Global Economics Monthly Review

February 13, 2017

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- **Global growth is expected to accelerate in 2017.**
- **Headline inflation is on the rise, but core inflation remains more or less stable.**
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- **Input prices inflation might be translated to a further increase in CPI inflation.**
- **BoE more optimistic on growth. The tone might change toward the hawkish side if inflation continues to rise.**

Global Economics – The Big Picture

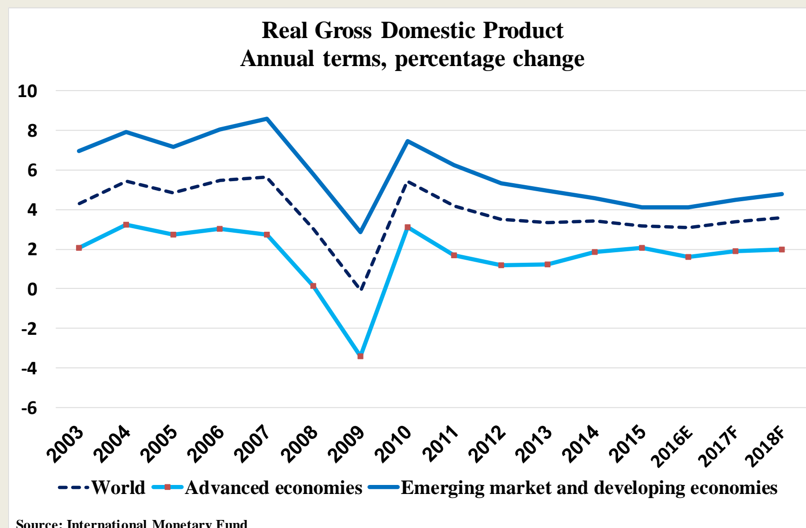
The improvement in global economic activity has continued in the beginning of 2017.

Recently released economic reports suggest that global economic activity continued to grow in the beginning of the first quarter of 2017, following an acceleration in growth around the world in the second half of last year, particularly in some of the major developed economies, including the US and the euro area economies. Moreover, in contrast to assessments that the UK economy will slow significantly due to the increased uncertainty from Brexit's consequences, economic activity has continued to recover, led by solid growth in services and a recovery in manufacturing.

In the emerging economies, China's economic growth edged up in the fourth quarter of last year to 6.8% y/y, after registering a stable growth of 6.7% in the first three quarters. These figures may suggest that the moderation in China's growth has halted for now. That said, we estimate that the economic growth in China will moderate in the next year, with further moderation expected in 2018, as the government is expected to scale back supportive policies due to high and rising corporate debt. In India, economic growth rates have remained relatively high; however, activity slowed in the past few months due to the banknotes ban in November. The ban's negative impact on activity is expected to remain visible in the first half of the current year.

Global growth is expected to accelerate in 2017.

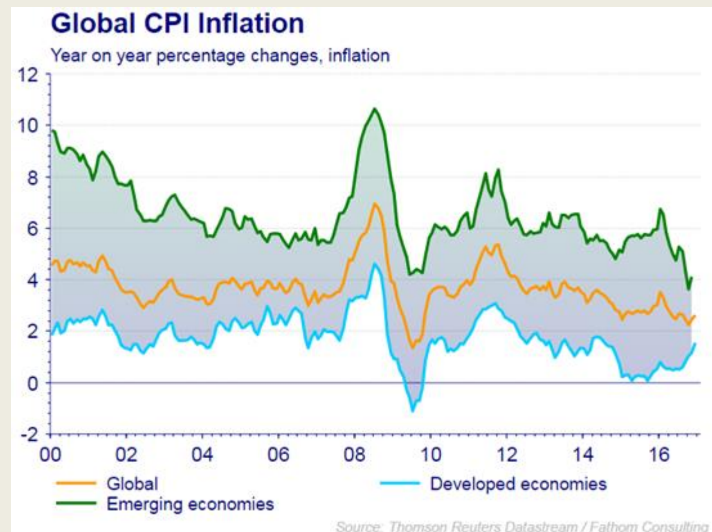
According to the latest global PMI reports, economic activity rose further in January. The improvement largely reflects the continued recovery in advanced economies, as a result of the strength in the services sectors and the substantial improvement in the manufacturing sector.



The recovery in economic activity is expected to continue throughout the year. We expect some acceleration in global growth, to 3.4% compared to 2.9% in 2016. The risks to our forecast stem mainly from heightened uncertainty, against the backdrop of, among other things, the political risks in Europe, US fiscal and trade policies under the Trump administration, financial risks in China, continuing weakness in some major

emerging economies such as Brazil, and geopolitical risks in the middle-east and other parts of the world, and more.

