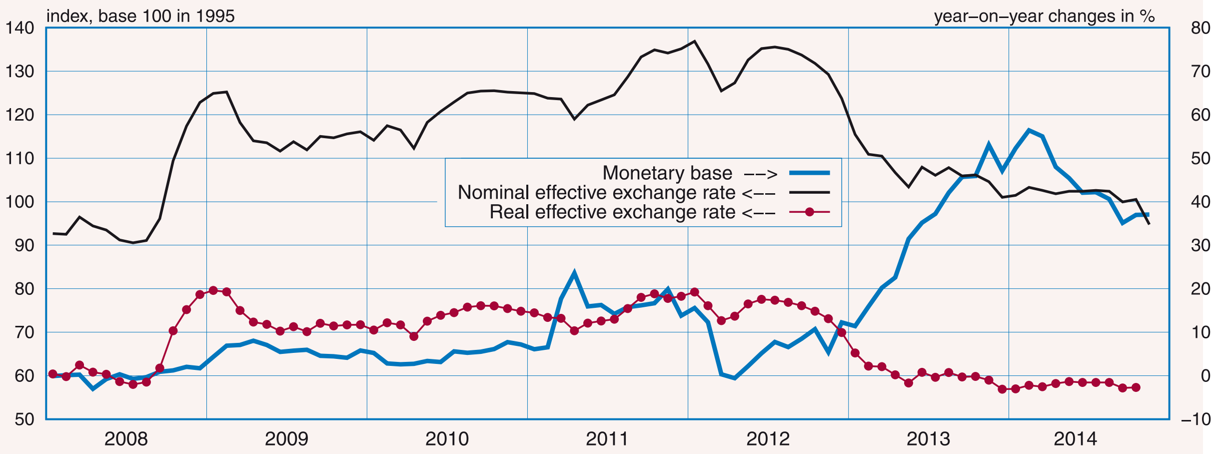
To finance this major stimulus package without putting strain on already highly damaged public finances (the government deficit reached 12% of GDP in 2013, taking its debt to 244% of GDP), the government decided on a parallel increase in VAT. Because of the likelihood of this slowing down the recovery, this rise was controversial. It was initially supposed to be put in place in two steps (from 5% to 8% in April 2014, then from 8% to 10% in October 2015).

A highly expansionist monetary policy

In parallel, and in agreement with the Japanese government, at the beginning of 2013 the Bank of Japan decided to greatly accentuate the expansionist nature of its monetary policy. It therefore inaugurated a policy aimed at targeting inflation of 2%, a very high objective for a country in which inflation was an average of -0.2% for the period 1998-2013. To meet this objective, the Bank of Japan decided to massively increase the monetary base from 60,000 billion yen to 70,000 billion yen (13 to 15% of GDP) per year *(Graph 1)*. This policy of qualitative and quantitative easing is aimed at lowering the long-term interest rate for various classes of low- and high-risk assets, in order to stimulate investment. It includes mass purchasing of long-maturity Treasury bonds, sovereign bonds and other government securities, but also higher-risk securities, such as stock-listed funds or mutual property funds.

In financial terms, implementation of this policy has had notable effects, theoretically beneficial for the Japanese economy in the short term. It led to a sharp depreciation of the Yen (almost 40% since 1st January 2013: *Graph 1*). It also led to a rise in the market capitalisation of Japanese companies *(Graph 2)*, capable of generating wealth effects for portfolio holders, that are beneficial for internal demand. Lastly, real long-term interest rates fell considerably.

1 - Japan's monetary base and effective exchange rate



Sources : Bank of Japan, Treasury calculations

The impact of the first two arrows is countered by the VAT rise in April 2014

Abenomics have been slow to have an effect on activity

The effects of the policy mix have been slow to work through into the real economy: GDP growth was +1.5% in 2013, as in 2012. Given the weak price elasticity of Japanese exports, the depreciation of the yen did not have a significant effect on the volumes of exports *(Graph 3)*, while it pushed up the cost of imports, particularly energy imports, with the balance of trade reaching a historic deficit. Furthermore, stock market rises do not seem to have accentuated the dynamism of household consumption through wealth effects. On the other hand, public investment contributed strongly to growth in 2013 (0.5 points), as did property investment, with a marked rise in prices as a corollary.

