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Global Macroeconomic Monthly Review

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- *Chile passed a reform permitting households to use of some of their pension funds, this in order to accelerate the recovery of the economy.*
- *inflation increased in developed countries after declining over several months; however, in Australia the inflation rate declined to a negative level.*
- *In England, the central bank did not change its monetary policy, but in Canada and Russia the central banks reduced the interest rate.*
- *US bond yields have declined since mid-July, while the bond yields of the major euro bloc economies also declined during July.*

United States (p. 9)

- *US GDP contracted 32.9% in the second quarter in annualized terms, mainly due to a sharp drop in private consumption.*
- *June data and preliminary indicators indicate a partial recovery in economic activity, and GDP is expected to increase in the third quarter of the year.*
- *the Fed kept its interest rate unchanged at 0.00% - 0.25% and declared the Fed's asset purchases will continue at least at the current pace. This statement by the Fed caused a drop in government bond yields and a decline in the slope of the yield curve.*
- *The consumer price index (CPI) increased in July and the core CPI increased as well.*

Euro Bloc (p. 13)

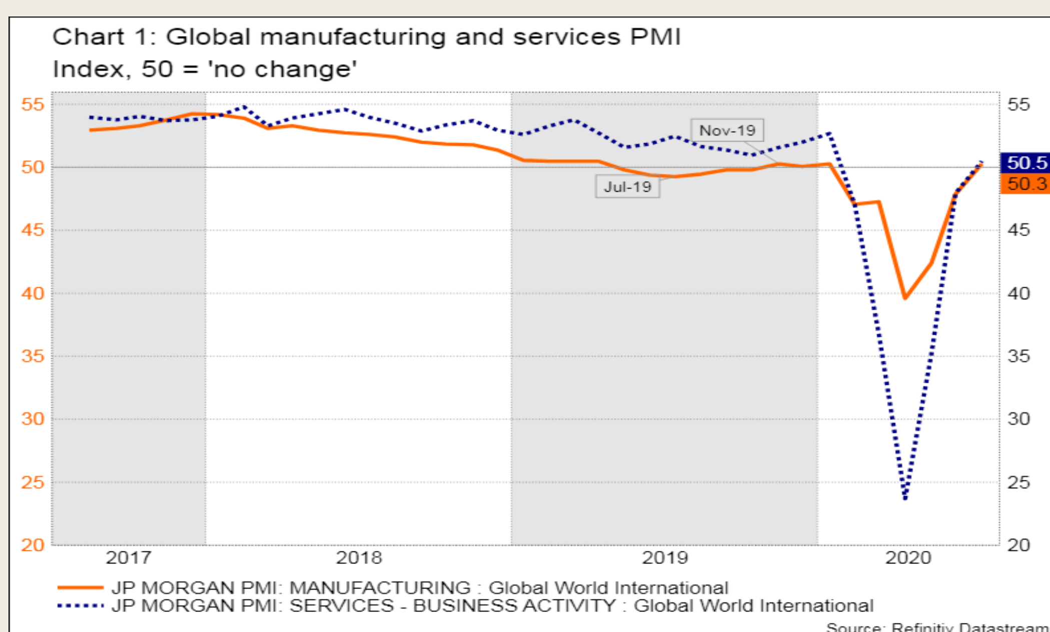
- *The GDP of the euro bloc contracted 12.1% in the second quarter (q/q), as the GDP of each of the major economies declined by a double-digit rate during the quarter.*
- *Towards the end of the second quarter economic activity started to recover, even by a relatively rapid rate in some of the larger economies in the bloc. However, the tourism sector remains vulnerable, and this sector is expected to weigh on the recovery of economies that rely heavily on tourism.*
- *the ECB left the interest rate unchanged at 0.00%, and it expects this rate to remain at this level until inflation converges to its target.*
- *Euro bloc countries reached an agreement to establish a €750bn recovery fund, of which €390bn will be provided as grants and €360bn as discounted loans.*

Leumi Global Economic Forecast, As of August 2020

	2017	2018	2019E	2020F	2021F
GDP – Real Growth Rate					
World	*3.8%*	*3.5%*	*2.6%*	*-4.1%*	*4.9%*
USA	*2.4%*	*2.9%*	*2.3%*	*-5.3%*	*3.7%*
UK	*1.9%*	*1.3%*	*1.4%*	*-9.0%*	*6.0%*
Japan	*2.2%*	*0.3%*	*0.7%*	*-5.2%*	*1.7%*
Eurozone	*2.7%*	*1.9%*	*1.3%*	*-8.4%*	*5.5%*
South East Asia (ex. Japan)	*5.3%*	*5.1%*	*4.4%*	*-1.8%*	*4.4%*
China	*6.8%*	*6.6%*	*6.1%*	*1.4%*	*8.0%*
India	*7.0%*	*6.1%*	*4.3%*	*-5.8%*	*9.4%*
Latin America	*0.9%*	*0.7%*	*-0.6%*	*-8.8%*	*4.0%*
Israel	*3.6%*	*3.4%*	*3.5%*	*-7.9%*	*5.5%*
Trade Volume, Growth (%)					
Global	*5.8%*	*3.7%*	*0.9%*	*-22.6%*	*11.9%*
Interest rates, Year End					
US Fed	*1.25-1.50%*	*2.25-2.50%*	*1.50%-1.75%*	*0.00-0.25%*	*0.00-0.25%*
Bank of England	*0.50%*	*0.75%*	*0.75%*	*0.1%*	*0.1 %*
Bank of Japan-Policy Rate	*-0.04%*	*-0.07%*	*0.0%*	*-0.1%*	*0.0%*
ECB-Main Refi	*0.00%*	*0.00%*	*0.00%*	*0.00%*	*0.5%*
Israel	*0.10%*	*0.25%*	*0.25%*	*0.00-0.25%*	*0.00-0.25%*

Economic activity: the global economy has begun to recover, but there are significant gaps between different countries. In India and Russia, the industrial manufacturing sector weakened over the last month. Retail sales have increased in developed economies; however, if the second wave of the virus causes a reinstatement of closures and restrictions, then retail sales may fall back. Chile passed a reform permitting households to use of some of their pension funds, this in order to accelerate the recovery of the economy.

