Global Economics Monthly Review

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- *The fourth quarter started on a positive note. We revised slightly upward our global growth estimates.*
- *The continuing improvement in global growth has led to a more hawkish bias, which is mainly prominent among the major developed economies.*
- *Dovish tightening in the UK.*
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- *US economic growth is expected to remain healthy also in 2018.*
- *The inflation environment is expected to increase in the short-run.*
- *The Fed sounds more optimistic on economic activity. Loosening financial conditions and ongoing asset price inflation could support further rate hikes.*
- *Jerome Powell's nomination for chairman of the Fed suggests continuity of the current monetary policy path.*
- *Further flattening of the yield curve - as we expected – the flattest in 10 years!*

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- *Further strength in euro area economic activity.*
- *Economic growth is expected to remain solid in the fourth quarter.*
- *Inflation is expected to rise modestly over the short-medium term. The recent receding in the euro appreciation may also support inflation.*
- *The ECB plans a cautious exit.*
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Global Economics – The Big Picture

The global economy grew relatively solidly in the third quarter: Based on reports on the preliminary national accounts of the major economies during the third quarter of the year, global growth continued, but probably decelerated somewhat. That said, the GDP growth figures somewhat surprised to the upside or were in line with previous estimates.
The US economy grew solidly and more than expected, overcoming the short-run and temporary negative effects of three hurricanes. The euro area economic growth rate slightly decelerated, but it grew by a healthy pace compared to the upward revised Q2 GDP growth figure. Additionally, the UK surprised to the upside, growing by 0.4% quarter-on-quarter in the third quarter from 0.3%, led by an improvement in the industrial and services sectors.

Despite the political risks stemming from Brexit's consequences, the UK economy is on track to grow 1.6% in 2017, just slightly below the 1.8% in the previous year. Growth is expected to moderate next year, but we do not rule out upward revisions due to the strength among UK households and the expected growth in external demand driven by the improvement in global economic activity and the depreciation in the exchange rate of the pound in the past two years.

With respect to the major emerging economies (EM), growth in China moderated in Q3, albeit slightly, to 6.8% year-on-year from 6.9%, as expected, in tandem with the financial deleveraging process led by the government. Growth in China may moderate further in the upcoming quarters as the newly-reshuffled Chinese government is expected to continue to lead regulatory steps and reforms in order to reduce financial risks in the private and financial sectors. China's economy is expected to slow gradually and its diminishing effect on global growth in 2018 is expected to moderate due to a recovery in other emerging economies, mainly in the commodity-exporting countries.

The fourth quarter started on a positive note. We revised slightly upward our global growth estimates: The global composite PMI increased slightly in the beginning of the fourth quarter as the rates of expansion of output, employment, and backlogs edged higher. Moreover, recent surveys suggest that developed economies had (on average) a positive influence over the global economy in recent months, while the trend among the emerging markets was mixed. Based on the available official data and the current business surveys, we have slightly revised upward our 2017 global growth estimate by 0.1 percentage point to 3.5%, following 3.2% growth in 2016, and also revised our 2018 estimate by 0.1 percentage point to 3.6%.

Risks to our growth outlook remain tilted to the downside. As we wrote in our previous review, there are several risks that may weigh on economic activity, including political risks ("Trump's economic policy risk", Eurosceptic and separatism movements such as in Catalonia, Brexit, etc.), geo-political developments (military tensions around North

Korea and the Middle East), and the rising financial risk in China – see the country review on China.

The continuing improvement in global growth leads to a more hawkish bias, which is mainly prominent among the major developed economies: The US Federal Reserve (the Fed) is expected to raise the interest rate in the upcoming meeting On December 13th for the fifth time in this current tightening cycle, while in October it started the balance sheet normalization process. The tightening cycle is expected to continue at least into 2018, led by the new upcoming chairman, Jerome Powell. In contrast to the Fed, the European Central Bank (ECB) is at an earlier stage in the exit process. At its last meeting, the ECB announced it will scale back further its asset purchase program, but rate hikes are currently not on the table. The Bank of Canada (BOC) also started to tighten its policy, after increasing the interest rate twice by a cumulative 50bp, to 1%. The tightening cycle is expected to continue, but at a moderate pace. In Japan, monetary policy developments are different.

Dovish tightening in the UK: The Bank of England (BOE) delivered a rate hike of 25bp to 0.5% in its last meeting, as expected. This was the first hike in a decade. In tandem, the BOE communicated dovish messages, hence we do not expect additional hikes in the near term, and we estimate that the tightening cycle in the UK will be much slower than in the US due to the political and economic uncertainty regarding the impact of Brexit on the macroeconomic environment. Based on market-derived expectations, the interest rate is expected to rise by an additional 25bp in the beginning of 2019 and reach 1% in the beginning of 2021. We do not rule out that the market is currently underestimating the potential for more rate hikes, as the macroeconomic environment may force the BOE to raise rates at a faster pace in the medium-term.