Wages picked up, but their increase remains very modest

To escape from deflation, the Japanese government hoped that higher wages given by companies to their employees would enable them to cope with the rise in prices. This mechanism seems only partly to have worked. In 2014, basic wages enjoyed renewed growth, for the first time since 2008, but increased only slightly year-on-year (+0.3% in October for basic wages, *Graph 4*) while inflation was boosted by the VAT rise (+2.9% - see below). Payroll was essentially driven by employment and exceptional bonuses. However, the favourable financial environment did benefit companies: their margin rate is very high and the manufacturing production capacity utilisation rate picked up. All in all, the share of added value shifted in favour of companies.

The April 2014 VAT rise threatens the Abenomics strategy

The rise in the VAT rate (from 5% to 8%) in April 2014 did increase inflation: the Consumer Price Index (excluding food) increased by 2.9% year-on-year in October 2014 *(Graph 5)*. But the Bank of Japan estimates that, without the fiscal shock, the price rise would only be 1.0%, a level comparable to that at the beginning of the year. In addition, a large part of inflation is due to imported inflation, strengthened by the depreciation of the yen.

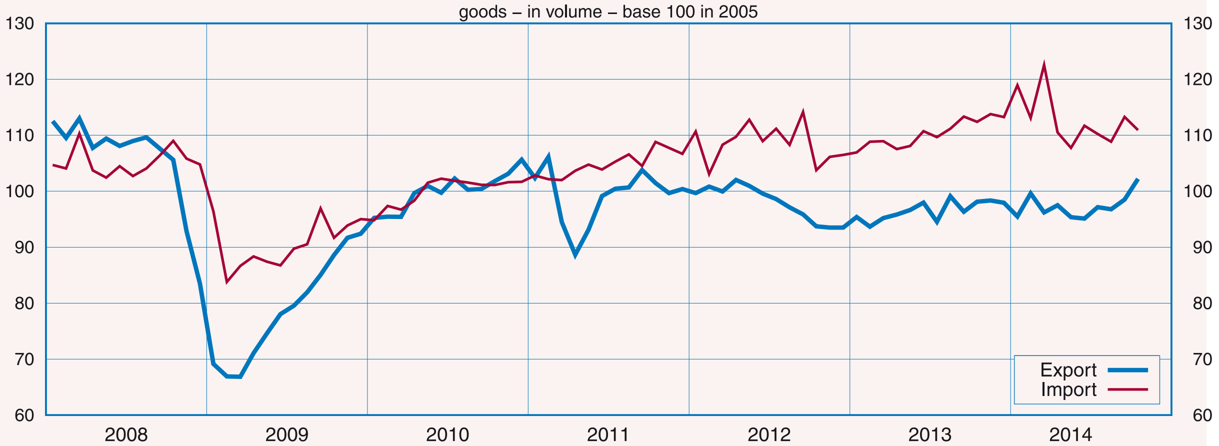
2 - Stock market indices for some advanced economies

base 100 in January 2012

Source : Macrobond

3 - Japan's exports and imports

goods – in volume – base 100 in 2005



Source: Trade statistics of Japan

In addition, the fiscal shock seems to have had a powerful recessive effect on the Japanese economy, much worse than the authorities had anticipated: therefore, once the effects of the rise in VAT fade, there is a risk that inflation may gradually fall back. Consequently, the Japanese government decided in November, at the same time as the dissolution of the Lower House, to postpone the next VAT rise, from 8% to 10%, initially planned for October 2015. The country's entry into recession also led the Bank of Japan to accentuate its expansionist monetary policy, raising the objective for growth of the monetary base to 80,000 billion yen (about 17% of GDP) per year.