- The global economy has begun to recover from the crisis, against the backdrop of the lifting of closures, and with the decisive majority of countries keeping their economies open. The PMI of the global manufacturing sector increased in July, reaching its highest level since the outbreak of the crisis that started with the spread of the coronavirus (see Chart 1), and it signals the growth of the sector during July. However, there are significant gaps in the economic recoveries among the different countries. In Australia, Britain, and China, the PMI of the manufacturing sector continues to rise, indicating growth in industrial production. In Brazil, the index continues to rise as well, and has even reached a historic peak of 58.2 points, indicating growth in the manufacturing sector despite the continued spread of the coronavirus. In contrast, in Russia and India, the PMI of the manufacturing sector weakened in July, indicating a continued contraction in economic activity.
- With the onset of recovery in economic activity, retail sales rose in the developed economies. This, after they dropped sharply in March-April during the outbreak of the coronavirus as a result of the halt in economic activity. However, against the backdrop of the second outbreak of the coronavirus in several countries and the rise in the rate of infection in the US, if the spread of the virus is not halted, then countries may reinstate the closures and social-distancing restrictions, and the recovery in retail sales may slow and may even halt.
- In Britain, the GDP rose by 8.7 in June (m/m). But it did not prevent GDP from falling sharply by 20.4% in the second quarter (q/q). retail sales rose 13.9% in June (m/m, see Chart 2), after also rising by a double-digit rate in May, and are now just 1% below the level registered in

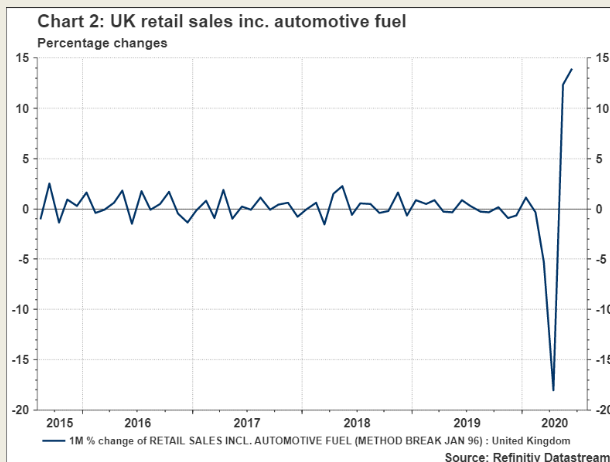


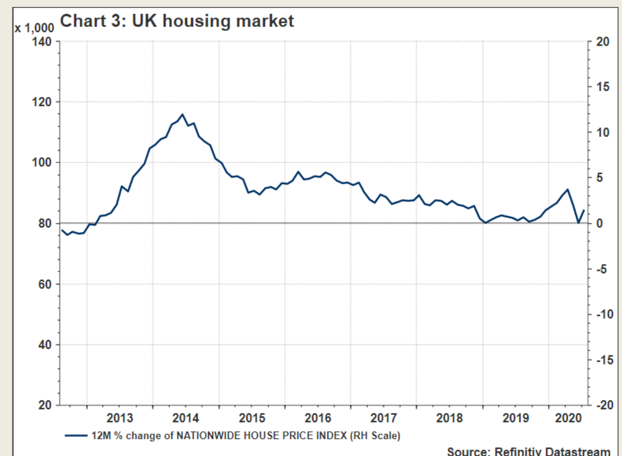
February, prior to the spread of the coronavirus in Britain. Preliminary survey indicators point to a continued recovery in economic activity at the beginning of the third quarter. The ESI survey of economic sentiment in Britain increased from 65.2 to 75.5 in July, and the composite PMI index rose in June from 47.7 to 57.1 points, indicating the growth in economic activity in Britain. The PMI of the services sector increased from 47.1 to 56.6, indicating a strong recovery of the services sector, which was the main victim of the crisis. However, the employment component of the index decreased, thus indicating a continued contraction in the labor market, which shows that GDP growth did not prevent layoffs and job losses. The central bank of England presented optimistic estimates for the English economy, estimating that the expected peak in the unemployment rate fell from 9.0% to 7.5% by the end of the year. According to the Nationwide HPI Index, housing prices in Britain rose in July after falling in May-June, and are now 1.5% higher than last year (y/y, see Chart 3). This is due to the rise in housing loans that increased in May-June after reaching a low in April, and the number of mortgage approvals increased in June after reaching in May the lowest level in the last three decades.

- In Japan, the June indicators point to some recovery in economic activity. Retail sales rose 13.1% (m/m) in the month and suggest a recovery in consumer spending that is expected to continue in the third quarter, even if some of the restrictions on economic activity will be reinstated. Industrial production rose slightly in June, amidst a recovery in domestic and external demand, after falling 16.7% (q/q) in the second quarter due to the government imposed closures and restrictions. The PMI of industrial production rose in July from its low level, but is lower than the index of other developed countries and the index indicates a continued slight contraction in economic activity, raising concerns that Japan's economic recovery will be relatively slow. This concern is growing against the backdrop of the renewed spread of the virus, which may lead to the reinstatement of restrictions and may even lead to another round of business closures.
- Economic activity in developing countries has started to recover. However, the preliminary indicators for July in some countries show a weakening of economic activity, and in some countries even a continued contraction. In China, GDP grew in the second quarter, after contracting in the first quarter of the year. However, there is a high degree of variance in growth rates among the different sectors, with the greatest growth registered in the high-tech and financial sectors; however, the retail and transportation sectors increased by a very low rate and the accommodations sector continued to contract.
- China's international trade also recovered in the second quarter. The bulk of the recovery in international trade occurred in imports, which rose in June from a negative level of -16.7% (y/y) to 2.7% (y/y); but Chinese exports also rose in June, from -3.3% (y/y) to 0.5% (y/y). The PMI index indicates a continued recovery in the manufacturing sector and its growth, but the component involving export orders, which also recovered, still indicates a contraction due to external demand that remains weak.
- In India, according to the preliminary indicators for July, the recovery of the economy is expected to be slow and gradual. Economic activity is expected to continue to contract at a lower rate than in recent months, with most of the contraction still in the services sector. The PMI of the manufacturing sector fell slightly in July after rising sharply in June with the lifting