Headline inflation is on the rise, but core inflation remains stable.



The aggregate inflation rate has risen sharply in advanced economies, reaching 1.6% in December, while in emerging markets inflation has decreased. The rebound in headline inflation in the developed economies is mostly a result of the recovery in energy prices since March 2016 in tandem with a moderate rise in some metals and agricultural commodities prices.

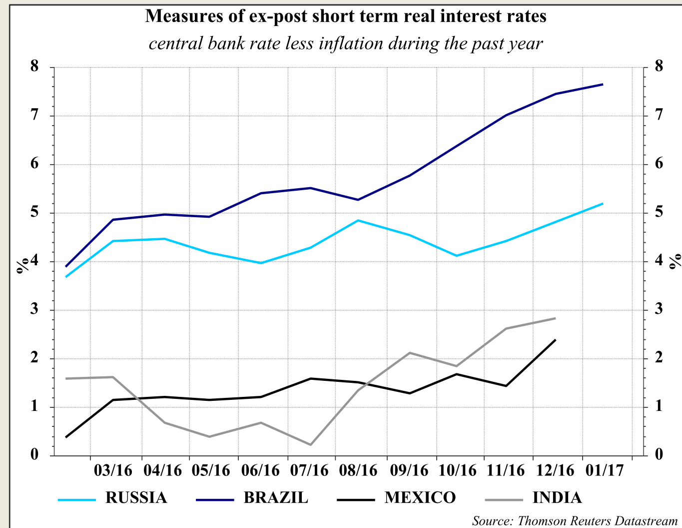
Other factors that support the rise in inflation include some improvement in underlying demand, and the continuing trend of depreciation of many currencies vis-à-vis the strong USD. However, at the same time, core inflation has remained stable, suggesting that the underlying price pressures are still insignificant. Based on recent surveys, producers' input prices, which serve as a leading indicator to headline CPI inflation, have continued to rise lately, suggesting that headline inflation may continue to rise, at least in the short-run.

Central banks' rhetoric may change in the short-run if inflation will continue to rise in tandem with a solid recovery in economic activity.

The major central banks did not implement any substantial changes in their monetary policies in the past month. However, the rise in inflation and the continuing improvement in economic activity caused some leading central bankers, including the chair of the US Federal Reserve Bank (the Fed), Janet Yellen, and the governor of the Bank of England, Mark Carney, to communicate hawkish messages recently. The US Fed is expected to tighten further its policy later this year.

On the other hand, the European Central Bank's expansionary monetary policy is expected to continue, but we do not rule out further tapering steps, albeit at a gradual pace. In the UK, monetary policy is expected to remain unchanged at least until the end of 2017, mainly due to the heightened uncertainty surrounding the Brexit consequences on economic growth and inflation. In Japan, the central bank did not adopt any changes to its policy in its last meeting on January 31st, as expected, but it became more upbeat on growth.

Among the central banks of emerging economies, the picture is mixed. Some of the economies that are characterized with high levels of interest rates, substantially higher than their falling inflation levels, such as Brazil and Russia, may continue to reduce policy rates in the short-run.



On the other hand, some central banks, particularly in those developing and emerging countries that are seem to be currently more susceptible to economic and political risks. These vulnerabilities are in the form of relatively high inflation rates and have relatively large exposure to higher US rates and a stronger USD. Some of the countries that fall into this group are Mexico, Turkey and South Africa and they are likely to continue to tighten their monetary policies in tandem with the interest rate cycle in the US.

India is likely to maintain a conservative approach and to limit its interest rate cuts until disinflation has been fully achieved and India's rate of inflation is in line with the world average. The recent large bank note ban appears to have been motivated in part but the merits of such a step in disinflation, stabilization and fiscal reform, as seen in some other countries that went through successful disinflation programs in the past.

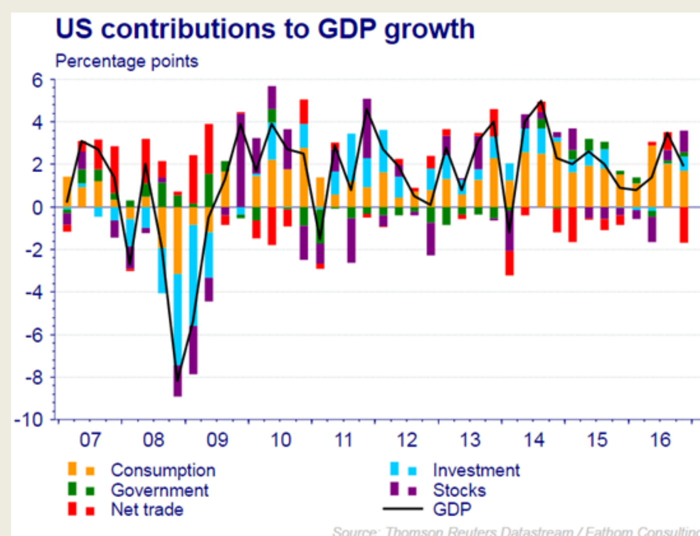
Leumi Global Economic Forecast, As of February 2017