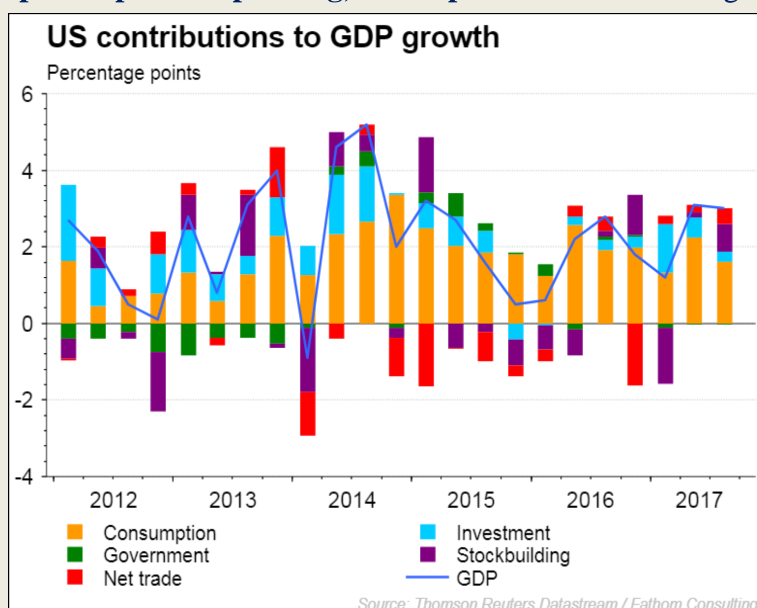
No change on the horizon in the BOJ's monetary policy: In its last meeting on October 31st, the Bank of Japan (BOJ) kept its monetary policy unchanged, as expected. In tandem, the central bank slightly upgraded its growth outlook for 2017, and revised downward its 2017-2018 inflation outlook. The bank also maintained its forecast that headline inflation will reach its 2% target by the end 2019 (fiscal year). We do not expect a change in Japan's monetary policy at least until the end of 2018, in contrast to the cautious tightening actions that are being taken by other central banks in major developed economies. It should be noted that the results of the elections in Japan also suggest that fiscal policy and monetary policy will remain expansionary.

Leumi Global Economic Forecast, As of November 2017

	2015	2016	2017F	2018F
GDP – Real Growth Rate				
World	*3.3%*	*3.2%*	*3.5%*	*3.6%*
USA	*2.9%*	*1.6%*	*2.2%*	*2.4%*
UK	*2.2%*	*1.8%*	*1.6%*	*1.4%*
Japan	*1.3%*	*1.0%*	*1.5%*	*1.1%*
Eurozone	*2.0%*	*1.7%*	*2.1%*	*1.8%*
South East Asia (ex. Japan)	*4.5%*	*4.5%*	*5.9%*	*5.8%*
China	*6.9%*	*6.7%*	*6.8%*	*6.5%*
India	*7.9%*	*7.1%*	*7.1%*	*6.8%*
Latin America	*0.1%*	*-0.8%*	*1.2%*	*2.4%*
Israel	*2.5%*	*4.0%*	*2.9%*	*4.0%*
Trade Volume, Growth (%)				
Global	*2.5%*	*2.3%*	*4.2%*	*4.0%*
CPI, Annual Average (%)				
USA	*0.1%*	*1.3%*	*2.1%*	*2.1%*
UK	*0.1%*	*0.7%*	*2.7%*	*2.6%*
Japan	*0.5%*	*1.0%*	*0.5%*	*0.8%*
Eurozone	*0.8%*	*-0.1%*	*1.5%*	*1.4%*
Israel	*-0.6%*	*-0.5%*	*0.2%*	*0.6%*
Interest rates, Year End				
US Fed	*0.25-0.50%*	*0.50-0.75%*	*1.00-1.50%*	*1.50-2.00%*
Bank of England	*0.50%*	*0.25%*	*0.50%*	*0.50-0.75%*
Bank of Japan-Policy Rate	*0.00%*	*-0.10%*	*-0.10%*	*-0.10%*
ECB-Main Refi	*0.05%*	*0.00%*	*0.00%*	*0.00%*
Israel	*0.10%*	*0.10%*	*0.10%*	*0.25%*

United States

Q3 GDP growth surprised to the upside mainly due to a significant rise in inventories, better than expected private spending, and exports data: According to the advance estimate released by the US Bureau of Economic Analysis (BEA) on the national accounts data, US GDP increased at an annual rate of 3.0% in the third quarter of 2017, almost unchanged from the 3.1% increase in the second quarter. On a year-over-year basis, the US economy grew 2.3%, which is the highest rate since Q3-2015.



The results were above consensus estimates as financial institutions expected moderate growth given the three hurricanes in August and September. The positive surprise may be attributed to a much quicker restoration of normal activity than expected, with weak August data offset by solid September activity. This development was probably reflected in the better-than-expected private consumption growth.