of the country's tightest and longest closure, indicating some pause in the recovery of economic activity. In addition, in June, for the first time in approximately 20 years, India registered a surplus in its goods trade balance, with the surplus reaching a historic peak of US$0.8bn, following a US$3.2bn deficit in May. In normal times, the surplus would have been a positive sign against the backdrop of the traditional deficit in India's trade balance; however, in these days of crisis, the deficit mainly reflects the weakening of domestic demand, and the surplus is created as a result of imports weakening more than exports.

- In Latin America, economic activity began to recover in some of the major economies. The industrial production of Argentina, Brazil, Chile and Mexico increased in June, yet remains significantly below the pre-coronavirus levels. The recovery in Brazil and Chile has not yet affected the labor market and their unemployment rates have continued to rise despite the decline in the workforce participation rate.
- In Peru, the unemployment rate more than doubled in April-June, while in May-June the unemployment rate rose by 7.3% and reached a peak of the last three decades of 16.3%. This is despite the slight increase in industrial production in May, as it still remains considerably low, and is now approximately 42% below its level from last year.
- In Mexico, industrial production rose in June by 17.9% (m/m) after declined in April – May and reached to 30.7% below last year's level. The decline in Mexican industrial production in the first half of the second quarter occurred in all the major sectors, suggesting that despite the manufacturing sector recovery in June, second quarter GDP is still expected to decline significantly. This comes against the backdrop of the increase in morbidity and the continued spread of the coronavirus, which threatens the reinstatement of closures and social restrictions, which could exacerbate the economic crisis in Latin America.
- Chile passed a reform that allows households to withdraw up to 10% of their pension savings tax free, up to a sum of 4m Chilean pesos (approximately US$5,285), in order to accelerate the recovery in economic activity. Apparently, there is a lot of interest surrounding this plan, and according to a survey by the Chamber of Commerce, roughly 80% of citizens who earn low-wages plan to withdraw the entire 10% of their pension savings that can be withdrawn tax free, and 60% of higher-wage earners plan to withdraw 10% of pension savings in their possession. Assuming the survey is indeed accurate, then the total withdrawal of pension funds is expected to amount to approximately US$14bn, which is equivalent to approximately 5.5% of Chilean GDP. Colombia is following Chile's example and is also trying to pass a similar law that will allow some pension funds to be used in order to raise consumption and to assist in the economic recovery. However, this step also has a long-term fiscal cost and the debt dynamics of Colombia, unlike Chile, is already problematic, and if the country passes a similar bill, then in the short-term this step will indeed help some recovery of the economy, but in the long-run, the fiscal cost will weigh on economic growth.
- Looking ahead, global GDP is expected to contract 4.1% in 2020, and increase 4.9% in 2021. The GDP of Britain is expected to contract 9.0% this year, the GDP of the euro bloc is expected to contract 8.4%, and the GDP of Latin America is expected to contract 8.8% this year. In 2021 the GDP rates of India and China are expected to grow by their highest rates. In our estimation, India's growth in 2021 is expected to reach 9.4%, and China's GDP is expected to grow 8.0% next year.



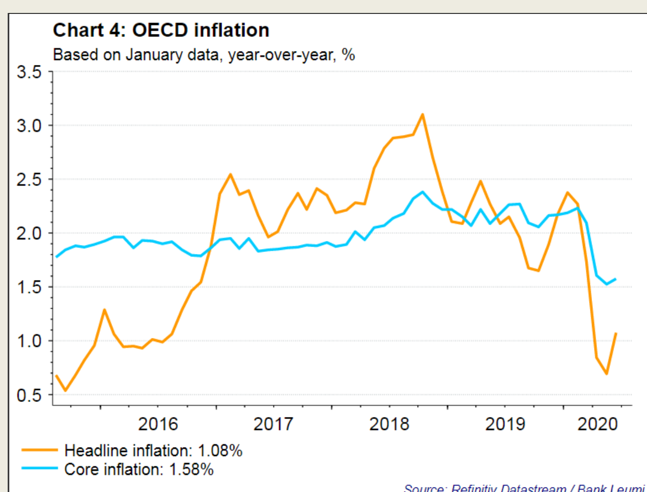


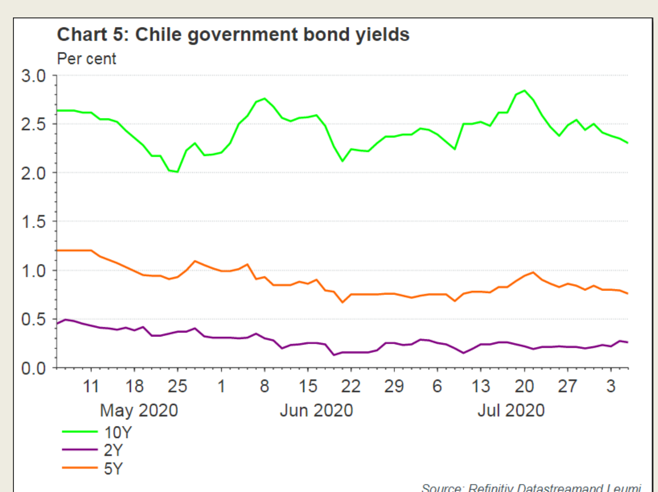
Inflation and monetary policy: monthly inflation increased in developed countries after declining over several months; however, in Australia the inflation rate declined to a negative level. In England, the central bank did not change its monetary policy, but in Canada and Russia the central banks reduced the interest rate. US bond yields have declined since mid-July, while the bond yields of the major euro bloc economies also declined during July.