GDP – Real Growth Rate	2015	2016E	2017F
World	3.2%	2.9%	3.4%
USA	2.6%	1.6%	2.3%
UK	2.2%	2.0%	1.4%
Japan	1.2%	0.8%	1.0%
Eurozone	2.0%	1.7%	1.5%
South East Asia (ex. Japan)	4.4%	4.5%	4.7%
China	6.9%	6.7%	6.2%
India	7.5%	6.5%	7.0%
Latin America	0.1%	-0.6%	1.7%
Israel	2.5%	3.8%	3.2%
Trade Volume, Growth Rate			
Global	2.7%	1.6%	2.7%
OECD	4.4%	2.0%	2.6%
Non-OECD	-0.4%	0.9%	2.8%
CPI, Rates of Change, % Annual Average			
USA	0.1%	1.2%	2.1%
UK	0.1%	0.7%	2.5%
Japan	0.5%	0.9%	2.0%
Eurozone	0.8%	-0.2%	1.2%
Israel	-0.6%	-0.5%	0.5%
Interest rates, Year End			
US Fed	0.25-0.50%	0.50-0.75%	1.00-1.50%
Bank of England	0.50%	0.0-0.25%	0.0-0.25%
Bank of Japan-Policy Rate Bal.	0.00%	-0.10%	-0.10%
ECB-Main Refi	0.05%	0.00%	0.00%
Israel	0.10%	0.10%	0.50%

United States

Further improvement in economic activity recently. Economic growth in 2017-2018 will be significantly affected by the economic policies of the Trump administration.

Fourth quarter GDP growth indeed moderated compared to the third quarter (1.9% q/q annualized vs. 3.5%), but the slowdown was mainly due to a downward correction in soybean exports after the temporary spike in demand from China that boosted the third quarter growth. Analysis of broader time periods shows that after a weak first half of 2016, when annualized GDP growth averaged only 1.1%, there was at least an acceleration to an average of 2.7% in the second half, which is well above the economy's potential growth rate of around 2%.



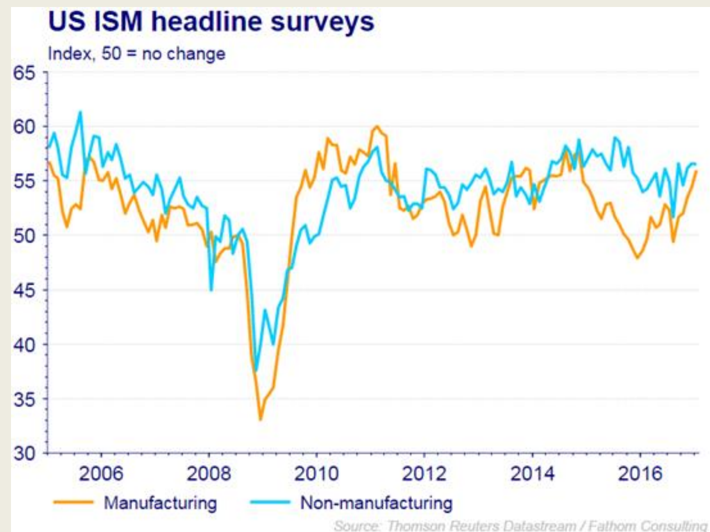
Analysis of US GDP components indicates some slowdown in consumption growth in the fourth quarter of last year, for the second quarter in a row. However, with consumer confidence surging and employment and wage growth looking healthy (despite the slight moderation in wage growth in January), we expect further growth in private consumption. This is especially true when households will be anticipating a decline in tax rates at some point this year, as proposed by the Trump administration.

In contrast to the moderation in personal spending, business investment expanded for the second quarter in a row, as the drag from the mining sector faded. Looking ahead, the trend in business investment will be dependent on the Trump administration's fiscal policy, mainly the size of the new administration's infrastructure investment package, as well as its composition and timing. We expect to have more clarity on this issue in the coming months. Residential investment also rebounded strongly, and the positive trend is expected to continue as demand and housing permits continue to rise. Further support for this comes from the fact the homebuilders' confidence index is close to its multi-year high.