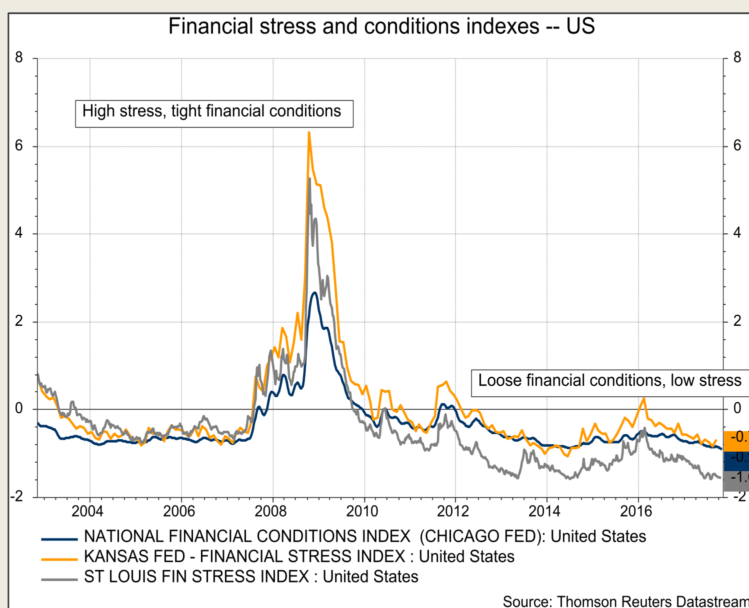
Another factor that affected growth in the third quarter was a sizeable rise in inventories, which may suggest that US businesses are ramping up inventories to meet the solid domestic demand. In addition, net trade also contributed to Q3 growth, for the third quarter in a row, as exports continued to grow solidly, supported by the positive effects from further improvement in global growth demand. US exports have grown in the past five out of six quarters, following six consecutive quarters of negative exports growth. We expect the positive trend in exports to continue also next year. On the other hand, there were also some signs of weakness, as residential and structures investment fell in tandem with a contraction in government investment.

US economic growth is expected to remain healthy also in 2018: We expect the strength in domestic demand to continue in the fourth quarter and into 2018, driven by improvement in the labor market and improvement in business sentiment. Furthermore, external demand is also expected to remain supportive of net trade, at least in the short-run. Recently released business surveys and leading indicators suggest that the US economy is expected to continue to grow at a rate of around two percent (in real terms) in the fourth quarter.

One of the main risks to our growth outlook involves uncertainty regarding the economic policy that will ultimately be implemented by the Trump administration. We currently maintain our 2017 GDP growth estimate unchanged at 2.2%, similar to consensus, up from 1.6% in 2016, and expect some acceleration in 2018 toward 2.4% due to an expected improvement in global growth and some expansion in fiscal policy.

Inflation environment is expected to increase in the short-run: PCE inflation remained moderate in September and below the Fed's target. Both PCE headline and core inflation remained unchanged in September at 1.6% and 1.3%, respectively. PCE inflation is likely to remain low in the upcoming months, but is expected to start recovering in the second quarter of 2018 as the negative base effects from weak points earlier in this year will drop out of the annual calculation. Moreover, it should be noted that import prices have been trending upward from mid-2016 as the drag from a stronger USD subsided and the momentum of commodity prices improved, which might be supportive of producer and consumer goods inflation in the upcoming months. In addition, other factors that may support inflation include a further decline in labor market slack and some improvement in productivity, which may support wage growth.

The Fed sounds more optimistic on economic activity. Loosening financial conditions and asset price inflation could support further rate hikes: The FOMC held the monetary policy rate unchanged at its last meeting, which ended on November 1st. The November statement was almost identical to the September statement, except for one change as the FOMC described economic growth as "solid" rather than the usual "moderate". Regarding inflation, the Fed did not change significantly its wording, noting that core inflation "remained soft".



The latest activity and inflation data may not interfere with the FOMC's intention to hike the interest rate in the upcoming December meeting, as projected by the FOMC members. We estimate that the substantially loose financial conditions, as reflected in the Fed's financial stress and monetary conditions indices (including the Chicago Fed Financial Conditions Index and the St. Louis Fed Financial Stress Index), and ongoing "asset price inflation", will affect the FOMC's decisions and support further policy

tightening. Based on market-derived interest rate expectations, there is around 90% probability for a rate hike in December, in line with consensus estimates.

Regarding 2018, we currently expect two rate hikes, which is below the FOMC's projections (three hikes) and above market expectations, which price in only one additional rate increase in 2018 (with a very low probability for a second hike) after the expected rate hike in December. The relatively large gap between the policy makers' projections and market expectations should be noted as a risk factor for financial markets, which may end up being surprised by the FOMC's actions.

Jerome Powell's nomination for Fed chair may suggest continuity of the current monetary policy path: On Thursday November 2nd the US president, Donald Trump, announced he would nominate Jerome Powell to be the next Federal Reserve chairman, replacing Janet Yellen after her term ends in February 2018. Powell has been a member of the Board of Governors since 2012, serving under both the previous chair, Ben Bernanke, and the current chair, Janet Yellen. Although having extensive experience in formulating and executing monetary policy, Powell is not an economist, and hence he is expected to rely on the Board members to help frame his views on economic outlook and monetary policy. We expect continuity in monetary policy, mainly with respect to the interest rate path and balance sheet normalization.

