

Global Macroeconomic Monthly Review

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June 2020

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- *Imposed shutdowns and restrictions substantially slowed global economic activity, and global GDP is expected to contract substantially in the second quarter.*
- *The spread of the coronavirus across South America is expected to cause a substantial contraction in GDP in these countries during the second quarter. In the event the spread of the coronavirus will halt during the year, then GDP is expected to increase again in 2021.*
- *Inflation in the developed countries is expected to continue to decline during the second quarter, due to the drop in domestic demand stemming from government initiated restrictions and social-distancing.*
- *Central banks in South America are adjusting their policies to deal with the crisis. Peru and Chile cut their interest rates aggressively at an early stage, in order to support the low domestic demand.*

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- *The US economic crisis is still underway. However, the number of new jobless claims has moderated, but remains very high in relation to the pre-coronavirus outbreak.*
- *In the second quarter of 2020 the services sector is expected to be hurt more than the manufacturing sector.*
- *The Fed is purchasing bonds across the entire length of the yield curve, in order to provide liquidity to the markets. The Fed purchases, that are unmatched with the composition of funding of the large federal deficit, led to a flattening at the shorter end (3M-2Y) of the yield curve, and a rise at the longer portions (2Y-10Y and 10Y-30Y).*
- *For the moment, the spread of the coronavirus is having a deflationary impact, but in the future, with the return of demand, the impact is expected to change to being inflationary.*

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- *Euro bloc GDP is expected to decline 20% (q/q) in the second quarter of this year, despite the easing of the shutdowns in some of the member countries.*
- *The services sector is expected to suffer the bulk of the damage, but the manufacturing sector is also expected to contract.*
- *The debt/GDP ratio of each of the euro bloc countries will rise as a result of the fiscal incentives provided by the governments and due to the loss of tax revenues.*
- *Germany allocated €100bn to rescue companies that have been hurt by the crisis.*

- The ECB increased its emergency purchase program (PEPP) by €600bn, and extended the duration of the plan to at least the end of June 2021.
- Germany and France proposed a €500bn EU recovery fund in order to finance the recovery from the crisis.
- The bond yields of Italy, Spain, and Greece started to decline.

Leumi Global Economic Forecast, As of June 2020

	2017	2018	2019E	2020F	2021F
GDP – Real Growth Rate					
<i>World</i>	3.8%	3.5%	2.7%	-3.4%	4.1%
<i>USA</i>	2.4%	2.9%	2.3%	-4.0%	2.4%
<i>UK</i>	1.9%	1.3%	1.4%	-8.7%	3.0%
<i>Japan</i>	2.2%	0.3%	0.7%	-5.2%	1.4%
<i>Eurozone</i>	2.7%	1.9%	1.2%	-8.0%	3.8%
<i>South East Asia (ex. Japan)</i>	5.3%	5.1%	4.4%	-0.7%	4.5%
<i>China</i>	6.8%	6.6%	6.1%	1.0%	8.0%
<i>India</i>	7.0%	6.1%	4.9%	-4.0%	5.0%
<i>Latin America</i>	1.9%	1.7%	-0.3%	-5.4%	3.7%
<i>Israel</i>	3.6%	3.4%	3.5%	-2.7%	6.5%
Trade Volume, Growth (%)					
<i>Global</i>	5.8%	3.7%	0.9%	-24.8%	20.9%
Interest rates, Year End					
<i>US Fed</i>	1.25-1.50%	2.25-2.50%	1.50%-1.75%	0.25-0.75%	0.50-1.00%
<i>Bank of England</i>	0.50%	0.75%	0.75%	0.1%	0.1 %
<i>Bank of Japan-Policy Rate</i>	-0.10%	-0.10%	-0.10%	-0.20%	-0.20%
<i>ECB-Main Refi</i>	0.00%	0.00%	0.00%	0.00%	0.00%
<i>Israel</i>	0.10%	0.25%	0.25%	0.00-0.25%	0.00-0.50%

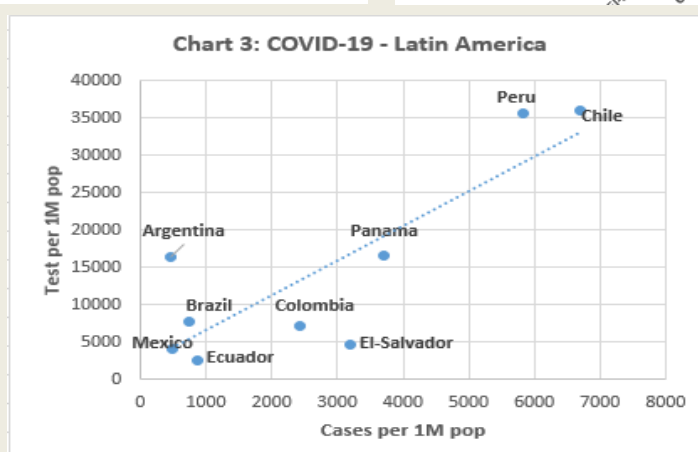
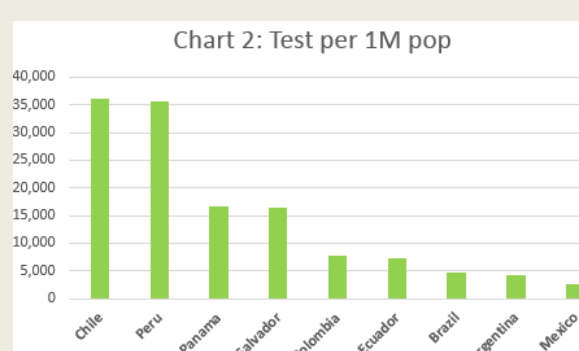
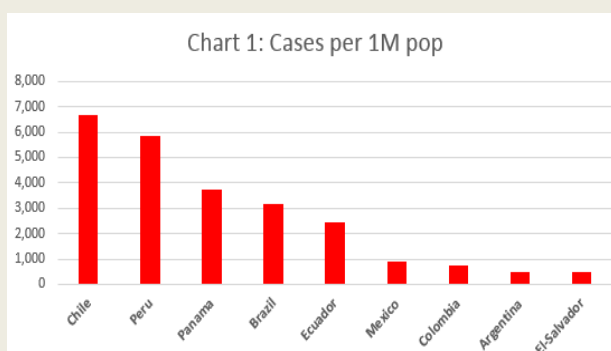
The Global Economy – Overview

