



year. With productivity and potential growth running low, the output gap should gradually narrow even with these modest rates of GDP growth, and past euro depreciation starting to become more visible in inflation. Core inflation should be close to historical norms in H2 2016. By end 2016, the ECB's medium-term headline inflation projections should be at levels consistent with tapering starting to be discussed at the ECB and implemented in 2017; we see the first ECB policy rate hike only at the end of 2018. The risk is that oil prices continue to decline in the near term and weigh on headline inflation. If this weakens medium-term inflation expectations, the late-2016 tapering risk should dissipate and the pressure for further ECB easing will grow. The refugee crisis will remain a theme in Europe and fear of a repeat of the Paris terror attacks will linger. While refugee and security-related public spending is likely to lead to some relaxation in the fiscal stance in the year ahead, we expect compliance with Europe's fiscal rules to improve into 2017.

We expect euro area political uncertainty to rise as 2017 approaches. The refugee crisis has created frictions within and between countries, but the common threat to security highlighted by the attacks in Paris may unify Europe and reduce the risk of local political events – including Greek debt relief negotiations, Portugal's minority government, Catalonia's independence bid and the UK's EU negotiations – from undermining area-wide stability in 2016. In our view, the unity won't last into 2017. The closer we get to the Dutch, French and German elections in 2017 – Italy may bring forward its election into 2017 too – the more political tensions are likely to build and impose a risk premium on the recovery.

There is little basis to expect a strong non-cyclical euro area recovery either. France may make some further modest progress on structural reforms in early 2016, but reform progress across the zone over the next couple of years is likely to remain slow.

UK economic growth appears set to slow over the next couple of years – but despite fiscal austerity, sterling currency strength and maybe some EU referendum-related uncertainty, GDP growth should be no worse than trend. We expect the robust labour market to keep private consumption growth well supported. Inflation base effects should push inflation up to close to the lower bound of the Bank of England's inflation target range before mid-year. We continue to expect the Bank of England to raise policy rates for the first time in this cycle in May. The EU referendum could be held as soon as late next year. According to opinion polls, the outcome looks closer than the last referendum in 1975 when 66% voted to remain in the EU.

Outlook for Japan

After what we view as a soft patch over the summer, due in part to unseasonable weather but also to a temporary pullback in capital investment, we see the economy bouncing back strongly in Q4 and then returning to its underlying 1-1.5% trend during 2016. For an economy that has been repeatedly buffeted by shocks – some self-inflicted, most genuinely exogenous – we are conscious of the difficulty of making firm forecasts. But we do see Japan's economy as following an underlying growth rate well above its long-run potential and are therefore likely to continue to see the labour market tightening from what is already the lowest unemployment rate in 20 years. Household income growth, reflecting the combination of rising wage growth and employment, should remain at about 2-2.5%, providing the main driver of growth for the economy.

While headline inflation should rise through 2016 as the base effect on past oil price declines drops out of the year-on-year comparison, we don't see it rising beyond 1% until 2017. "Core core" inflation, excluding food and energy prices,