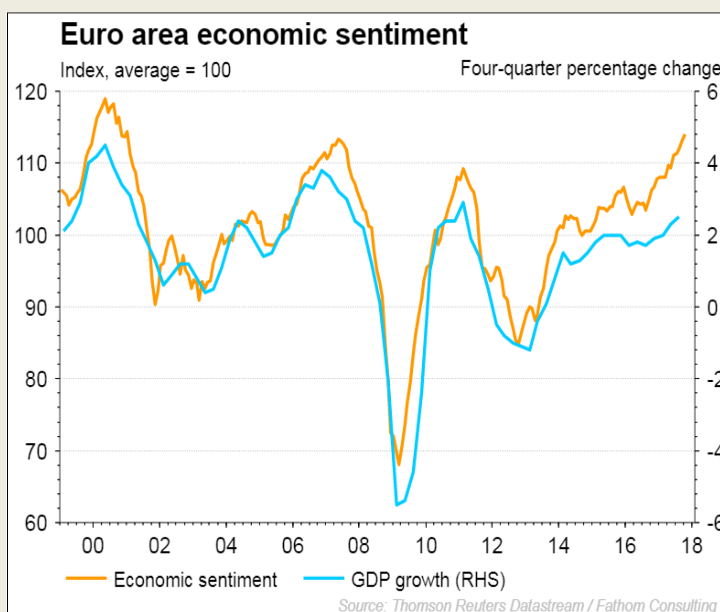
Further flattening of the yield curve, as we expected. The recent rise in market-derived interest rate expectations was mainly reflected along the shorter sections of the curve for Treasuries, while the longer sections of the yield curve rose, albeit to a lesser extent. The softer upward trend in longer-term bond yields was a result of several factors, among them being the recent Treasury Department announcement that it would keep the auction sizes of issues of longer-term Treasuries steady in the upcoming months. The reaction in the market might be a reflection of investors' perceptions and uncertainty with regard to the ability of the Trump administration to implement its economic policy agenda. Other factors that weighed on longer-term Treasury yields were the disappointing employment and inflation data, in tandem with expectations that the monetary policy trajectory will remain unchanged in the medium-term (moderate and gradual) under the new elected Fed chairman, Jerome Powell. The yield-to-maturity of the 2-year Treasury bond increased 15bps to 1.65% in the past month (as of November 10h). Simultaneously, the 10-year yield increased 6bps in the last month to 2.40%. The current differential between the yields-to-maturity of the 10-year and the 2-year bonds has somewhat compressed to 75bps, close to its 10-year low. Based on the central scenarios within our macro-economic forecasts, we expect the interest rate trajectory over the short- and medium–terms, together with the balance sheet normalization, to support a modest rise in yields, mainly in the short-term portion of the curve, which may lead to a further, albeit modest, flattening.

Euro Area

Further strength in euro area economic activity: The preliminary flash estimate of euro area GDP shows that GDP growth slightly moderated in the third quarter of the year to 0.6% quarter-on-quarter (above consensus: 0.5%) from the upward revised GDP figure for Q2 of 0.7%. On a year-on-year basis, euro area economic activity growth accelerated from 2.3% to 2.5%, slightly higher than the US growth rate. On a per-capita basis, the euro area economy continues to expand even at a greater pace than the US economy.

Among the major countries within the euro area that have already published their national accounts data, the results reflect solid growth despite the slight moderation. Quarterly growth in France and Spain edged down by 0.1% percentage points to 0.5% and 0.8% quarter-on-quarter, respectively. The GDP flash estimates for Germany and Italy will be published in mid-November. Eurostat has not published the expenditure breakdown yet (expected date: December 5th), but based on the monthly data, we believe that domestic demand remained solid, supported by improvement in the labor market, an increase in consumer and business confidence levels, and loose credit conditions. Furthermore, based on the trade data and business surveys, we believe that exports also supported growth in the third quarter.