Economic activity: imposed shutdowns and restrictions substantially slowed global economic activity, and global GDP is expected to contract substantially in the second quarter. The spread of the coronavirus across South America is expected to cause a substantial contraction in GDP in these countries during the second quarter. In the event the spread of the coronavirus will halt during the year, then GDP is expected to increase rapidly in 2021.

- The economic crisis created as a result of the spread of the coronavirus and the halt in economic activity is expected to cause global GDP to contract 3.4% in 2020, this compared to a contraction of 0.5% in the 2009 global financial crisis. Global trade volume is expected to contract 24.8% in 2020. In 2021 global GDP is expected to increase 4.1%, on the assumption the spread of the coronavirus will halt during the year. In the second quarter, GDP is expected to decline by the sharpest rate in recent decades, due to the closures and restrictions under force during a significant portion of the quarter in a large number of countries.
- Revenues from tourism in the second quarter are expected to be very low, due to the shutdowns and restrictions that countries enacted in their attempts to halt the spread of the coronavirus, and the countries whose revenues are based on tourism are expected to be severely hurt in the second quarter. Retail sales, which represent an important component of private consumption, are expected to recover in the second quarter, due to the lifting of a large portion of the shutdowns and easing of restrictions.
- Economic activity in the European Union (EU) is expected to contract by a more substantial rate than in other places around the world. In our opinion, the GDP of the EU is expected to contract 8.0% in 2020, and in the US, the GDP is expected to contract 4.0% in 2020. In Latin America, the GDP is expected to contract 5.4% in 2020 and to grow 3.7% in 2021. The later chapters in this survey will discuss in detail the economic developments in the US and in the euro bloc, while this chapter will focus on other developed countries and on Latin American countries.
- The spread of the coronavirus across Latin America remains underway. In Brazil, currently the second largest epicenter in the world for the spread of the virus, after the US, more than 850,000 persons have been infected, with almost half of these being active cases, and the virus continues to spread. Since mid-May, the number of new infections in Brazil almost every single day is greater than 10,000, with new infections even reaching greater than 30,000 on some days. Regulatory authorities in Brazil approved a large-scale drug trial, involving 2,000 people, for a vaccine developed by Oxford University in partnership with British-Swedish pharmaceutical company AstraZeneca. In Peru, which represents the second largest epicenter in Latin America, the virus has infected more than 225,000 persons, with almost half of these remaining as active cases.
- In Chile, the third largest epicenter in Latin America, the virus has infected more than 167,000 persons, with most of these recovered and it seems that Chile has passed the peak of the first wave of the coronavirus even though Chile has the highest rate of infection per capita in Latin America (see Chart 1). Most of the infected persons in Mexico have recovered, but in

Argentina and Columbia most of those infected by the virus remain active cases. Panama is currently experiencing a second wave of infections, after the number of active cases fell from a peak of 6,953 on May 9 down to 2,510 on May 13; however, since then the number of active cases increased to a new record of 7,191 active cases and decreased slightly, and currently there are more than 5,800 persons who are active cases. Apparently, the high rate of infections among the populations of Chile and Peru stems from the fact that the number of tests carried out in these countries relative to their populations is hundreds of percentages higher that the rate of testing carried out in other Latin American countries (see Chart 2). This situation likely reflects an underestimation of the actual number of virus infections in other countries that performed fewer tests relative to their populations. This is because of the direct correlation between the number of tests conducted relative to the population, and the number of infected persons relative to the population (see Chart 3) (The data in this paragraph are correct as of 8:00GMT on June 14, 2020).

COVID-19 - Latin America					
	Cases	Active cases	Recover	Cases per 1M pop	Test per 1M pop
Brazil	850,796	380,395	437,512	3,184	4,706
Peru	225,132	106,910	111,724	5,821	35,611
Chile	167,355	26,985	137,296	6,686	35,985
Mexico	142,690	20,981	104,975	882	2,579
Colombia	48,746	27,728	19,426	748	7,857
Ecuador	46,356	19,617	22,865	2,424	7,188
Argentina	30,295	20,397	9,083	488	4,191
Panama	20,059	5,871	13,759	3,713	16,687
El-Salvador	3,603	1,793	1,738	465	16,432