Still no sign of the third 'arrow' being implemented

The third 'arrow' of Abenomics, and the most delicate to implement, consists in carrying out a medium-term growth strategy. This 'strategy for the revitalisation of Japan', reaffirmed by the S. Abe government in June 2014, can be divided into several macroeconomic or sector-specific structural reform projects, announced by the government in June 2014, but which remain at this stage fairly fuzzy.

Labour market reform to encourage activity

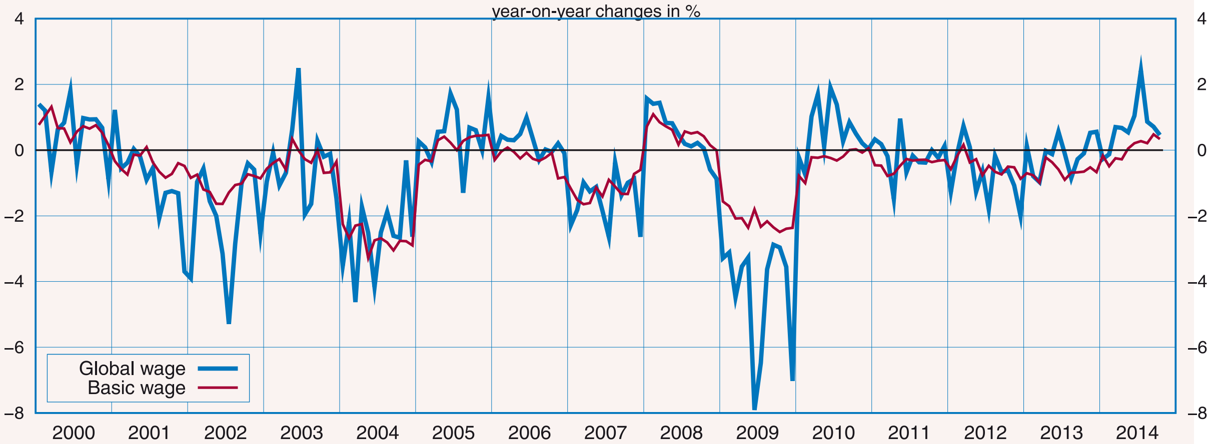
Japan is an ageing country. Its active population has been decreasing since the late 1990s, which weighs down on the country's potential growth. To fight this trend, the Japanese government will facilitate female employment, which is lagging behind other developed countries *(Graph 6)*, by increasing childcare capacities and encouraging the promotion of women to executive positions.

In addition, through increased support for innovation and research, the government intends to stimulate the country's productivity. Several programmes, particularly for helping investment in R&D, were put in place in 2014. In future, the government intends to carry out a 'robotic revolution' to reinforce automation of the economy massively (up to twice as many robots in the manufacturing industry, and twenty times more in non-manufacturing industries by 2020). This should help fight against the forecast labour force deficit.