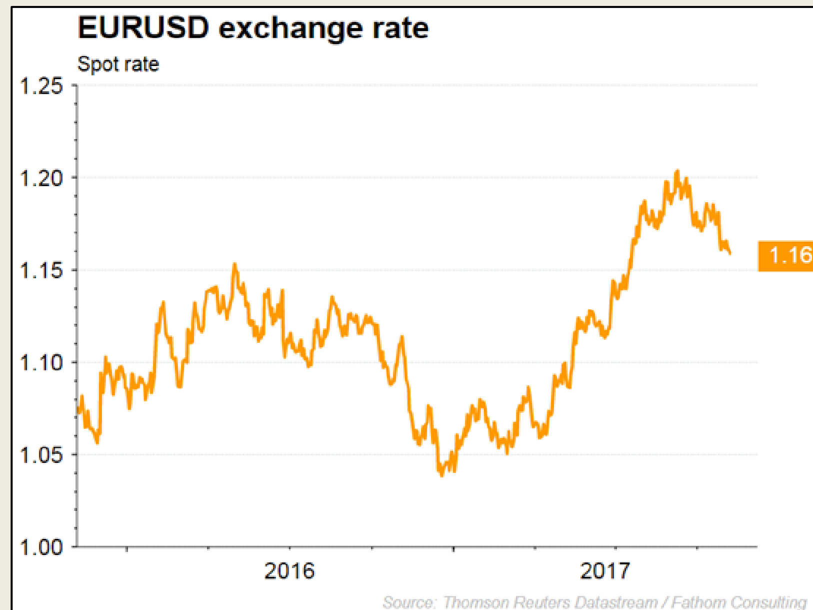
Economic growth is expected to remain solid in the fourth quarter: Recently released business and consumer surveys point to further solid economic growth in the beginning of the fourth quarter of the year. Based on a survey by the European Commission, eurozone economic activity rose strongly in July as the ESI (Economic Sentiment Indicator) reached its highest level since January 2001. Moreover, although the PMI (Purchasing Managers' Index) moderated slightly in October, it still points to solid growth in the fourth quarter.



Overall, based on the economic surveys and other leading indicators, such as new orders and employment data, we expect further growth in the fourth quarter of the year. However, growth within the euro area countries remains unequal, and the growth outlook varies from country to country. Some of the countries that still suffer from economic weakness, in tandem with relatively high financial risks, include Greece and

to some extent Italy as well. Moreover, it should be noted that the degree of political risk remains an important factor and may weigh on growth in the short-medium term.

Inflation is expected to rise modestly over the short-medium term. The recent receding in the euro appreciation may also support inflation: According to flash estimates, eurozone inflation decreased from 1.5% to 1.4% in October, in line with the consensus forecast. Meanwhile, core inflation decreased below expectations, from 1.1% to a five-month low of 0.9%, well below the ECB's near-2% medium-term target for the headline rate, and there is still a variation in core data among the eurozone countries, as some of the economies are characterized with a near-zero inflation environment.



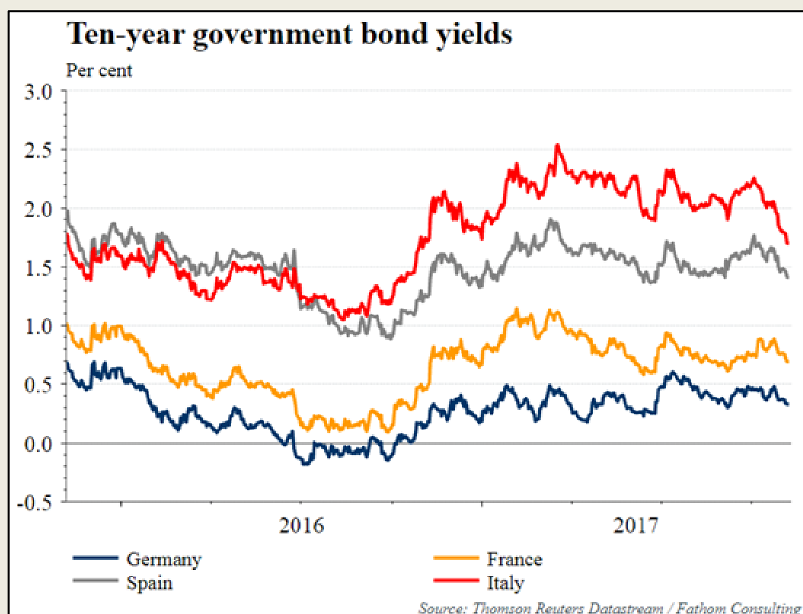
Looking forward, inflation is expected to rise modestly in the short-medium term as domestic demand is on the rise. However, the rise in core inflation is expected to be very moderate due to continuing spare capacity, which is being reflected in low wage growth after a multi-year moderation and negative output gap in some of the major eurozone countries, including Italy. The recent receding appreciation pressures on the euro exchange rate may also support a rise in inflation, albeit at a moderate pace.

The ECB exits very cautiously: At its monetary meeting on October 26th the ECB kept its interest rates unchanged, but announced that it will extend its asset purchase program until at least September 2018, and in tandem will reduce its monthly asset purchases from January next year, from the current pace of €60bn to €30bn. Simultaneously, the ECB communicated messages that were interpreted by the market as dovish. The ECB reiterated that it is prepared to increase QE in terms of size and/or duration if the outlook becomes less favorable, mainly in term of inflation outlook.

Moreover, the ECB did not mention a definitive end-time for its asset purchase program, as some financial institutions expected. In addition, the ECB also reiterated that the Governing Council continues to expect the key ECB interest rates to remain at their present levels for an extended period of time, and well past the horizon of the net asset purchases. Based on the ECB's forward guidance, we continue to estimate that the first hike may occur not before 2019 - conditional mainly on an improvement in the

inflation outlook. This will be in tandem with further moderate and gradual tapering of its QE purchases.