- In Brazil, GDP contracted 1.5% (q/q) in the first quarter due to a decline in consumer expenditures and exports, even though the country implemented a shutdown at a relatively late stage. The data signal the country is entering into a deep economic crisis. Industrial manufacturing declined 18.1% (m/m) in April after a 9.1% (m/m) decline in March, thus hinting of a sharp drop in GDP expected in the second quarter. In our opinion, second quarter GDP is expected to contract by a double-digit rate. The public debt/GDP rate is expected to reach 90% by the end of 2020 (compared to 76% at year-end 2019), and the budget deficit is expected to expand due to the fall in state revenues and the rise in expenditures stemming from the fiscal support of the government. The slow recovery from the crisis and the continuing fiscal support are likely to raise the deficit to more than 10% of GDP. Brazil's recovery is expected to be slower than the recovery in other developing countries, due to the rapid spread of the coronavirus in Brazil and the high number of infected persons. Furthermore, the political clashes in Brazil between the president, who opposes the implementation of shutdowns and social distancing, and government officials, particularly the minister of health who was dismissed for supporting social distancing as a means of dealing with the spread of the coronavirus, may hamper the return of business confidence and any recovery of investments in the economy. Allegations of corruption raised against the president are also complicating matters. Furthermore, the Brazil's government decision to halt the publication of coronavirus data, is expected to raise the concern about Covid-19 data reliability and this may fuel the political crisis and increase the distrust among investors.
- The Mexican economy was only slightly hurt relative to other South American countries, with a 1.6% (q/q) contraction in first quarter GDP. The bulk of the decline in the GDP stemmed from a drop in the manufacturing and the services sectors, both of which contracted 1.4% (q/q). In the second quarter, the contraction is expected to be more severe, due to heightened restrictions in April, thus the GDP is expected to contract 12% (q/q) in the second quarter. In addition, the government owned oil company, Pemex, suspended oil production temporarily due to low oil prices. In the event oil prices will weaken again, then the company is likely to encounter a debt crisis. It is possible the cost of saving the company from a deep crisis will be too high for Mexico.
- Peru was the most severely hurt country in South America in the first quarter, as a result of the implementation of an aggressive shutdown and due to social-distancing, which halted most of the activity of the manufacturing sector. The actions by Peru were initiated at an earlier stage compared to other countries in South America. The GDP of Peru contracted 5% (q/q) in the first quarter, while second quarter GDP is expected to contract 15% (q/q), due to continuing infections and the number of new daily infections, which remains high.
- In Columbia, the unemployment rate spiked upward in April from 12.6% to 19.8%, against the backdrop of a sharp drop in the workforce participation rate, which fell during the month from 59.2% to 51.8%. This is after the GDP had contracted 2.4% (q/q) in the first quarter. In the second quarter, GDP is expected to contract 14% due to the continuation in the shutdown and restrictions that were in place during a large part of the quarter. Even after the lifting of some of the restrictions, economic activity is expected in June to equal only 60%-70% of the pre-coronavirus levels. Furthermore, low oil prices increase the risk to the economy, and also decrease exports and government revenues.

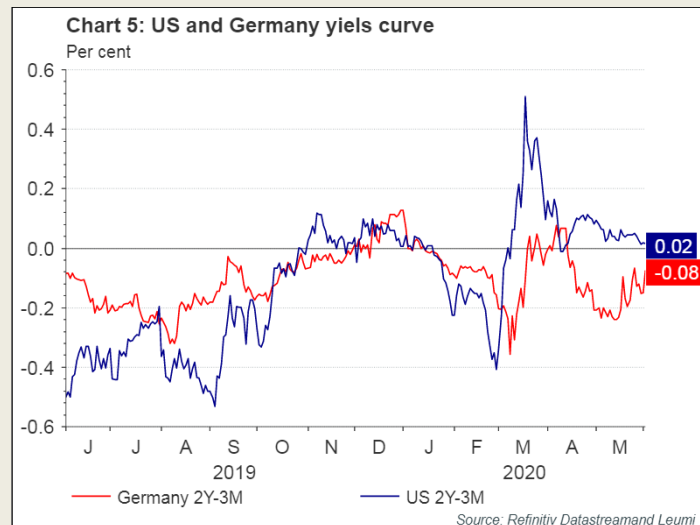
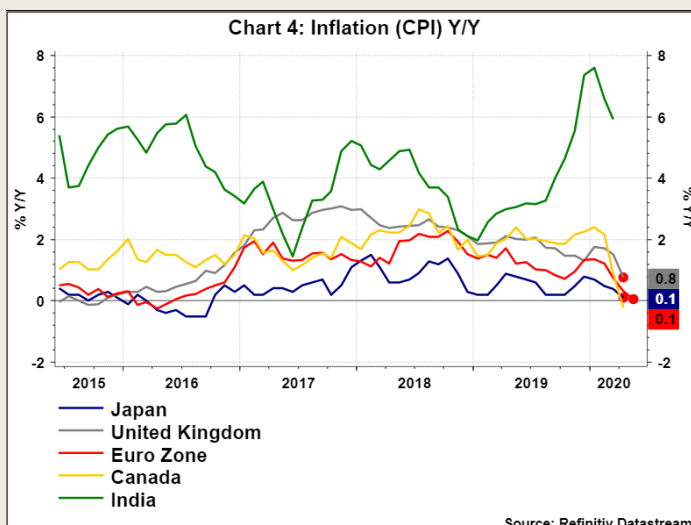
- In Ecuador, the government plans to save US\$4bn, approximately 4% of GDP, through cuts in public spending and through asset sales. This is in order to offset the deficit created by the fall in tax revenues, by the drop in oil prices that is hurting state revenues, and by the increase in health expenditures. The planned cuts in public expenditures, especially in light of the health crisis, could reignite protests that occurred in October following the government's attempts to remove fuel subsidies.
- Looking forward, global GDP is expected to contract 3.4% in 2020 and global trade volume is expected to decline 24.8%. The damage to developed countries is expected to be more severe, particularly for the countries whose economies are based on tourism. In Latin America, GDP is expected to contract 5.4%, but the damage to Argentina and to Mexico is expected to be much greater than the average for all Latin American countries. In the event the spread of the coronavirus will halt during the year, then a substantial recovery is expected in 2021.