On the other hand, net trade is expected to weigh on GDP growth in the short-run, as imports are expected to remain solid and the strength of the USD may weigh on exports. Expected upcoming US trade policy decisions by the Trump administration will strongly affect net trade in the near future. These may include the provision of incentives to exporters, the imposition of tariffs on imported goods, and withdrawal from existing trade agreements. Even though the Trump administration is moving

very quickly on many other policy matters, there is still a high degree of uncertainty surrounding future US trade policy.

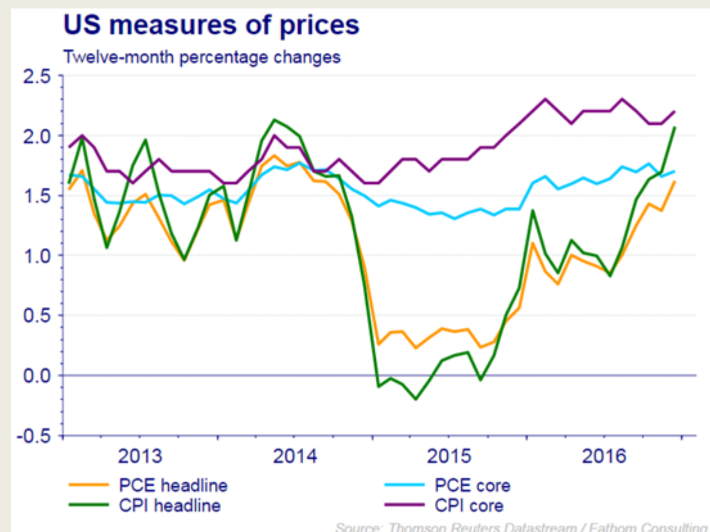
Moreover, newly released data for January show that the manufacturing and services PMI figures rose in January, attesting to a positive start for 2017. According to the data, it seems that the strong dollar continued to weigh on exports, while domestic demand clearly remains buoyant. Job creation also remained solid, as business expectations of future growth are at their highest in 1.5 years.



All in all, we expect the US economy to grow by 2.3% in 2017. However, our forecast may change throughout the year, depending on the economic policies that will be introduced and approved by the Trump administration later on this year. While growth in 2017 is likely to be boosted by expectations for government spending and tax rate reform, failure to meet the high expectations that have been set may weigh on economic growth in 2018.

Inflation is near the Fed's target, and may even rise further.

Both CPI and PCE inflation rose in December, thus continuing to suggest that the base effects from past energy price declines and dollar-pass through are fading. CPI headline inflation rose to 2.1% y/y on stronger energy prices. Core inflation edged up to 2.2% y/y from 2.1%. Core inflation has ranged between 2.1% and 2.3% since December 2015. December PCE revealed similar trends, with headline PCE inflation rising to 1.6% y/y from 1.4% a month earlier, nearing the Fed's inflation target. Core PCE inflation was unchanged at 1.6% y/y. In tandem, market-based inflation expectations have increased further in the past month. Currently, longer-run inflation expectations are above the Fed's longer-run inflation target of 2%.



The recent inflation reports provided further confirmation of energy base effects supporting a rise in headline inflation. Core inflation is expected to remain close to the Fed' target, supported by services prices and continuing strength in domestic demand. In addition, the recovery in energy prices may continue in the short-run, and support a further rise in headline inflation.

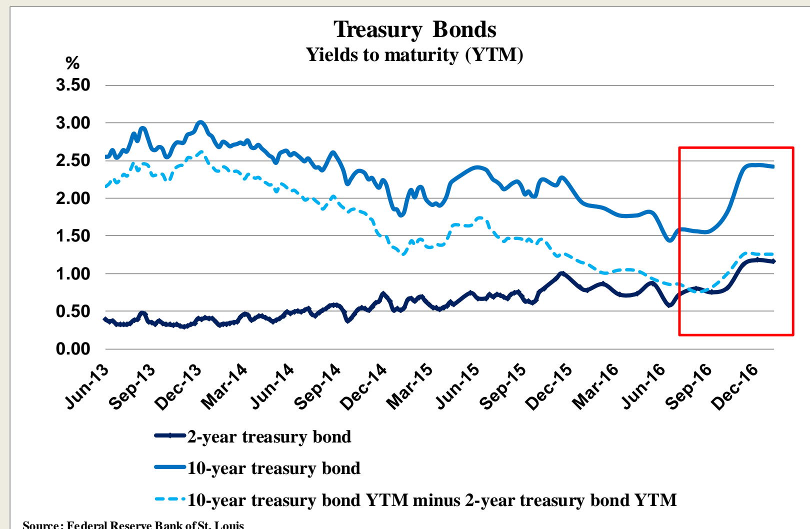
Interest rates are expected to rise moderately over the short- and medium-terms, but we do not rule out a more rapid pace of hikes.