- The rate of inflation in developed countries increased in June after falling in recent months amidst declining demand stemming from the crisis and government imposed closures. The OECD inflation rate rose in June from 0.7% to 1.1% (y/y, see Chart 4). Meanwhile, the food component continued to increase, even increasing slightly more than in May, while the energy component fell in June by a lower rate than in May. The core inflation rate (excluding food and energy) also increased in June, from 1.5% to 1.6%. In Canada, the inflation rate increased sharply in June, from 0.4% to 0.7%, against the backdrop of rising energy prices. This sharp increase comes after two months in which inflation was at a negative level and against the backdrop of the return of economic activity. In Australia, the inflation rate entered negative territory in the second quarter, for the first time since 1997, declining from 2.2% to -0.3%, against the backdrop of falling energy prices during the second quarter.
- The central bank of England, as expected, left its monetary policy unchanged. We estimate the Bank of England (BOE) will increase the scope of financial asset purchases by the end of 2021 by £250bn, in addition to the existing £300bn framework. Of this, £100bn is expected to be added in November and £150bn is expected to be added during 2021. The Monetary Committee's economic forecasts for the month do not yet indicate the need for further expansionary monetary policy measures. The committee estimates that the inflation rate is expected to reach the target of 2% in 2022. However, in our opinion, the central bank's forecasts appear too optimistic, and it is expected that further expansionary policy measures will be needed to raise the inflation rate. The Monetary Committee also said that "negative interest rates at this time are likely to be less effective as a tool to encourage the economy" and noted that "other instruments are available" and added that "the Committee does not intend to tighten monetary policy until there is clear evidence of stable achievement toward the 2% inflation target." This implies the central bank is willing to maintain an expansionary

monetary policy even when inflation rises above the 2% target. This is an approach whereby the inflation target becomes more flexible than before. This approach may also be applied in the US economy.

- In Russia, the central bank cut the interest rate by 25bps to 4.25%, after it had fallen in June to a historic low since the fall of the Soviet Union. The central bank also hinted that the expansionary monetary policy may continue. In our estimation, further monetary expansion is expected, and further interest rate cuts may also be possible, this due to dis-inflationary pressures and against the backdrop of the central bank's assessment that the recovery will be gradual; nonetheless, the rate of monetary expansion will slow.
- In Canada, the central bank announced it does not intend to change its interest rate policy until the inflation rate reaches a target of 2%, implying that the bank does not expect an interest rate hike at least until 2023. In addition, the Canadian central bank is expected to continue bond purchases, at least by a sum of US$5bn.
- The slope at the medium and longer portions of the US yield curve (3M-10Y, 2Y-10Y) decreased moderately during July, while the slope at the short end of the yield curve (3M-2Y) remained stable. US government bond yields, both the short- and the long-terms, fell following the Fed's July announcement that it was keeping its interest rate at the current level until the economy overcomes the crisis. The Fed also announced it will continue to buy financial assets. At the same time, long-term government bond yields of the major economies in the euro bloc continued to fall throughout July, while Italian long-term government bond yields fell sharply. In Chile, the medium- and long-term government bond yields fell in July, despite the passage of the reform permitting the use of some pension funds for the current consumption of households, thus creating a long-term fiscal cost, but short-term government bond yields declined slightly (see Chart 5).





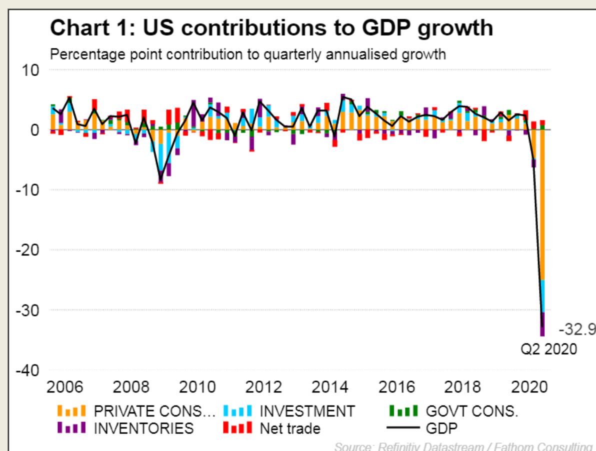
United States

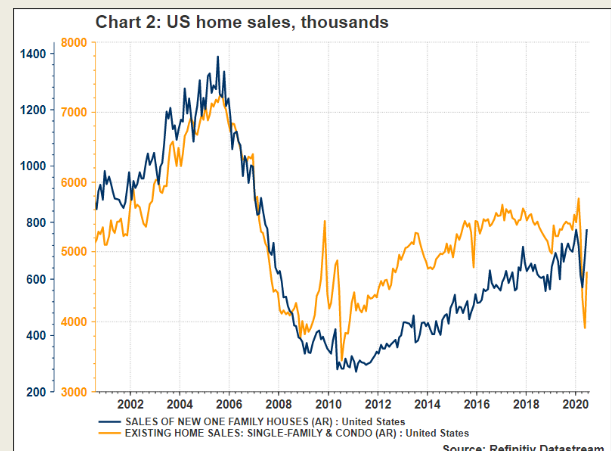
Economic activity: US GDP contracted 32.9% in the second quarter in annualized terms, mainly due to a sharp drop in private consumption. June data and preliminary indicators indicate a partial recovery in economic activity, and GDP is expected to increase in the third quarter of the year.