Inflation and monetary policy: inflation in the developed countries is expected to continue to decline during the second quarter, due to the drop in domestic demand stemming from government initiated restrictions and social-distancing. Central banks in South America are adjusting their policies to deal with the crisis. Peru and Chile cut their interest rates aggressively at an early stage, in order to support the low domestic demand.

- Inflation in the developed countries continued to decline in April and is expected to continue to decline during the second quarter of 2020. The decline in inflation is due to the fall in domestic demand that is stemming from the government initiated restrictions and the social-distancing practiced in an effort to halt the spread of the coronavirus, and due to the sharp decline in the energy component, which offset the rise in food prices. Inflation in the OECD countries fell in April from 1.7% to 0.9% (see Chart 4). The energy component in the CPI fell 12.2%, the sharpest decline since September 2015, despite a rise in oil prices. Core inflation in the OECD, excluding food and energy prices, also declined in April, from 2.1% to 1.6%, reaching the lowest level since February 2014. In most of the Latin American countries, the annual rate of inflation declined in April, against the backdrop of the fall in domestic demand stemming from the shutdowns and restrictions implemented by the governments in order to halt the spread of the coronavirus.
- The central banks in Latin America cut short-term interest rates against the backdrop of the crisis created by the breakout of the coronavirus. However, in contrast to other central banks around the world, the central banks in Latin America have not intervened in the interest rates of long-term government bonds by purchasing such bonds. This is because the Latin American countries entered the crisis at a time when their interest rates were not close to a near-zero rate, and thus they could act by lowering effective rates. The central bank of Brazil lowered its interest rate by 75bps to 3.00% and the bank hinted that an additional rate cut is likely due to the severe damage to the local economy stemming from the spread of the coronavirus. In our opinion, the central bank of Brazil will cut its interest rate by an additional 50bps. The central bank of Mexico cut its interest rate by 50bps to 5.50%, and in our opinion, an additional cut is expected of a further 50bps. In Columbia, the central bank cut its interest

rate by 50bps at the end of May to 2.75% due to the decline in the inflation rate and the expectation that local demand will remain low and the weakness in the labor market will continue. This interest rate cut comes following two additional rate cuts that occurred since the beginning of the year that lowered the interest rate from 4.25%, the level at which the rate stood for more than one year. In Peru, the central bank kept its interest rate unchanged in May at 0.25%. This after the rate fell from a level of 2.25% in March by two rate cuts of 100bps each. In Chile, the central bank also kept its rate unchanged in May at a level of 0.50%, after having cut the rate sharply at an earlier stage in the crisis. The central bank of Chile cut the interest rate during March in two stages, bringing the rate down from 1.75% to 0.50%.

- Argentina is well on a path toward its ninth insolvency, after the country postponed a US\$500m payment to bond holders. Government bondholders rejected Argentina's first offer for debt settlement, according to which Argentina proposed a 'haircut' of almost US\$40bn by means of a 62% reduction in interest rate payments and a 5.4% reduction in the principle. Argentina proposed to creditors a second offer for debt settlement that provides a higher value to government bondholders. The bondholders are continuing to conduct negotiations on the debt settlement, even though in actuality the deadline for an agreement has already passed.
- US government bond purchases by the US Fed, that are unmatched with the composition of the large amount of funding of the federal government's budget deficit. caused a flattening only at the shorter end (3M-2Y) of the yield curve (see Chart 5). This is due to purchases by the Fed across the entire yield curve, and not only long-term government bonds. The US yield curve became steeper at the medium-long segment. In the euro bloc, the bond yields of Italy and Spain began to decline, apparently due to the emergency purchase program (PEPP) of the ECB. In Germany, the yield curve remained inverted at its shorter end (2M-2Y) during all of May, after it had initially inverted at the end of April, a development that reduces the worthwhileness of the banks to loan money to the markets and is likely to hamper Germany's exit from the crisis.



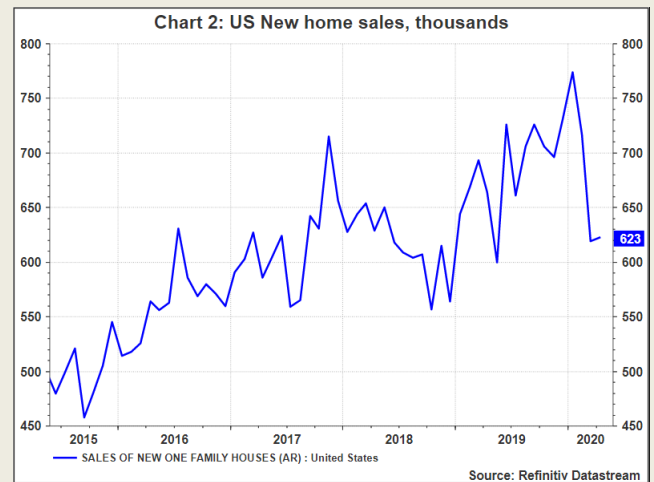
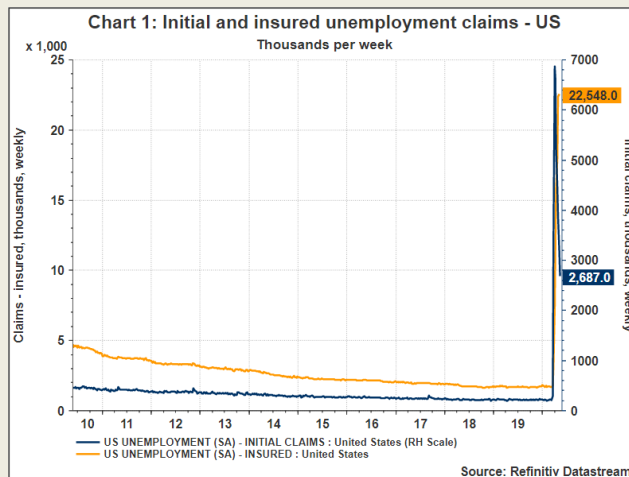
United States

Economic activity: the US economic crisis is still underway. However, the number of new jobless claims has moderated, but remains very high in relation to the pre-coronavirus outbreak. In the second quarter of 2020 the services sector is expected to be hurt more than the manufacturing sector.