The Fed decided to leave its monetary policy unchanged at the February meeting, as expected. Consistent with the recent tone adopted by the FOMC members, the statement signaled further progress toward the Fed's full employment mandate: "…the labor market has continued to strengthen" and "job gains remained solid and the unemployment rate stayed near its recent low" (see chart that includes the official rate and the broader unemployment rate U-6: Total unemployed, plus all persons marginally attached to the labor force, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all persons marginally attached to the labor force.)

On inflation, reflecting the recent rise in inflation, but also the fact the PCE inflation remains below target, the statement reflected a somewhat dovish stance, "Inflation increased in recent quarters but is still below the Committee's 2 percent longer-run objective…", and "market-based measures of inflation compensation remain low." Looking forward, the Fed is expected to remain on hold until it gets more clarity on the scale of the fiscal stimulus being planned by the Trump administration. We expect two to three rate hikes this year. Based on interest rate expectations, the first hike this year is expected to be in the middle of the year, probably in the June meeting, which will be accompanied by the Fed's projections.

Opposing views and estimations surrounding the uncertainties regarding Trump's economic policies may cause volatility in the Treasuries market.

The yields-to-maturity in both the short- and the longer portions of the yield curve have barely changed since the beginning of January. Looking ahead, based on the interest rate expectations and our estimates, we expect the short-end of the curve to rise moderately over the short-run. We expect the yield-to-maturity of the 2-year Treasury bond to rise to 1.3%-1.7% by the end of 2017 (fourth quarter average). The yield of the 10-year bond is expected to rise to 2.5%-2.8% by the final quarter of 2017. We expect the (10-year less 2-year) yield curve will flatten toward 100 basis points by the end of the year. However, we do not rule out a steeper yield curve in the short-run if medium- and long-term inflation expectations will continue to rise.

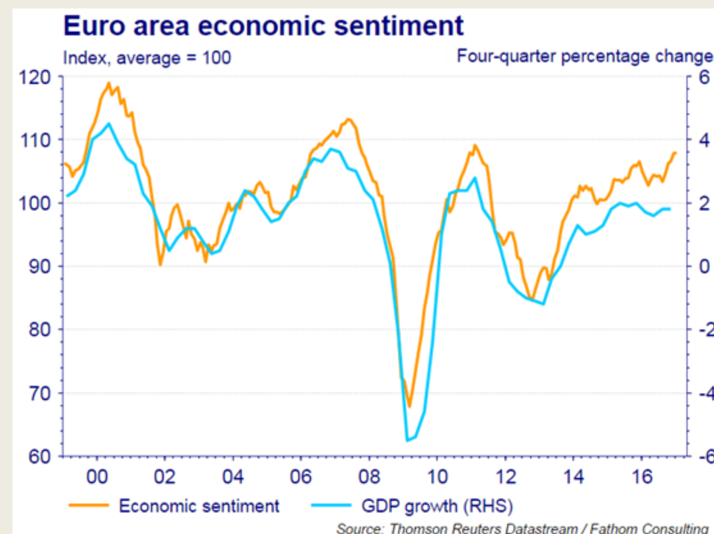


Euro Area

Further improvement in economic activity led by domestic demand. Heightened political risk environment is expected to weigh on growth.

Based on the flash estimate of national accounts, euro area (EA) GDP growth expanded in the fourth quarter of last year by 0.5%, compared to the third quarter's upwardly revised GDP growth figure of 0.4%. On a year-on-year basis, the rate of growth in the fourth quarter remained 1.8%, which is quite good. The expenditure breakdown has not been released yet, but based on some national estimates and other economic data, we expect that domestic demand was the main growth driver, with some positive contribution of net exports to growth. Newly released data and surveys for January attest to further recovery in economic activity in the beginning of this year, led by the services sectors and improvement in manufacturing activity.

Looking forward, we expect private consumption to remain the main growth driver as labor market indicators have improved and consumer confidence is high. It should be noted that the rise in inflation may weigh on EA households' purchasing power, but the negative effect on growth is expected to be marginal. The investment component, which moderated significantly in the third quarter, is expected to recover in the short-run, as forward-looking components of economic sentiment and manufacturing PMIs data show. Moreover, the recent increase in producer prices may also support a recovery in profit margins, in tandem with slow increases in wages and a low interest rate environment.