- US GDP declined 32.9% in the second quarter in annualized terms, the sharpest decline in the last tens of years. This sharp decline stems mainly from a 34.6% contraction in private consumption, caused by government-imposed shutdowns during a large portion of the second quarter in the US, which obligated consumers to stay in their homes (see Chart 1). Services consumption declined 43.5%, with the largest declines occurring in health related services, as non-essential check-ups and treatments were cancelled. Entertainment and leisure services also suffered heavily. Investments contracted 27% in the second quarter; however, it appears this is only a temporary decline, and in our opinion, investments are expected to recover at a rapid pace. A substantial contraction occurred also in foreign trade, as exports declined 64% in annualized terms and imports (which are greater than exports) fell 53%, such that the contribution of net exports to the growth of GDP was positive. On the other hand, a drop in inventories caused a negative contribution to GDP. Fiscal incentives provided by the government contributed to a 2.7% increase in public consumption, although the rate of increase would have been greater excluding the 5.6% decline in the expenditures of the states and local counties that were compelled to make cuts due to the drop in the revenues of the authorities, this in order to maintain fiscal balance.
- Various preliminary indicators show a slight recovery in economic activity. The composite PMI increased in July from 47.9 to 50.0 points, signaling a cessation in the contraction in economic activity, while the index hints that the industrial manufacturing sector is expected to increase in July and the services sector is likely to contract slightly, yet it is also expected to continue to recover. Private consumption increased in June 5.2% (m/m), this in part against the backdrop of the large volumes of various government transfer payments to households.
- Industrial manufacturing increased as well in June, against the backdrop of a rise in demand, yet it remains 10.9% below its February level. Durable goods orders increased 7.3% in June (m/m) and core orders increased 3.3% (m/m), with these currently being only 3.7% below their February level, thus indicating the damage to investments during the crisis period was not that severe. The increase in orders was registered despite a drop in aircraft orders that was offset by an 85.7% spike in orders for motor vehicles. This increase occurred following a sharp 15.1% increase (m/m) in May durable goods orders, and signals the strength of the recovery in economic activity.
- The consumer confidence index declined in July to a low level, which has been maintained since the breakout of the crisis, and reflects the drop in the economic confidence of households against the backdrop of the uncertainty regarding the conclusion of the weekly addition of US$600 to unemployment benefits that are intended to help households during the current crisis. This comes against the backdrop of the continuing spread of the coronavirus across the US and the return of shutdowns and restrictions in some regions of the

country that are likely to hurt the economy's recovery. In particular, this is in light of the closure of places of leisure and entertainment in some states. This development is expected to substantially limit the strength of the recovery in private consumption in the second half of 2020, and thus the recovery in the GDP will be limited as well.

- The housing market continues to recover and the number of new homes sold increased 13.8% in June (m/m, see Chart 2). This is the second consecutive month in which the number of home sales increased at double-digit rates, while the increase occurred in all the regions of the country and not only in specific areas. However, the number of new homes sold in the southern part of the US was lower, against the backdrop of the spread of the coronavirus in this region. The number of existing home sales increased in June by a sharp rate of 20.7% (m/m), yet sales remained 18.0% below the level registered in February prior to the breakout of the coronavirus. Construction starts increased 17.3% in June (m/m) and are currently 4.0% below the level they were at during the parallel period of last year. Furthermore, the number of construction permits also increased in June, albeit by a low rate, yet the rise in permits signals the continuation in the expected rise in construction starts.
- Looking ahead, GDP is expected to increase in the third quarter by a positive rate against the backdrop of the recovery reflected in the preliminary indicators and from the June data. However, the continued spread of the coronavirus in the US and the return of restrictions in some places are likely to weigh on GDP growth over time and on the recovery in economic activity. In our opinion, in 2020 US GDP is expected to contract 5.3%, and in 2021 GDP is expected to grow 3.7%, yet it will still remain below its level in 2019.





Inflation and monetary policy: the Fed kept its interest rate unchanged at 0.00% - 0.25% and declared the Fed's asset purchases will continue at least at the current pace. This statement by the Fed caused a drop in government bond yields and a decline in the slope of the yield curve. The consumer price index (CPI) increased in July and the core CPI increased as well.

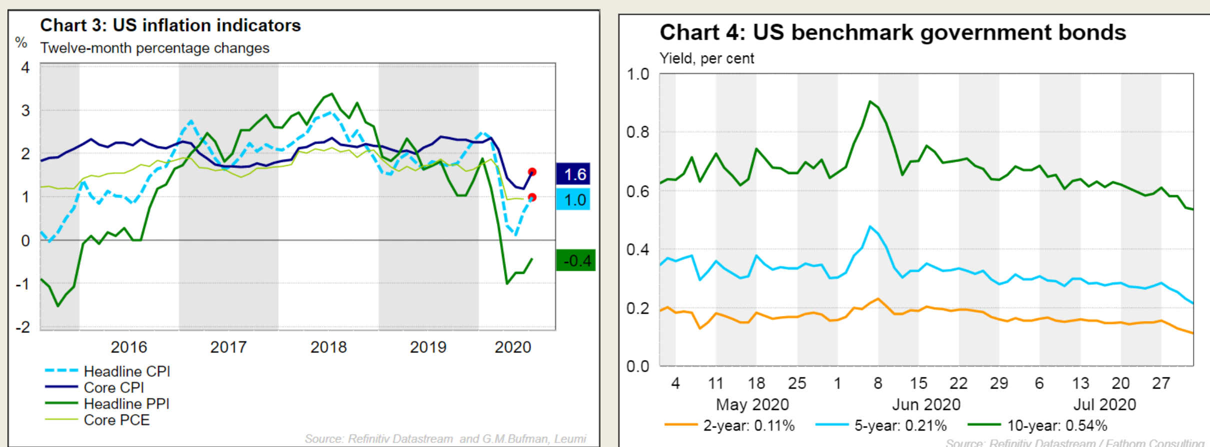
- At its July 29 meeting the Fed kept its interest rate unchanged at 0.00% - 0.25% and stated the Fed expects the rate to remain at this level until it will be certain the economy has overcome the crisis. The Fed also noted a further condition for any future rate change will be evidence that employment and price stability figures are moving toward the Fed's target

levels. In addition, the interest rate announcement states that asset purchases will continue "at least at the current pace" in order to maintain liquidity in the markets, thus hinting that the Fed's purchase plan may increase in the future; however, no specific change in financial asset purchases was exposed. The Fed emphasized its obligation to use all the tools at its disposal in order to support the US economy at the time of this current crisis, in order to strengthen the labor market and to maintain price stability ("the double mandate"). The Fed also noted that economic activity has begun to recover, yet remains below its level from the beginning of the year, prior to the breakout of the coronavirus.