- The May data show some moderation in the intensity of the US economic crisis, which was created by the spread of the coronavirus. The rise in the consumer confidence index, coupled with the decline in May's unemployment rate to 13.3%, shows the positive contribution of the US government's fiscal efforts, suggesting that the economy may gradually recover as the spread of the coronavirus in the US is halted. The rise in the consumer confidence index is consistent with the assessment that most households are still not facing substantial economic pressure. For example, the number of home renters who did not pay rent in April was only 3% higher than last year. Also, the moderation in the number of new unemployment claims during May indicates that the intensity of the crisis has moderated; nonetheless, the number of continuing unemployment claims remains very large compared to the period before the spread of the coronavirus (see Chart 1). Preventing any deterioration in the status of US households is expected to require the local and the federal governments to make substantial transfer payments.
- According to the OECD forecast, US GDP is expected to decline this year by 8.5% if a second wave of the corona virus breaks out, and 7.3% if a second wave is avoided. The FED is a bit more optimistic than the OECD forecast and expects the US GDP to shrink this year by 6.5%. According to the FED, US GDP is expected to grow by 5.0% in 2021 and by 3.5% in 2022. The FED also expects that unemployment rate will decrease to 9.3% in the last quarter of 2020 and to 6.5% at the last 2021. In 2022, the unemployment rate is expected to continue to decline, but at a slower pace, to 5.5%. According to the FED forecast from this month, US GDP is expected to grow from the end of 2019 to the end of 2022 by 1.6%. Compared with the FED forecast from December 2019, before the spread of the corona virus in the US, the FED expected GDP to grow in the years 2020-2022 by 5.8%. This means, that the crisis created following the spread of the corona virus is expected to reduce growth in the years 2020-2022 by 4.2%, compared to the growth that was without the outbreak of the corona virus.
- In May, 2.5m new employees were added to the economy and the unemployment rate fell from 17.4% in the beginning of the month to 13.3% by the end of the month. The drop in unemployment was faster than expected, with "technical" aspects that may very well reflect considerable problems with respect to measuring the data. Thus, the decline in the unemployment rate comes as a result of an increase in the workforce participation rate, which increased in May from 60.2% to 60.8%; however, this level is substantially below the workforce participation rate in February, which stood at 63.4%. This means there are a large number of unemployed people who are not actively looking for work and are not included in the official unemployment rate. Also, part of the increase in the number of employees likely stems from the government's Paycheck Protection Program (PPP), which incentivizes small business owners to continue to employ workers by providing a federal government subsidy.

In the hospitality and leisure sector, the most severely affected industry in the current crisis, with employment plummeting 45% in April, an additional 1.24m employees were added. In the construction sector, approximately 500,000 employees were added, and in the health and education sectors 400,000 employees were added.