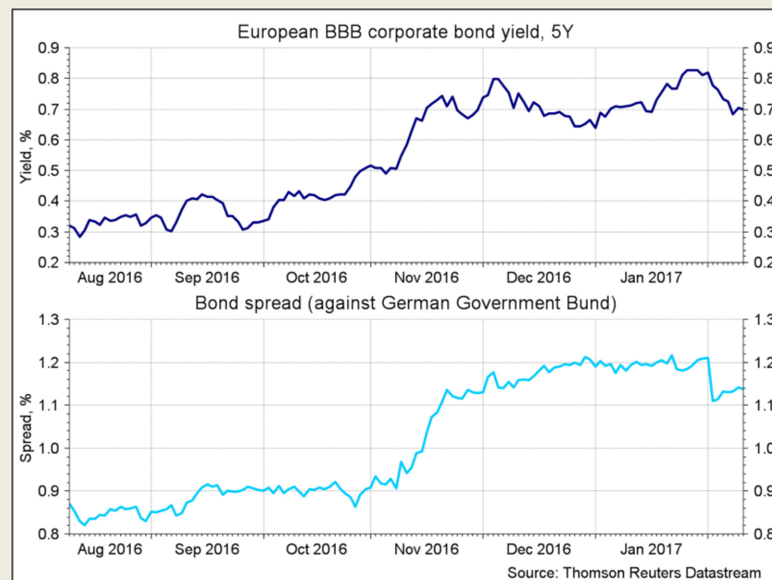


As a result of the improvement in economic activity and sentiment, 2017 growth forecasts have been revised upward recently. The domestic demand outlook seems better, and external demand has improved for the following reasons: the UK's recovery from the post Brexit downturn; expectations for expansionary fiscal policy in the US that may spillover internationally; the rise in assets prices; and some stabilization in China. We recently revised upward our 2017 EA growth estimate to 1.5% from 1.4%.

One of the factors that may weigh on domestic demand in the short-run is the heightened political risks environment in 2017 (please read Leumi's December 2016

Global Economics Review). The rise in European political risks is a result of the increase in uncertainty surrounding the national elections outcomes in Europe, as the political power of Eurosceptic and anti-establishments parties is on the rise. It appears that the skepticism is aimed primarily at the European Monetary Union (EMU) and not at the European Economic Area (EEA). This reflects the shortfalls of the EMU being felt by both strong and weak economies, while the benefits of belonging to the EEA, including free trade and movement, are appreciated.

There are also other political factors that may weigh on economic sentiment throughout the year, including a rising probability for a snap election in Italy, uncertainty regarding UK's Brexit consequences, and Greece's debt sustainability problems. These uncertainties have manifested themselves in changes in bond spreads throughout some of Europe's markets – both sovereign and corporate.



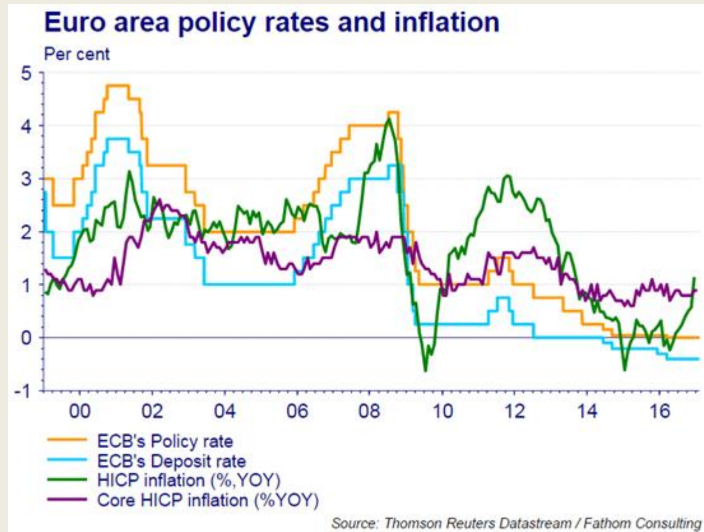
Inflation rose strongly in January, but underlying price pressures are moderate. Core inflation is expected to rise modestly.

Based on flash estimates, euro area CPI inflation increased significantly from 1.1% year-on-year in December 2016 to 1.8% year-on-year in January this year – the highest since February 2013 and consistent with the ECB's target of "below, but close to, 2%". The core rate remained stable at a subdued level of 0.9%. We expect headline inflation to remain near the 2% level in the upcoming months supported by the recovery in energy and food prices. Core inflation is expected to rise, albeit moderately due to the remaining slack in the labor market and still modest recovery in domestic demand.

The ECB's rhetoric might become more hawkish if inflation indicators will continue to rise.