- The Fed provided a pessimistic forecast and it expects the health crisis will continue to weigh on economic activity, on employment, and on inflation in the near term. In it opinion, a recovery in economic activity will continue to be dependent on the developments related to the spread of the coronavirus, such that as long as the virus will continue to spread across the US, particularly against the backdrop of the rise in the number of new virus infections, then an economic slowdown is expected.
- The consumer price index (CPI) increased in July by 0.6% (m/m) and the inflation rate rose from 0.6% to 1.0% in annualized terms (see Chart 3). This is due to a rise in core components, especially in car insurance premiums and also due to the rise in prices in the air-travel prices, which began to recovery slowly following the substantial fall in prices in April-May as a result of the shutdown and restrictions that were implemented. As a result, there was rise of core price inflation in July from 1.2% to 1.6% in year-on-year terms.
- This increase in CPI inflation reflects the recovery of products and services prices that were most affected during the early stages of the spread of the virus, but their prices are still lower than in the pre—pandemic period. In addition, the sharp increase in inflation rate indicates that the disinflationary impact of the crisis resulting from the decline in demand is beginning to fade. In our opinion, there may be another increase in inflation rate, but it is not expected to rise significantly in the coming months. In the medium term, the inflation is expected to climb against the backdrop of an increase in local demand, and also against the backdrop of an increase in energy prices in the distant-medium term. Despite the rise in the CPI and core inflation, it will take a long time until the FED start to hike its interest rate.
- The current volume of the increase in the Fed's balance sheet in the current crisis is considerably larger than in the crisis that began during 2007 and intensified during 2008-2009. Also, in the current crisis, the variety of expansion measures is considerably larger than in the past and includes new and very significant measures in their scope and coverage, with special emphasis on emergency loans for the direct benefit of the private sector by various means. Recently, the Fed announced an extension of the duration of the implementation of these monetary expansion plans.
- In the previous crisis, which worsened dramatically in late 2008, the increase in banks' reserves was greater, as the Fed's goal was to increase liquidity in the financial system and by direct means vis-à-vis the banking system. In contrast, in the current crisis, the level of banks' reserves was relatively high in the first place, and thus the emphasis has been on creating direct or "almost-direct" sources of credit from the Fed to the business and private sectors.

- The emphasis on increasing bank reserves in the crisis that intensified since late 2008 is reflected in a substantial increase in the money base (the narrow money aggregate), M0, which mainly includes the banks' reserves and also the cash in circulation. This aggregate does not include most of the monetary components held by the citizens and businesses, including current deposits, other deposits, etc. The M1 aggregate is a broader aggregate, which includes the cash held by the public as well as current deposits. This aggregate reflects to a greater extent, though not completely, the volume of "liquid money" held by citizens and businesses, and can affect demand and prices.
- In contrast, in the current crisis, so far, the increase in the two aforementioned aggregates is similar, meaning that the Fed's monetary expansion operations are reflected in the monetary aggregate "of the public", M1. This is reflected in the current continuing rise in the money creation multiplier, such that each dollar flow creates an increase of more than one dollar in money held by the public.
- An attempt to explain the timid inflation figures in the US following the substantial monetary expansions that followed the crisis that intensified since late 2008 requires reference to a wide range of variables and processes. However, since inflation is a monetary phenomenon, it is possible to explain, even in part, that a significant factor behind the maintenance of "price stability" during the period in question, involves the fact that the monetary expansion reached mainly the banks' reserves. In other words, the money flows from the Fed at that time reached the banks' reserves and then were "locked up" there, with only a relatively moderate effect on the quantity of liquid money held by the public. Of course, there are other important variables such as the deterioration in the labor market situation at that time, the formation of a global overcapacity, and more.
- At present, the pass-through from the Fed's operations to the quantity of money held by the public is more substantial than in the past, and therefore in the future there may be an effect of this expansion, which is reaching the citizens' pockets, on prices. To this should also be added some aspects of economic policy. The first aspect concerns the Fed's stated desire to adopt a symmetrical approach to the inflation target, which allows for a high degree of tolerance in relation to the situation of rising inflation above the target in the future. Similarly, there are also calls for the adoption of an "average inflation" target in which relatively high inflation should be permitted against the low inflation of previous years.
- Second, US government debt is expected to grow by approximately US$4tn this year, with the debt/GDP ratio rising to its highest level since World War II to 146 percent of GDP next year. In view of the considerable increase in debt these days, one can expect an initiative by the US government to increase the tax burden in the future, this as a means to finance future debt and interest payments. One means of taxation is "inflation tax" ("Seigniorage"), by which the government erodes the real value of its liabilities (cash, unlinked debt), and in this kind of "zero-sum game", the erosion of government liabilities through inflation tax represents an erosion in the value of assets held by the public, and thus actual taxation. Against this backdrop, it is not surprising that inflation expectations in the US, for periods of five years or more, have recently been on an upward trend, which means the market is increasingly pricing in an acceleration in inflation in the more distant future.

- The slope at the medium and long portions of the yield curve (3M-10Y, 2Y-10Y) decreased moderately during July. The slope at the shorter end of the yield curve (3M-2Y) remained stable in July, after having flattened over the past few months due to Fed government bond purchases across the entire yield curve and given market expectations that the Fed interest rate will remain at near-zero levels over time. The Fed's statement that the interest rate will remain at the current level until the economy overcomes the crisis and that asset purchases will continue "at least similar to the current rate", have led to a decrease in both long-term and short-term government bond yields (see Chart 4). There has also been a decrease in the slope of the curve at both the shorter portion, and also the medium and longer portions. As inflation expectations rise and the government's financing needs balloon, this will eventually lead to a gradual increase in long term interest rates.