A fiscal reform aimed at stimulating investment

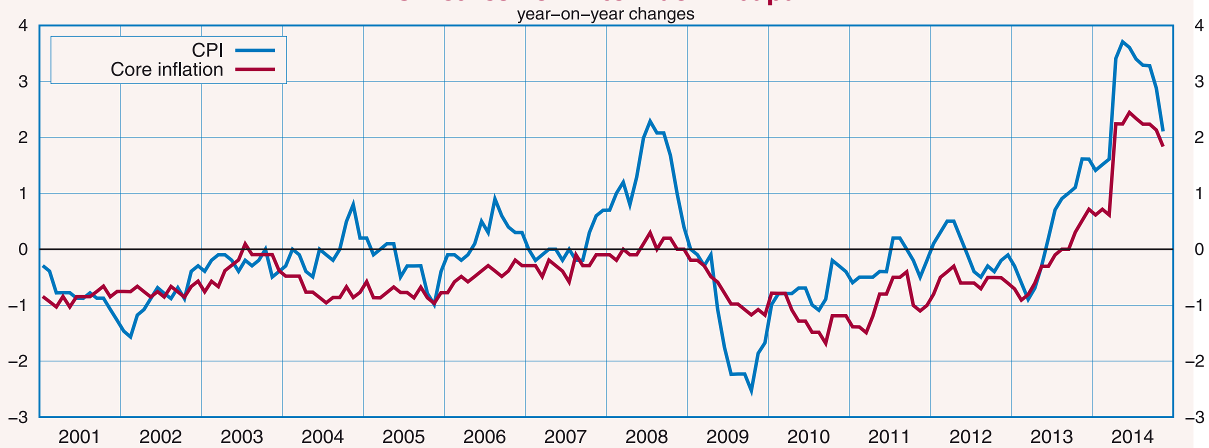
In April 2014, the corporation tax rate was reduced from 38% to 35.6%, and is expected to be lowered again in 2015. In the medium term, the Japanese government is likely to reduce corporate taxation to a level below 30%. It also intends to encourage companies to improve the profitability of their shareholders' equity, particularly through a reform of corporate governance. A reform aimed at improving the supply of certain sectors by making them more competitive, notably the agricultural and energy sectors, is also on the agenda.

4 - Wages in Japan



Source: Japan Cabinet Office

5 - Consumer Price Index in Japan



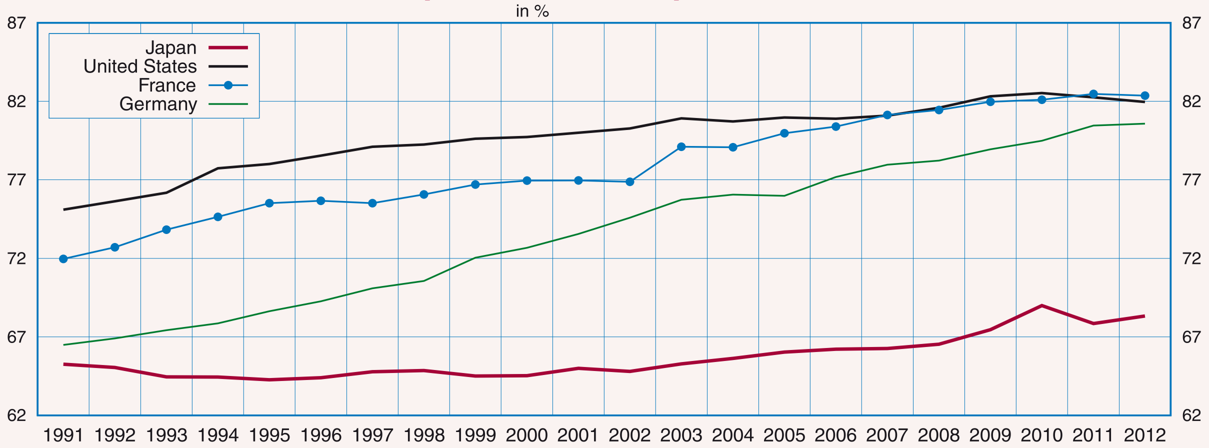
How to reading : The last known point is October 2014. The November point is an estimate based on the consumer prices in Tokyo only.
Source: Statistics Bureau of Japan

Conclusion: mixed results

All in all, the proactive policy of S. Abe's government has had marked effects on the lowering of the interest rate and rise in prices but has been slow to influence the real economy. For instance, wages have only tentatively followed the dynamic of prices, with the result that the VAT rise implemented in April 2014 weighed heavily on internal demand, plunging Japan into recession. In addition, in spite of monetary expansion encouraging very low credit costs, private agents continue to deleverage. Therefore, corporate investment does not appear to have been positively affected by Abenomics.■