The ECB left its monetary policy unchanged, as expected, at its last meeting on January 19th. At the press conference that followed the publication of the monetary statement, the president of the ECB, Mario Draghi, made it clear that the increase in headline

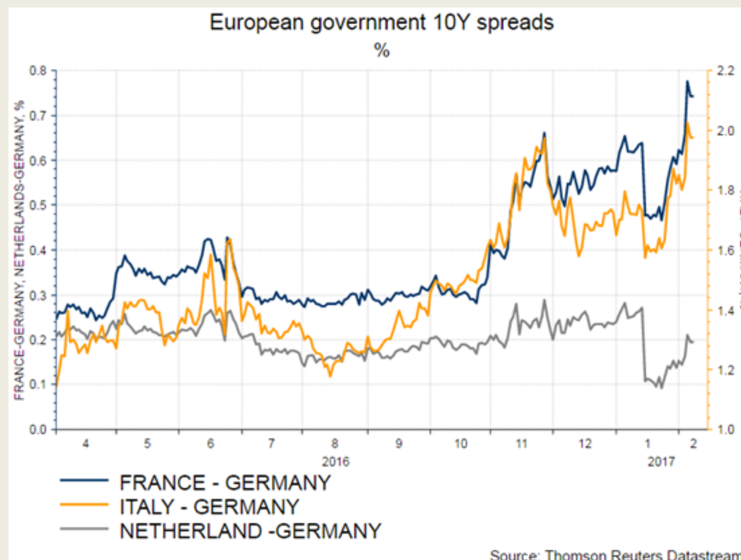
inflation is largely the result of base effects driven by energy and food prices and may be only temporary. Moreover, he said that the ECB will monitor closely the pick-up in headline inflation, analyzing whether it is transient, and will also review the implications on the long-term inflation dynamics.



The ECB's communication will be especially important in the upcoming months, as headline inflation and inflation expectations are expected to remain close to the inflation target. We expect the expansionary monetary policy to continue, but if core inflation will start to rise, then we will not rule out further tapering steps, albeit at a gradual pace, in the short-medium term. One of the main risks to this estimation is the rise in European political risks.

The spread between German government bund yields and the yields within its major European counterpart nations increased further as political uncertainty is on the rise.

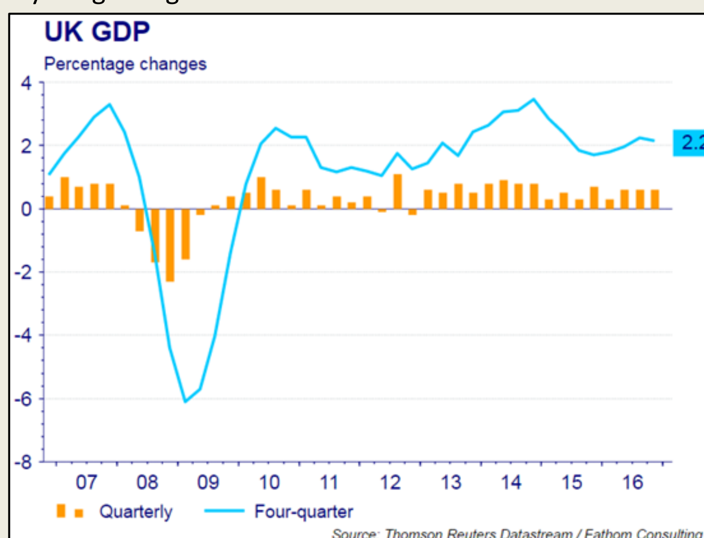
The upcoming elections in the Netherlands, France, Germany and possibly in Italy, in addition to the rising concerns regarding the Greek debt crisis, caused government bonds yield gaps to widen further recently, as investors have become more risk averse. The spread between the 10-year German bund yield and its Italian counterpart is around two percent, which is the highest in the past three years.



The gap with France's 10-year bond reached 79 basis points, the highest since November 2012. The rise in political risk in tandem with estimations that the ECB's tapering steps may continue if core inflation will follow the headline measure of consumer prices, support further heightened volatility in the European bonds market.

United Kingdom

The UK economy continues to show resilience. Uncertainty stemming from the vast unknowns of the Brexit process may weigh on growth in 2017.



Preliminary national account data show that the UK economy was not hit following the Brexit referendum. Q4-16 GDP growth was 0.6% q/q, slightly above consensus expectations (0.5%). On a year-on-year basis, GDP rose by 2.2% in the fourth quarter. Although the headline GDP growth figure was unchanged from Q3-16, the GDP components' composition showed a slightly weaker services sector. Manufacturing, meanwhile, has been recovering, albeit slowly.