Government bond yields fell in line with the ECB's communication: Eurozone government bond yields dropped as a result of the dovish messages made by the ECB, mainly regarding its interest rate outlook and the possibility for further QE. The recent fall in core inflation probably has also a downward effect on yields. We believe that a further fall in yields is limited due to the solid improvement in economic activity. Looking ahead, we expect European government bond yields to rise next year, albeit moderately and gradually, in tandem with the expected moderate rise in US Treasury yields. As we claimed in the past, we believe that the potential for a significant rise in yields during next year will be limited due to the below target inflation environment and the continuing spare capacity in the economy.



Country Review: China

Risks are still high, but signs of improvement are emerging

Population (2016)	1,382m
GDP (2016)	US$11,232bn
GDP per capita (PPP)	US$15,395
CDS Spread (last)	52bp
S&P - Rating downgrade: Sept. 2017	A+ Stable
Moody's Rating downgrade: May 2017	A1 Stable
Fitch - Ratification: Nov. 2016	A+ Stable

	2012	**2013**	**2014**	**2015**	**2016**	**2017F**	**2018F**
GDP growth (% change)	7.9	7.8	7.3	6.9	6.7	6.8	6.5
CPI inflation (%, average)	2.7	2.6	2.0	1.4	2.0	1.8	2.4
Govt. balance (as % of GDP)	-0.3	-0.8	-0.9	-2.8	-3.7	-3.7	-3.7
Govt. Debt/GDP (%)	34.3	37.0	39.9	41.1	44.3	47.6	50.8
CA balance (as % of GDP)	2.5	1.5	2.2	2.7	1.7	1.4	1.2

Source: IMF – WEO Update October 2017.

Main Findings

- Business sector debt continues to rise and is currently at an historical peak level, and is very high in an international comparison, thus testifying to an increase in financial risks. According to the Chinese government, this is the central risk in the Chinese economy.
- Due to the increase in risk, S&P and Moody's lowered their credit ratings on China recently. However, the rating outlook remains "stable", this due to, among other things, reforms being advanced by the authorities.
- Following the changes in the Chinese authorities that occurred within the framework of the 19th Congress of the Communist Party, and which strengthened the political power of the president of China, Xi Jinping, the authorities are expected to continue to advance, and perhaps even to heighten, supervision over the financial sector and to tighten the conditions for credit in order to lessen the risks in the economy.

- Despite the existing risk environment in China, it appears the concerns of investors in the financial markets have declined recently, as expressed in a substantial decline in the CDS spread down to 50bps compared to 110bps one year ago. This is due to, among other things, the improvement in economic activity during 2017 and also the steps being taken by the Chinese authorities to deal with the risks. The risk environment in China is highly dependent on the degree of success of the reforms of the Chinese authorities.
- The growth environment has stabilized over recent quarters, and this year the Chinese economy is even likely to grow at a rate slightly above that in 2016.
- However, a continuing trend of heightened regulation is expected to weigh on economic growth in the coming years. International economic institutions expect a slowdown in economic activity in the coming years, in continuation of the trend in the preceding years.

Economic Strengths:

- China's potential growth is high in an international comparison.

- Foreign currency reserves remain high despite the decline in recent years.

- A surplus of assets over liabilities. A surplus in the current account.

- Structural reforms expected to improve the growth environment and lower risks.

- International political power.

Economic Weaknesses:

- Continued deterioration in the economic conditions is likely to cause social unrest and a rise in political risks.

- A high degree of corruption and a low level of transparency in the publication of economic data, and doubts regarding the credibility of the data.

- Credit risk has increased in recent years and is relatively high.

- An aging population, and a low rate of increase in the population.

- A medium-low GDP per capita, and thus the financial flexibility of households is limited, primarily at times of recession.

- Bureaucratic difficulties in conducting business – ranked 78 out of 190 countries in an index on the ease of doing business. A medium degree of competitiveness.

Following a number of years of moderation in economic activity, the growth rate is expected to remain stable this year. However, economic activity is expected to moderate in the coming years against the backdrop of policies by the authorities, including tightening the conditions for credit in the economy: The Chinese economy grew 6.8% y/y in the third quarter of this year, compared to average growth of 6.9% in the first two quarters. According to the growth data in the first three quarters and other economic indicators, it appears the growth rate this year will be slightly higher compared to last year, following six consecutive years of slowing growth. The factors that supported the stabilization in growth are primarily private consumption and the improvement in exports against the backdrop of the global recovery.

As we noted in the past, in light of the lack in transparency of the Chinese authorities, there is doubt regarding the credibility of official data. Some of the leading international financial institutions assume that the "true" growth rate of China is below that expressed in the official data. As is known, over a long-term perspective the growth rate of China has fallen substantially in recent years, also as part of the process of convergence to a higher GDP per capita. The growth rate in 2016 (6.7%) was the lowest since 1990, while the average growth rate in 1980-2015 was 9.7%.