6 - Ratio of female activity rate to male activity rate in some advanced countries

in %



Source: International Labour Organisation

Emerging economies

Emerging economies no longer emerging at the same pace

In Q3 2014, the emerging economies maintained moderate growth. Industrial production weakened, particularly in China and Brazil. Despite past depreciations of their currencies, activity in emerging countries should remain lacklustre during the coming quarters. The business climate remains at a relatively poor level, although it has picked up moderately since March. Imports contracted in H1 2014 but should bounce back markedly in H2, and then progress in H1 2015 at a lower than pre-crisis pace. Exports rebounded in Q2 2014, but should progress more slowly through to mid-2015. All in all, the emerging economies' imports should be less dynamic in 2014 than in 2013 (+3.7% after +5.8%), while exports should progress hardly any more quickly (+4.6% after +4.5%). In H1 2015, the foreign trade of emerging countries should be a little more dynamic, though not enough to recover its pre-crisis momentum: at the end of the half-year, the growth overhang should be +4.7% for exports and +4.3% for imports.

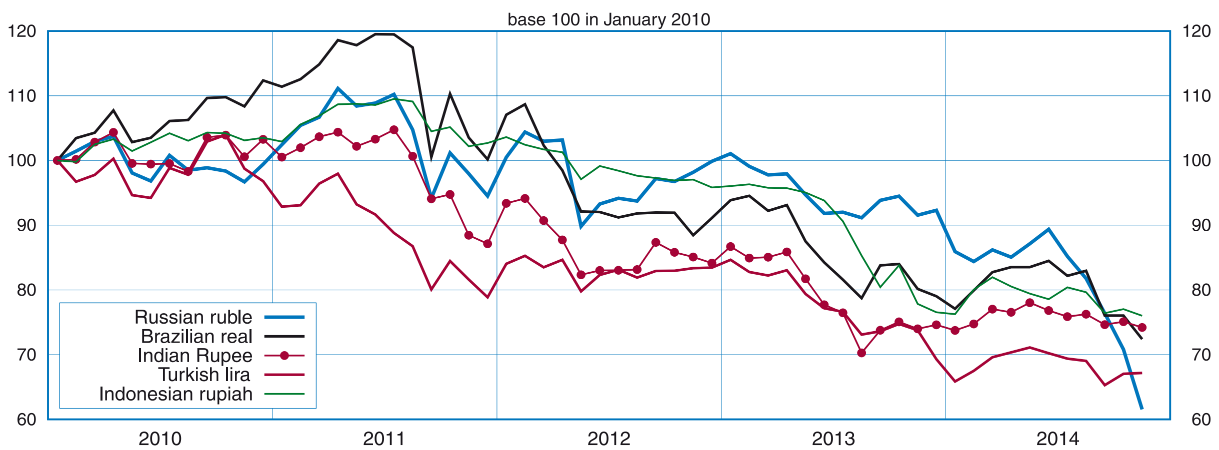
Despite the reduction in monetary tensions, the central banks still face fundamental

A wave of capital outflows in late 2013 and early 2014 led several central banks from emerging countries to raise their policy rates in order to strengthen their rapidly depreciating currencies. Since Q2 2014, the currencies of large emerging countries have generally stabilised, notably those of India, Indonesia and Turkey *(Graph 1)*. Nevertheless, several countries remain subject to macroeconomic imbalances that cast doubt on their ability to recover in the medium term (see Special Analysis). As a consequence, their central banks are still adjusting their monetary policies. For instance, faced with strong capital outflows and downward pressure on the ruble, the Russian central bank abandoned the euro and dollar soft peg. In Brazil, the depreciation of the real led the central bank to raise its policy rate again (11.75%), which should weigh a little heavier on an already weak internal demand.