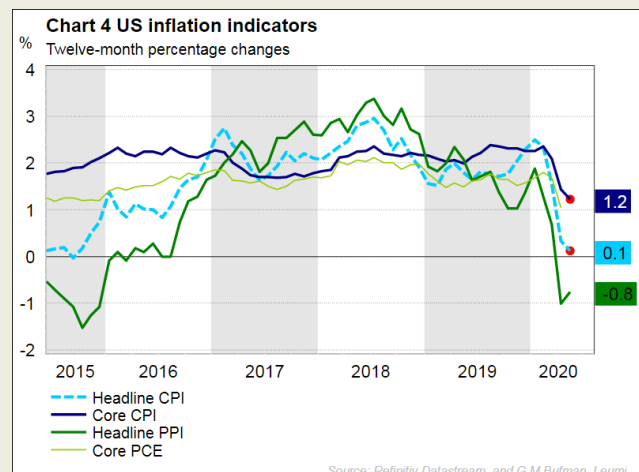
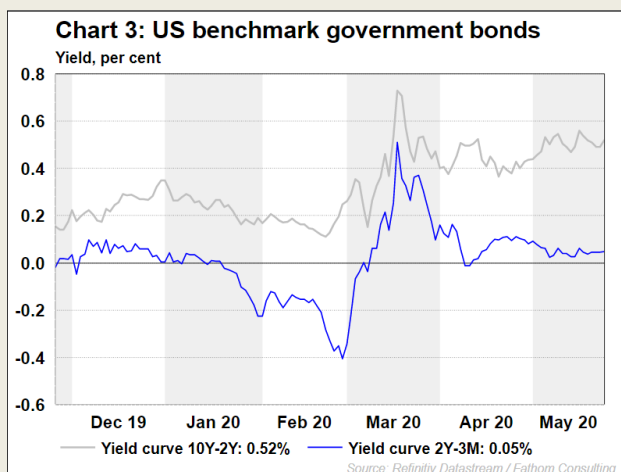
- The economic crisis, coupled with the high unemployment rate, is expected to cause a fall in state and city revenues. As a result of budgetary balancing laws, if Congress does not provide broad federal support to cities and states whose income has been hit, the fall in revenues is likely to be offset by a reduction in the expenditures of the relevant authorities. This is expected to exacerbate the slowdown in economic activity and make it more difficult for the economy to recover.
- The initial indicators for May show continued economic contraction, but by a more moderate rate than in April. The May PMI remained also this month below 50 points, indicating continued contraction of the American economy, both in the manufacturing and the service sectors. However, the services sector is likely to contract slightly more than the manufacturing sector. The composite PMI increased in May from 27.0 to 36.4, while the PMI of the manufacturing sector increased from 36.1 to 39.8 and the PMI of the services sector increased from 26.7 to 36.9. The Empire State Manufacturing Survey, the monthly survey of manufacturers in New York State conducted by the Federal Reserve Bank of New York, increased in May from -78.2, the historic low it had reached in the preceding month, to -48.5. This index remains low even compared to the level to which it reached in the financial crisis of 2008-2009. The manufacturing survey of the Federal Reserve Bank of Philadelphia also increased slightly in May, from -56.6 to -43.1.
- Housing construction starts declined in April by 30.2% (m/m) due to the economic shutdown. However, with the return of the economy to activity, construction starts are also expected to recover. New home sales recovered from their low in March and increased in April by 0.6% (see Chart 2). This increase reflects the contribution of the decline in mortgage interest rates. Sales of previously owned homes declined 17.8% in April. The decline in sales of previously owned homes occurred across the entire US, yet the rates of decline were more substantial in the south and in the western portions of the country.
- Looking ahead, GDP is expected to contract 5.4% in 2020. In the second quarter, GDP is expected to contract by up to 40% (y/y). With the halt in the spread of the coronavirus and the return to economic activity, the unemployment rate is expected to return to a single digit number. New home sales are expected to continue to increase as restrictions on economic activity are lifted, particularly due to the fall in mortgage interest rates. However, in light of the rise in the unemployment rate, particularly among low-income earners, it appears the demand for housing at the medium and lower price levels will remain weak.



Inflation and monetary policy: the Fed is purchasing bonds across the entire length of the yield curve, in order to provide liquidity to the markets. The Fed purchases led to a flattening at the shorter end (3M-2Y) of the yield curve, and a rise of the amount of steeply at the longer portions (10Y-30Y). For the moment, the spread of the coronavirus is having a deflationary impact, but in the future, with the return of demand, the impact is expected to change to being inflationary.

- The developments in economic policy in the US include a number of components. These include a trend of budgetary expansion, which has not yet been fully realized; a Fed rate cut to a range of 0.00%-0.25%; a Fed purchase program of government and non-financial private sector bonds at unprecedented levels; a plan for providing liquidity to local authorities, cities, and states; and additional actions by the Fed to improve credit conditions for the private sector. The current quantitative expansion is the largest and quickest in the history of US quantitative expansion programs. Since March 13 this year, the Fed has purchased US\$1.6tn worth of US government bonds. These bond purchases have been designed to support the liquidity of the financial system, which led the Fed to purchase bonds across the entire yield curve. This comes in contrast to previous QE programs in which Fed purchases focused on long-term government bonds. The Fed purchases across the entire curve flattened the shorter portion (3M-2Y) of the yield curve (see Chart 3).
- Parallel to these broad purchases, the administration is also substantially expanding fiscal policy, and the budget deficit is likely to reach more than 20% of GDP in 2020. Funding this huge deficit requires the US administration to issue many bonds, and the amount of capital raising by the American administration is expected to increase substantially in the remainder of the year. The US Treasury has included a substantial number of bond issues with durations of 10 and 30 years. Increasing the supply of long-term government bonds raised the "duration premium" demanded by investors, prompting an increase at the longer portions of the US yield curve (2Y-10Y and also 10Y-30Y). In addition, the gap between savings and investment, which was not so substantial prior to the breakout of the coronavirus, is expected to increase due to the fall in savings that is expected to be greater than the fall in investments. A rise in the differential between savings and investment is expected to cause an increase in the slope of the yield curve.

- The FED at its meeting on 10 June, keep the interest rate unchanged in the range of 0.00%-0.25% and he expects the interest rates will remain close to 0% even at the end of 2022. This forecast is expected to keep the yields of short-term government bonds close to 0%. Furthermore, the purchase of government bonds by the FED are expected to continue at least the current pace. This is after the FED reduce the weekly purchase from \$350bn to only \$20bn. The FED noted that low demand along with low oil prices cause inflation to remain low. In addition, "The ongoing public health crisis will weigh heavily on economic activity, employment, and inflation in the near term, and poses considerable risks to the economic outlook over the medium term".
- A look at the minutes of the FOMC meeting at the end of April shows the Fed believes there is a substantial probability for additional waves of breakout of the coronavirus. Such an occurrence is likely to lead to an extended period of declining economic activity. The Fed is worried that the long-term effects of the crisis will make it difficult for unemployed persons to return to the workforce and consequently the productivity of the business sector will be hurt. In addition, the Fed recommends to Congress to broaden budgetary assistance and fiscal support in the event the economic slowdown will continue. We note that in the FOMC meeting there was no discussion of a negative interest rate, thus illustrating the low probability that the Fed will actually cut the interest rate to a negative level in the coming months.
- The US consumer price index (CPI) declined 0.2% (y/y) in May after a drop of 1.2% in April (see Chart 4). The core CPI index declined as well to 1.2%, the lowest level in the last nine years. The fall in the core index stemmed primarily from components linked to travelling and tourism, since expenditures on these components fell significantly due to the shutdowns and restrictions implemented across the US. The core index of the PCE rose slightly as this index takes into consideration frequent changes in consumption. This is in contrast to the CPI, the weightings of which are adjusted once a year.
- The effect of the spread of the coronavirus includes deflationary and inflationary aspects. Currently, the effect of the virus is deflationary. Prices at the wholesale level point to continuing declines in consumer prices in the coming months, particularly against the backdrop of demand, which remains low. Furthermore, the fall in producer prices at a rate of 1.3% in April, hint that in the near term the spread of the virus will have a deflationary effect on consumers. Looking ahead, when demand will start to recover, since the supply of goods and services will be limited due to the shutdowns and restrictions, and also due to continued supply chain disruptions, the effect of the virus is likely to change from deflationary to inflationary.