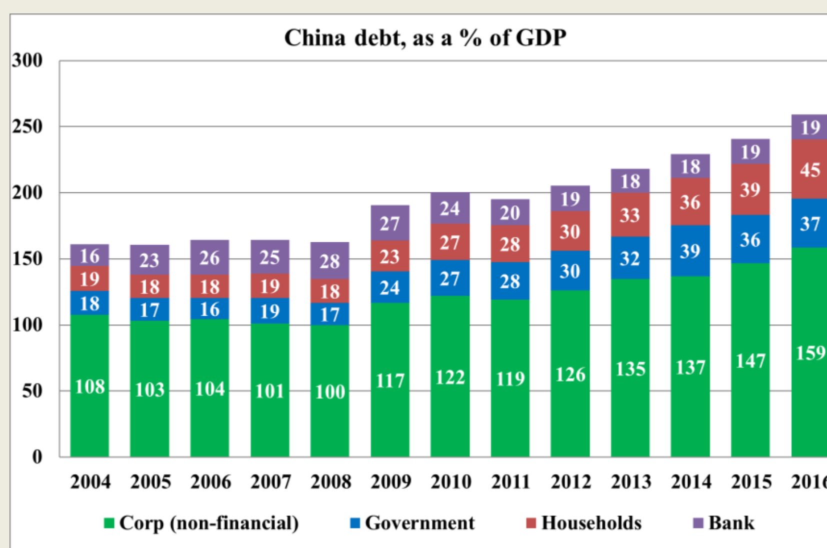
The factors that weighed on growth in the Chinese economy in recent years include the slowdown in local demand that stemmed from a number of factors, including: overproduction beyond demand in certain industries over time; a slowdown in investments by local and foreign investors as a result of a decline in economic sentiment that stemmed from uncertainty against the backdrop of the weakness in the global economy and concerns of the public regarding an "asset bubble" in the housing and credit markets; negative sentiment in the financial markets over recent years; and the weakness in external demand against the backdrop of the slowdown in global activity in the years 2010-2016 that weighed on the activity in the local industrial and services sectors.

Against this backdrop, China's export activity, which was the central growth engine of the economy in the years prior to the breakout of the global crisis, weakened in recent

years. Yet, as mentioned, the economy has been in a trend of recovery over the past year. Exports from China are expected to increase 4.7% in 2017, following a negative average growth rate of 0.6% in the years 2015-2016. It is important to note that between the years 2002-2007 (between the two economic crises) Chinese exports increased at an average annual rate of 25%!

According to different estimates, the economic growth rate in China is expected to return to a downward trend in the coming year, this due to government policies to reduce the financial risks in China, reflected in the very high leverage of the business sector (details below). The Chinese economy is expected to grow 6.8% this year, or 0.1 percentage points higher than last year's growth rate. The annual growth rate in the years 2018-2022 is expected to average 6.2%. It is important to note that due to the slight improvement in economic activity this year, some of the international economic institutions, among them the IMF, raised to some degree their growth forecasts for China for the medium-term.

The rise in business sector debt over recent years is the central risk: According to official data, the debt of the business sector (excluding the financial sector) equaled 172% of GDP in 2016 compared to 109% of GDP in 2006. Also, government debt increased in recent years (see details below), this with the goal of launching the state's economic plans into action, including investment in infrastructure. China has still not succeeded to diversify its financing sources for government investments. Alongside the large weighting of government investments, which are financed through local bank credit and fundraising by the local authorities in the domestic bond market, there is a continuing increase in corporate debt, together with a rise in risks associated with credit quality. S&P estimates within its "middle scenario" that the banks of China have sufficient financial strength for the short-term.



Another realm that brings along with it a rapid increase in local credit is the real estate sector, in which land prices in the areas of high demand are rising rapidly, and developers are increasing their amounts of financing and risk. It is important to note that also the debt of local households increased substantially in recent years, reaching

a level of 44% of GDP in 2016 compared to 11% of GDP prior to the breakout of the crisis (almost quadrupling).

In our opinion, the substantial increase in financial leverage in recent years, particularly in the business sector, alongside the fact that the Chinese credit market is characterized by irregularities, a lack of transparency, and the absence of proper risk management practices, and this in parallel with a slowdown in growth that has occurred in recent years, represents a substantial risk to the Chinese economy. On the other hand, it is important to note that the Chinese government considers these financial risks with the utmost importance, and it appears the government is acting to moderate the increase in leverage. This is being expressed in a slowdown in credit in recent years. Another risk that is important to note is the long-term upward trend in housing prices in recent years, especially in the larger cities, this against the backdrop of the high level of demand in these regions. It should be noted that recently there has been a slowdown in the rate of increase in housing prices to 6.3%, this following a period in which the rate of increase was greater than 10% (in the first half of 2016 and the second half of 2017).