The Chinese economy is slowing down again

Current relatively sluggish activity is common to all the emerging economies. In China, activity decelerated slightly in Q3 2014 (+1.9% after +2.0%). The slowdown in the manufacturing sector illustrates the shift in domestic demand: consumption remains weak and corporate investment continues to slow down. Property investment is still decelerating, after stalling in early 2014. In Q4 2014, the business climate picked up in services but remains poor in industry, so activity should accelerate only very slightly over the forecasting period. With respect to the demand side, household consumption should increase moderately: since the beginning of the year, retail sales have stabilised and vehicle registrations have fallen back. In addition, with credit to the private sector remaining weak, investment should continue to slow down: in October, it grew +15.9% year-on-year, its lowest level since 2001.

1 - Russia in monetary turmoil



Sources: Mcrobond financial AB

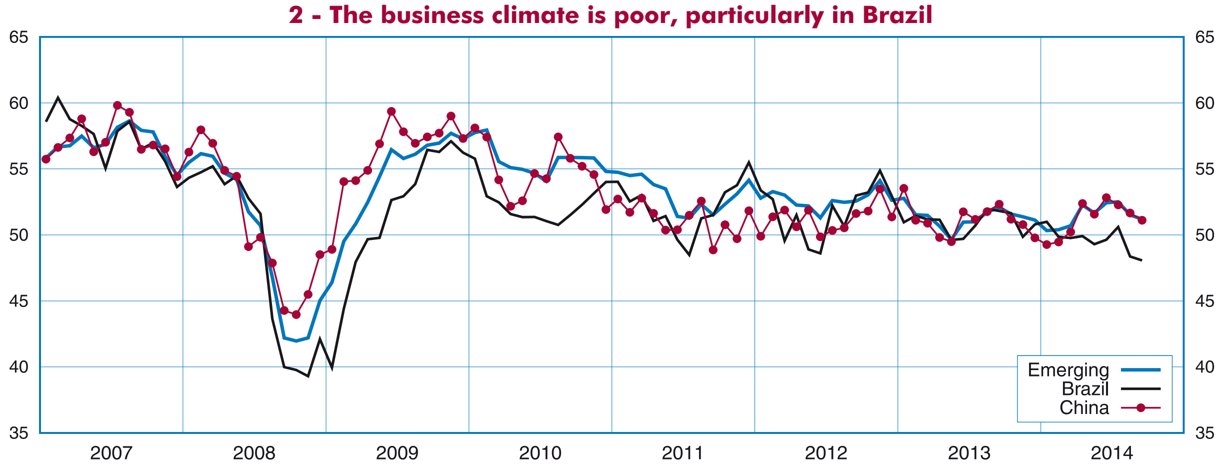
Brazil is in difficulty

Brazil narrowly came out of recession in Q3 (+0.1%) but GDP remains below its level of Q3 2013 (-0.2% year-on-year). The upturn in interest rates and the long period of uncertainty due to the presidential elections in October have weighed down on activity. The business climate remains poor according to tendency surveys *(Graph 2)*. Moreover, household confidence remains low despite a slight rise in September. In Q3, industrial production contracted again and activity remains generally weak. Likewise, exports of goods fell sharply in volume despite the depreciation of the real. Weakened again by the rise in interest rates, activity should remain depressed over the forecasting period.

Russia faces economic sanctions

In Russia, activity again slowed down slightly in Q3, to +0.7% after +0.8% year-on-year. The geopolitical crisis and the economic and financial sanctions have led to a depreciation of the ruble by more than 40% against the dollar since early summer 2014. The combination of monetary tightening in response to the depreciation of the ruble, capital outflows and the deterioration of household purchasing power, affected by the rise in prices, points to even more depressed activity during the coming quarters. However, renewed confidence in industry and the acceleration of production (growth overhang of +1.2% in October for Q4 after +0.4% in Q3), possibly due to the shift of consumption towards the internal market and to competitiveness being strengthened by the fall of the ruble, should allow the Russian economy to avoid recession in the very short term. In the Eastern European countries (Hungary, Czech Republic and Poland), the Ukrainian crisis seems to be weighing less heavily on industrial prospects, and activity may accelerate a little. ■

2 - The business climate is poor, particularly in Brazil



Source : Markit