The expenditure breakdown will be released only later this month, but based on monthly data, we assume private consumption was the main contributor to GDP growth in the fourth quarter. Newly released data for January suggest that the UK economy lost some steam in January as the PMI measure decreased due to a fall in the services sectors, following the strong end to 2016. Based on past data, the PMI surveys are collectively signaling that GDP will rise by a robust 0.5% q/q in the first quarter of the year, close to the pace in the previous quarter, if current growth is sustained in the next few months.

We expect economic growth to be driven primarily by private consumption in the short-run, supported by positive labor market conditions. We expect investment to be a drag on headline GDP growth, which would be consistent with the latest surveys on investment intentions. We also expect net trade to contribute positively, driven largely by the depreciation in the GBP since end-2015 and the improvement in economic activity among the UK's trading partners. We expect GDP growth of 1.4% in 2017, reflecting a moderation compared to the growth rate in 2016 (BoE's estimation: 2.2%). The main risk to growth remains the uncertainty surrounding Brexit's consequences.

Input prices inflation might be translated to a further increase in CPI inflation.

UK headline CPI inflation rose from 1.2% year-on-year in November to 1.6% in December. The rise was supported by energy and food prices. Moreover, the rise in core inflation from 1.4% to 1.6% in December was mainly due to the volatile airfares component, yet this will probably be at least partly reversed in the coming months. It

should be noted that inflationary pressures at the beginning of the supply chain have continued to build as a result of the drop in the pound. Input price inflation rose to 15.8% year-on-year and output price inflation picked up to 2.7% – both the highest in around five years. These increases are expected to be translated into a further rise in consumer prices. A further rise in core inflation may have an effect on the communications of the Bank of England (BoE) toward a more hawkish tone.

BoE more optimistic on growth. The tone might change toward the hawkish side if inflation continues to rise.

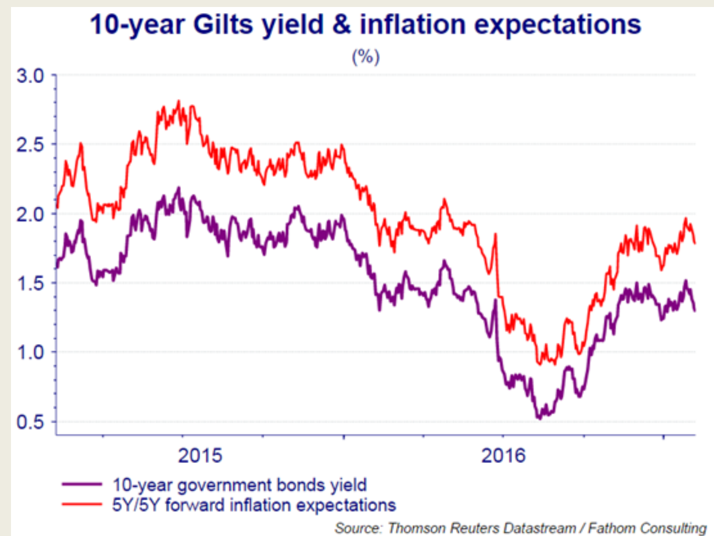
At its meeting concluding on February 1st, the Monetary Policy Committee (MPC) of the BoE decided to leave its monetary policy unchanged, as expected. The vote on the Bank Rate was 9-0 in favor of the status quo. The Bank Rate was left unchanged at 0.25% and the stock of the Asset Purchase Facility program was left unchanged as well at £435bn for UK gilts and £10bn for non-financial GBP investment-grade corporate bonds.

The BoE released its new macro forecasts in the accompanied Inflation Report. The BoE raised its 2017 GDP growth forecast significantly by 0.6 percentage points to 2%. This upward revision to growth reflected a number of factors, including the easing of the fiscal squeeze announced in December, estimates regarding further improvement in global economic activity, looser credit conditions, and continued strong growth in household spending. Despite the positive outlook for growth, inflation forecasts were left broadly unchanged, averaging 2.7% for the first quarter of next year. Moreover, the BoE expects the Bank Rate to be 0.5% in Q1-2019, reflecting only one rate hike until then.

Despite the improved outlook, we expect monetary policy to remain unchanged at least until the end of 2017, mainly due to the heightened uncertainty surrounding the Brexit consequences on economic growth and inflation. That said, if inflation will increase significantly further upward, then the BoE's communication might change toward the hawkish side.

Meanwhile, as a result of the rise in inflation expectations since the second quarter of last year, market-based interest rate expectations and the 10-year government bond

yields rose. Currently, the medium-term inflation expectations are close to BoE's inflation target, and it seems that the potential for a significant increase in the medium-longer term inflation expectations is limited at the current high level as some of the rise has been driven by transitory factors (exchange rate and commodity prices) and as



risks to growth, and domestic demand in particular, are tilted to the downside.

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