The Euro Bloc

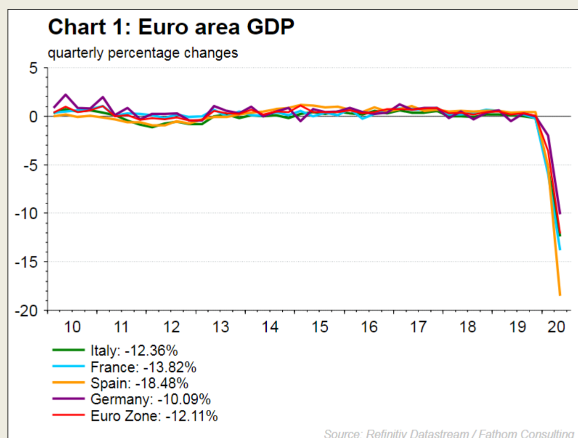
Economic activity: the GDP of the euro bloc contracted 12.1% in the second quarter (q/q), as the GDP of each of the major economies declined by a double-digit rate during the quarter. Towards the end of the second quarter economic activity started to recover, even by a relatively rapid rate in some of the larger economies in the bloc. However, the tourism sector remains vulnerable, and this sector is expected to weigh on the recovery of economies that rely heavily on tourism.

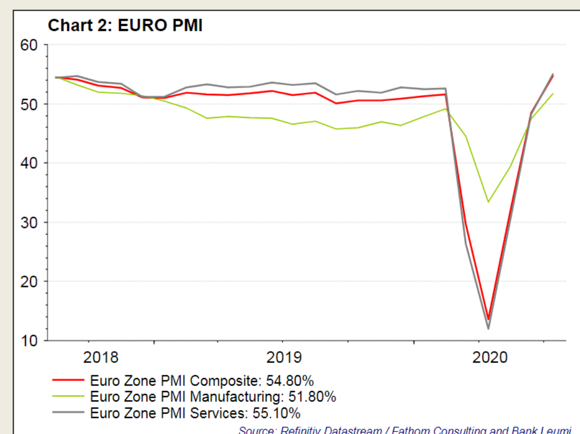
- The GDP of the euro bloc declined 12.1% in the second quarter (q/q, see Chart 1), reflecting a 40.3% decline in annualized terms, the sharpest decline in history. This is due to the government-imposed shutdowns in a large number of countries across the euro bloc and particularly in the stronger economies, in the first half of the second quarter. However, the rise in business confidence in June – July, the substantial increase in consumer confidence in May – July, and the sharp rise in retail sales and in industrial production in May – June, following the lifting of some of the closures, attest to the fact that economic activity started to recover towards the end of the second quarter.

- In addition, preliminary indicators show a continuing recovery in economic activity at the start of the third quarter. The ESI survey, which analyzes economic sentiment in the euro bloc, increased in July, thus signaling that economic activity is continuing to recover. The composite PMI index of the euro bloc increased in July from 48.5 to 54.8 points (see Chart 2), thereby indicating the return of euro bloc economic activity to a path of growth (indicated by a value higher than 50). Growth is expected to occur in both the manufacturing and the services sectors, yet the growth of the services sector is expected to be stronger. However, the employment component in the index remains at a level below 50 points, thus indicating that despite the recovery in economic activity, the euro bloc labor market has not yet started to recover.
- The labor market in the euro bloc remains weak in part. While the unemployment rate rose in June from 7.7% to 7.8%, the rate among young people rose from 16.5% to 17.0% in the same month. The rise in the unemployment rate occurred in almost all the major economies of the euro bloc, with the exception of France, where it fell in June from 8.2% to 7.7%. Some of the government programs supporting the employment market that were provided in the short-term will soon come to an end, which could place even more pressure on the labor market and increase the number of unemployed in the coming months. The rise in the unemployment rate, together with concerns regarding its recovery in the near-term, led to a slight decline in consumer confidence in July. This is a sign that the recovery in euro bloc economic activity is expected to be slower over the next quarter and most likely beyond.
- By country, GDP declined in the second quarter within all the major euro bloc economies by double-digit rates, mainly due to declining private consumption and business investment. Spain was hit the hardest of the major economies in the euro bloc, as its GDP fell 18.5% (q/q) in the second quarter. The sharp contraction in GDP illustrates the severity of the closure in the country and the partial recovery in economic activity after the lifting of the closure and the easing of the social restrictions imposed. France's GDP contracted 13.8% (q/q) in the second quarter, due to the aggressive closure in the country. However, according to preliminary indicators, economic activity in France has started to recover relatively quickly since the closure was lifted, and indicators show the recovery continued into the beginning of the third quarter as well.
- Italian GDP contracted 12.4% (q/q) in the second quarter, and preliminary indicators apparently show that Italian economic activity started to relatively recover at a rapid pace in the second half of the second quarter, and the industrial manufacturing sector is even expected to grow in the beginning of the third quarter. In Germany, GDP contracted 10.1% (q/q) in the second quarter, following a contraction of only 2.0% (q/q) in the first quarter, and this was the smallest decline among the major economies of the euro bloc. The contraction in German GDP occurred in all the components of GDP except for government consumption, which increased during the second quarter. The IFO survey for measuring business sector confidence in Germany increased in July, and together with the rise in the PMI, these hint that the German economy is recovering at a stable pace. The PMI increased in both the services and the industrial manufacturing sectors, and it indicates substantial growth in the services sector, which has suffered the most in the current crisis. This comes against the

backdrop of Germany's success at stopping the second wave of the coronavirus. The high rating with respect to the expectations component of the IFO survey hints that in the event Germany will continue to contain the second wave and will maintain a low number of active patients, then business confidence is expected to continue to climb in August and economic activity is likely to continue to recover.