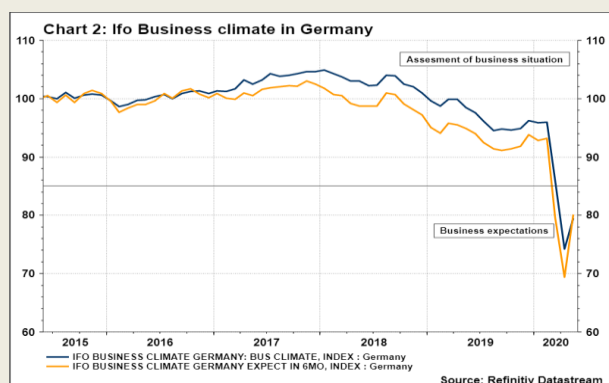
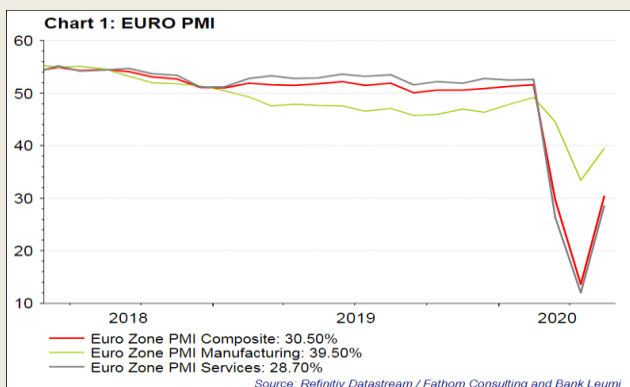
The Euro Bloc

Economic activity: euro bloc GDP is expected to decline 20% (q/q) in the second quarter of this year, despite the easing of the shutdowns in some of the member countries. The services sector is expected to suffer the bulk of the damage, but the manufacturing sector is also expected to contract. The debt/GDP ratio of each of the euro bloc countries will rise as a result of the fiscal incentives provided by the governments and due to the loss of tax revenues. Germany allocated €100bn to rescue companies that have been hurt by the crisis.

- The GDP of the euro bloc is expected to continue to contract in the second quarter of the year, as the countries deal with the spread of the coronavirus by means of shutdowns and restrictions across wide portions of the euro bloc during the quarter. The initial indicators show the contraction in May is expected to be more moderate than the contraction in April, due to the lifting of some of the shutdowns and restrictions in a large number of countries; however, the economy will continue to contract. The composite PMI of the euro bloc increased in May from a low of 13.6 to 30.5 (see Chart 1), yet this index still indicates a continued contraction in both the manufacturing and the services sectors. The PMI of the manufacturing sector increased in May from 33.4 to 39.5, while the PMI of the services sector increased from 12.0 to 28.7. The consumer confidence index of the euro bloc increased slightly in May from -22.0 to -18.8, yet this index remains very low compared to its level over recent years. The slight improvement hints that consumers are somewhat less pessimistic; however, the economic recovery is expected to be gradual. The business sentiment index declined in May from -1.99 to -2.43, the lowest level in the last decade.
- The public debt/GDP ratio in each of the euro bloc countries is expected to increase this year, as a result of the fiscal incentives offered by governments and due to the loss of tax revenues

stemming from the sharp drop in economic activity. However, in most of the euro bloc countries the public debt/GDP ratio is expected to start to decline again, after the coronavirus stops to spread and with the return of economic activity. In addition, the rise in asset prices and housing rental prices was stopped in the first quarter and is expected to recover at a very slow pace despite the opening of the economies in a large portion of the countries, due to the uncertainty prevailing in the economy.