It is likely that the actions of the authorities to tighten credit terms were among the factors that supported the slowdown in the rate of increase in prices recently. The relatively high inventory of housing units in China, together with the efforts of the authorities to moderate the degree of leverage among households, limits any substantial upward pricing pressures on housing in the short-medium term. In our opinion, in the event there will be a substantial slowdown and/or a decline in housing prices due to the economic policies, this will likely hurt consumer confidence, and will consequently also weigh on local demand.

Additional risks that are likely to affect the Chinese economy are protective trade policies, which are likely to strengthen in continuation of the trend over recent years, and a rise in geo-political risks in regards to North Korea. However, from a macro-outlook, we estimate that the risk environment in China is not as low as is reflected in the CDS spreads, but as we remarked prior, the risk environment will be strongly dependent on the success of the government reforms.

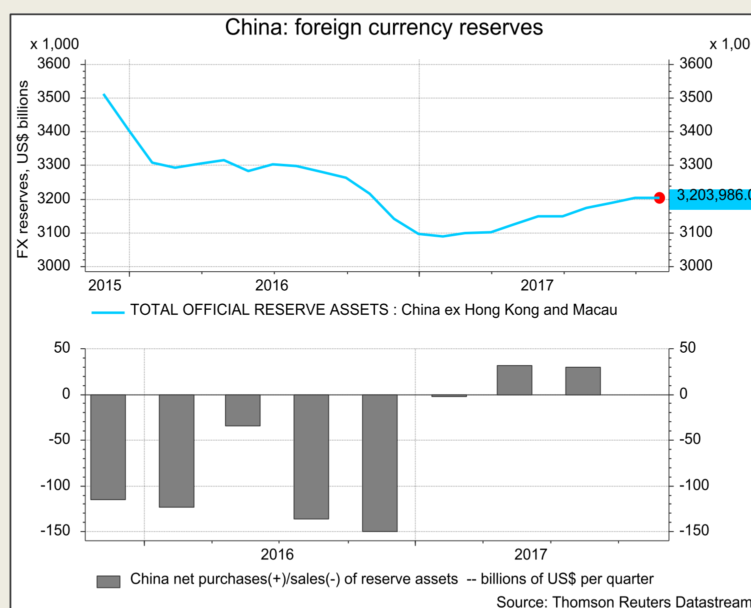
The government's economic policies are likely to lessen the risks. One of the central questions is if the government will succeed to lower the risks in the financial sector, and to lead reforms, and at the same time maintain a relatively high growth environment that will be sustainable in the medium-long term. Economic activity and the risk environment will be affected in the near-term by the economic policies of the government and by monetary policy. The government is expected to continue to increase expenditures in the near term, primarily with regard to investments in public infrastructure and in industry in order to support the labor market and local demand. In addition, the Chinese government has been initiating structural reforms in recent years that are aimed at supporting sustainable growth. Steps taken

include, among other things, strengthening competition in certain industries, privatizing government companies, encouraging investments by foreigners through increasing transparency, removing barriers to entry within certain industries, as well as regulating and limiting the credit market (primarily of shadow banking).

In addition, recently the Chinese government has been conducting a campaign against corruption in the public sector, especially in the local governments and in government companies. These steps are likely to support greater confidence on the part of the public in the rule of law, an improvement in the business environment, and much greater efficiencies in the distribution of resources. Some of the steps and reforms are likely to have an impact already in the short-term and to support a cessation in the moderating trend in the growth rate. Another portion of the steps being taken is likely to support a rise in productivity, and consequently a relatively high growth rate in the medium-long term.

The economic policies that the government is initiating are expected to cause a rise in expenditures, which will be translated into a rise in the deficit and in government debt in the coming years, although not by a substantial degree. However, if economic activity will deteriorate and in the event the "true" economic data of China will turn out to be more negative, then there is a risk that the fiscal expansion will be more substantial, and this will be reflected in a deterioration in the country's fiscal profile. In the event the fiscal policies and reforms of the Chinese authorities will prove themselves to be ineffective, and if economic activity substantially moderates, then there is likely to be an expansion in criticism among the Chinese public. Such a development is likely to lead to social unrest and is likely to substantially disrupt economic activity.

A decline in the surplus in the current account in recent years. Signs of a cessation in the downward trend in the amount of foreign currency reserves and in financial capital flight: China has been characterized by a surplus in its current account over recent years, but the level as a percentage of GDP is expected to decline in the coming years as a result of a decline in the surplus in China's trade balance. In addition, China holds a surplus of assets over liabilities (16% of GDP) and the country maintains a high amount of foreign



currency reserves amounting to US$3.1 trillion. These factors on their own contribute to China's strength. It should be noted that from mid-2014 until the beginning of 2017 there was a decline in foreign currency reserves (in June 2014 these stood at US$4 trillion) against the backdrop of internal demand from Chinese companies or foreign investors for US dollars that were provided by the government from its reserves, but not only from this. Another factor that affected the country's reserves were the changes that occurred in the cross currency exchange rates in the world from mid-2014 (the reserves are calculated in US dollars and therefore its strength leads to a decline in the value of the reserves denominated in the different currencies). Overall, China is characterized by strong external accounts; however, these have weakened in recent years.

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