- A combination of travel and aviation restrictions, along with the caution taken by tourists, may make it difficult for the tourism industry to recover, and thus hamper the recovery of Italy, Greece, Spain, and Portugal from the crisis, as tourism accounts for a significant share of their GDP. For example, the direct revenues deriving from tourism in Greece account for over 8% of GDP, while in Italy and Spain tourism revenues account for over 6% of GDP. However, tourism also increases GDP indirectly, and when these effects are also taken into account, according to estimates, tourism in Greece accounts for approximately 20% of GDP, in Spain about 14% of GDP, and in Italy about 13% of GDP. Germany is also expected to be hurt by the continued restrictions on cross-border travel; however, the damage is expected to be lighter as its tourism sector, in particular incoming tourism, is relatively small.
- Looking ahead, the economic recovery in the euro bloc is expected to continue, as long as the rate of spread of the coronavirus does not increase. In our opinion, euro bloc GDP is expected to contract 8.4% this year, and to increase in 2021 by 5.5%. However, GDP is not expected to return to its level from 2019 before year-end 2022.





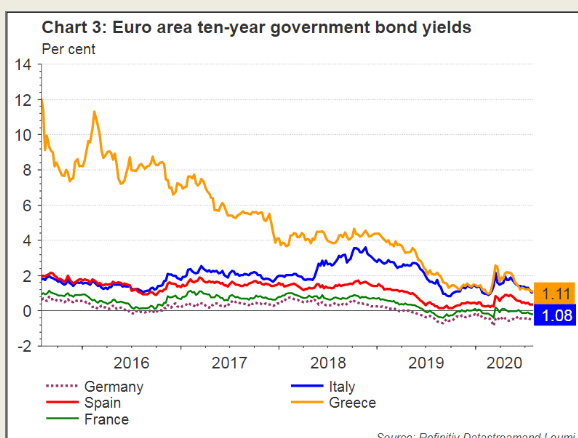
Inflation and monetary policy: the ECB left the interest rate unchanged at 0.00%, and it expects this rate to remain at this level until inflation converges to its target. Euro bloc countries reached an agreement to establish a €750bn recovery fund, of which €390bn will be provided as grants and €360bn as discounted loans.

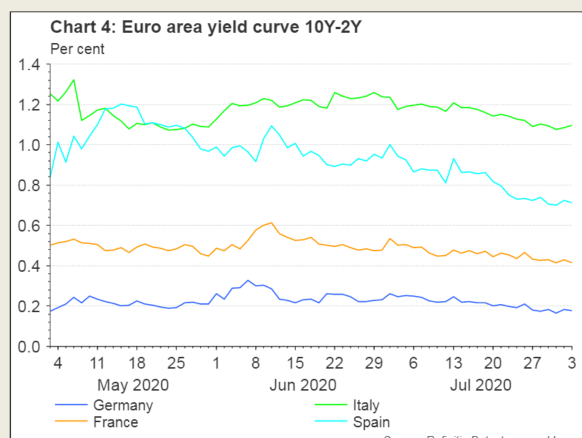
- As expected, the ECB left monetary policy unchanged and the interest rate remains at 0.00%, amid the calm in the bond market and also against the backdrop of encouraging economic data. The ECB also noted the monetary committee expects interest rates to remain at this level until the rate of the rise in prices will converge towards the inflation target, which is just below 2%. In addition, the ECB will continue to purchase financial assets within the framework of the Pandemic Emergency Purchase Program (PEPP), up to a total of €1.35tn. These purchases will continue at least until year-end 2021, and in any case, they will continue

until the crisis caused by the spread of the virus will pass. The proceeds from the acquisition of the financial assets will also be invested in the emergency acquisition program at least until the end of 2022. It should be noted that the president of the ECB, Christine Lagarde, rejected the proposals that were raised at the press conference, suggesting the ECB would not use all the funds allocated to the emergency purchase program, thus indicating the central bank's determination to continue financial asset acquisitions.

- The ECB's bank lending survey indicates credit conditions are expected to tighten during the third quarter. This follows an increase in loans in the second quarter, resulting from a sharp increase in the demand for loans to finance the day-to-day management of companies during the second quarter, which was due to the sharp decline in revenues caused by the halt in economic activity. At the same time, demand for loans for investment purposes fell sharply in the second quarter. In our view, demand for loans is expected to continue to rise in the third quarter, but at a slower pace. The expected tightening of loan conditions comes after the credit conditions for households tightened in the first half of 2020, while the credit conditions for companies remained unchanged. This tightening of credit conditions, which is a factor that makes it difficult for companies in the economy, may cause governments to extend government guarantees to non-financial companies, at least until the end of the year.
- The euro bloc countries reached an agreement on the establishment of a €750bn "recovery fund", which will be financed through the joint raising of debt by all euro bloc members. Approximately €390bn from the fund, or 2.8% of the euro bloc's GDP, will be used for grants to countries struggling to recover from the current crisis, and the balance will be given as cheap loans. The amount approved for grants is lower than the European Commission's initial proposal, which offered €500bn in grants. In actuality, this fund will support the weaker countries of the euro bloc, and will assist them to achieve fiscal stability and recover from the current crisis. The fund, together with the ECB's PEPP, is expected to help maintain the euro bloc countries' government bond yields at a reasonable level, and to prevent a sharp rise in yields.
- The euro bloc consumer price index (HICP) increased in July from 0.3% (annual rate) to 0.4%, despite the low inflation in Germany, which fell from 0.9% to a negative level of -0.1% against the backdrop of a VAT rate cut. The annual core inflation rate (excluding energy, food, alcohol, and tobacco) of the euro bloc increased in July from 0.8% to 1.2%, due to rising prices of non-energy industrial products. In our estimation, euro bloc inflation will equal 0.3% this year, and in 2021 the inflation rate is expected to rise to 1.1%.
- Yields-to-maturity on long-term government bonds of the major euro bloc economies continued to decline during July, with Italy's long-term bond yields falling by a very sharp rate and returning to below the level of Greek bond yields (see Chart 3). The slope at the longer portion of the yield curves (2Y - 10Y) of the major economies fell slightly during the second half of July (see Chart 4), while the decline in the slope of the yield curve of Spain and Italy was greater. This development apparently stems from the support that these countries received from the statement of the ECB that illustrated its determination to continue the purchase of financial assets, as well as the expected assistance to countries affected during

the crisis from the recovery fund. Thus, it seems the current level of yields-to-maturity will be maintained in the near term.





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