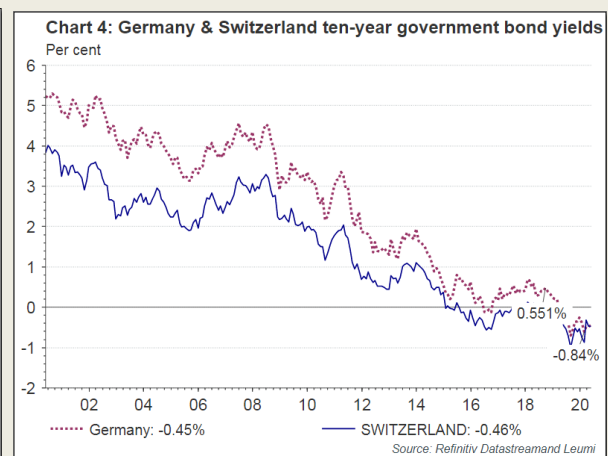
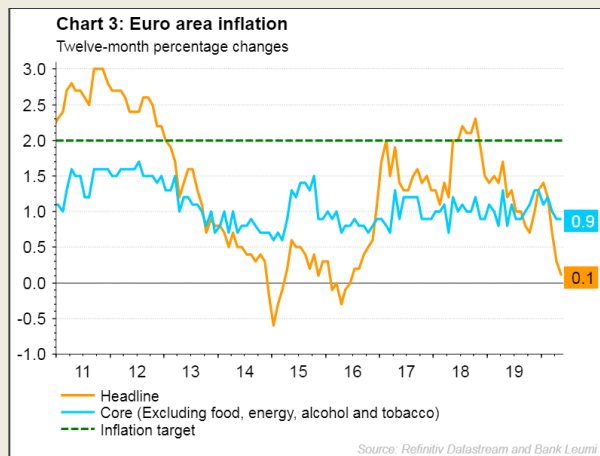
- In a country breakdown, Germany's composite PMI increased in May from 17.4 to 31.4. The bulk of the rise in the index occurred in the services sector; however, this sector is still expected to continue to contract during May. The IFO index of business confidence increased in May, from its April low, by 5.3 points, reaching a level of 79.5 (see Chart 2). The increase in this index reflects the gradual return of economic activity with the lifting of a substantial portion of the restrictions in Germany on April 20. In France, the composite PMI increased in May from 11.1 to 30.5. This level is slightly below Germany's level, and thus likely hints that the contraction in the French economy in May could be slightly more severe than in Germany. The bulk of the contraction is expected to be in the services sector; however, the French manufacturing sector will apparently contract by a lower rate compared to the contraction of the German manufacturing sector.
- Germany proposed a €9.8bn rescue package for German airline Lufthansa. The plan will grant the German government 20% ownership of the shares of the company. State ownership of the company will be temporary; however, the timing of the sale of the company to private investors will be dependent on the company's recovery. Germany allocated €100bn to rescuing companies that have been hurt by the crisis, thus signaling the possibility that the airline's acquisition is only the beginning of a round of company purchases by the German government.
- Looking ahead, in the second quarter the GDP of the euro bloc is expected to contract 20% (q/q), against the backdrop of the decline in consumer expenditures that are expected to contract 18% (q/q). In addition, the fiscal deficit of all the euro bloc countries is expected to increase in 2020. According to the consensus forecast, the GDP of the euro bloc will contract 7% in 2020, and will grow 5.1% in 2021. In Germany, the GDP is expected to contract 10% in the second quarter (q/q) and in all of 2020 the German GDP is expected to contract 8%. In France, GDP is expected to decline in the second quarter by at least 12%.



Inflation and monetary policy: the ECB increased its emergency purchase program (PEPP) by €600bn, and extended the duration of the plan to at least the end of June 2021. Germany and France proposed a €500bn EU recovery fund in order to finance the recovery from the crisis. The bond yields of Italy, Spain, and Greece started to decline.

- At its meeting in the beginning of June, the ECB increased its Pandemic Emergency Purchase Program (PEPP) by €600bn. Total purchases of the ECB by means of this program will amount to €1.35tn and the profits from these purchases will also be allocated to bond purchases through the emergency purchase plan. Furthermore, the ECB extended the period in which it will purchase bonds, to at least the end of June 2021. Meanwhile, purchases of additional bonds with the profits received from the purchases within the program will occur at least through the end of 2022. According to the ECB, the euro bloc economy will contract 8.7% during this year, while in 2021 the economy is expected to grow substantially. However, the GDP will remain below pre-coronavirus levels until 2022. The ECB forecasts the inflation rate in 2022 will equal 1.3%, and the core inflation rate in 2022 will equal 0.9%. This rate is far from the target, which aims for an inflation rate of slightly below 2%.
- Germany and France proposed a €500bn communal European Union (EU) recovery fund, equivalent to 3.6% of EU GDP, in order to finance the recovery from the crisis. The debt will be communal for all the members of the EU and will be issued by the European Commission (EC). The issue of communal debt is likely to be a positive process for the government debt of periphery countries within the EU, since the cost of raising debt for such countries is more expensive. The EC increased the sum that was proposed by Germany and France to €750bn, or 5.4% of the GDP of the EU. The use of these funds will include €500bn to be provided as grants and €250bn to be distributed as loans. The distribution among the different countries remains to be decided; however, Italy and Spain will apparently receive a substantial portion of the assistance, since they are among the larger countries within the EU that suffered heavily during the crisis.
- The inflation rate (annual rate) in the euro bloc (HICP) declined in May from 0.3% to 0.1% (see Chart 3). The energy component in the index fell substantially, despite the increase in oil price, and offset the rise in food prices that moderated slightly compared to April. Core inflation (excluding energy, food, alcohol, and tobacco) remained unchanged in May at a rate of 0.9%, despite a rise in services prices. In our opinion, inflation is expected to continue to decline and it is possible inflation may even turn negative, due to the sharp decline in local demand stemming from the implementation of shutdowns in certain countries within the euro bloc. Average core inflation in 2020 is expected to equal 0.5%.
- Italian, Spanish, and Greek bond yields began to decline, apparently as a result of the Pandemic Emergency Purchase Program (PEPP) of the ECB. This comes after yields had increased sharply due to the spread of the coronavirus and the economic crisis created as a result, which caused uncertainty with respect to these countries' ability to service their debt. The yield differential between German and Swiss 10-year bonds closed for the first time in the last twenty years as the yields in both countries became negative (see Chart 4), after the ECB initiated the PEPP. In our opinion, this bond yield differential is expected to open up once again. The yield curve of Germany remained inverted at the shorter end (3M – 2Y)

during all of May, which indicates the deep economic crisis that is occurring in the German economy and raises the probability for continued monetary policy expansion.



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