# Global Macroeconomic Monthly Review

*December 2020*

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## Key Issues and Table of Contents



- *The global economy continues to recover, but there are large differences among the regions of the world resulting from the rise in morbidity along with tightening restrictions again in some countries.*
- *Global GDP is expected to contract 4.1% this year, but in 2021 it is expected to recover to the extent that depends on achieving "living alongside the coronavirus".*
- *The inflation rate declined in October in the developed countries, except in the euro bloc where it remained unchanged at a negative level.*
- *The Fed and the ECB hinted about increasing monetary support.*
- *Long-term government bond yields in the US have been in an upward trend in recent months, whereas the yields of euro bloc long-term government bonds have been in a moderate downward trend.*



- *Growth in economic activity in the US continues despite rising morbidity and the spread of a third wave of the virus, which has led to tightened restrictions in a number of states.*
- *Economic activity is expected to continue to grow during the final quarter of 2020 at a moderate positive rate.*
- *An increase in the number of initial unemployment claims may attest to the fragility of the degree of economic recovery, and the signs of the impact of tightening restrictions within the market.*
- *At the last FOMC meeting, there were several signs there may be an expansion in monetary support.*
- *The consumer price index (CPI) declined in October and reflects the weakness in demand also in core goods.*



- *Euro bloc GDP is expected to contract in the final quarter of 2020 due to tightening restrictions on economic activity, with the German economy expected to contract by a lower rate than the other large economies in the bloc.*
- *For all of 2020, euro bloc GDP is expected to contract 8.0%, and to increase 4.9% in 2021.*
- *The ECB is expected to broaden its monetary support in order to support the market at the time when economic restrictions are being tightened.*
- *The Harmonized Index of Consumer Prices (HICP) remained unchanged and the annual inflation rate remained at a negative level for the third consecutive month, indicating the weakness in local demand.*

## *Leumi Global Economic Forecast, As of December 2020*

| | 2017 | 2018 | 2019E | 2020F | 2021F |
|---|---|---|---|---|---|
| **GDP – Real Growth Rate** | | | | | |
| *World* | *3.8%* | *3.5%* | *2.6%* | *-4.1%* | *4.4%* |
| *USA* | *2.3%* | *3.0%* | *2.2%* | *-3.8%* | *3.2%* |
| *UK* | *1.7%* | *1.3%* | *1.3%* | *-9.5%* | *6.9%* |
| *Japan* | *2.2%* | *0.3%* | *0.7%* | *-6.4%* | *1.7%* |
| *Eurozone* | *2.7%* | *1.9%* | *1.3%* | *-8.0%* | *4.9%* |
| *South East Asia (ex. Japan)* | *5.3%* | *5.1%* | *4.4%* | *-3.8%* | *4.1%* |
| *China* | *6.8%* | *6.6%* | *6.1%* | *1.8%* | *7.3%* |
| *India* | *7.0%* | *6.1%* | *4.2%* | *-9.8%* | *6.9%* |
| *Latin America* | *0.9%* | *0.7%* | *-0.6%* | *-7.8%* | *3.6%* |
| *Israel* | *3.6%* | *3.5%* | *3.4%* | *-3.9%* | *4.9%* |
| **Trade Volume, Growth (%)** | | | | | |
| *Global* | *5.8%* | *3.7%* | *0.9%* | *-10.6%* | *7.0%* |
| **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%* | *-0.1%* |
| *ECB-Main Refi* | *0.00%* | *0.00%* | *0.00%* | *0.00%* | *0.00%* |
| *Israel* | *0.10%* | *0.25%* | *0.25%* | *0.00-0.25%* | *0.00-0.25%* |

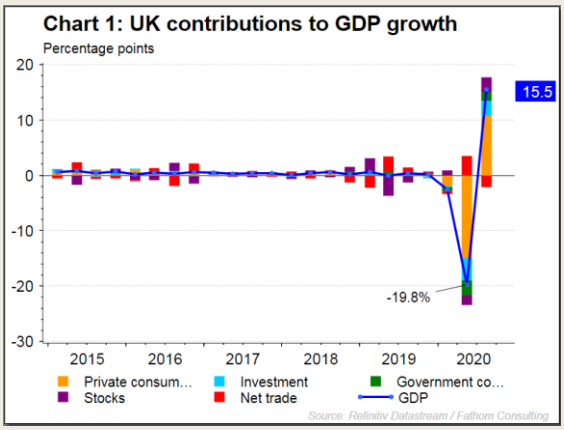
## The Global Economy – Overview

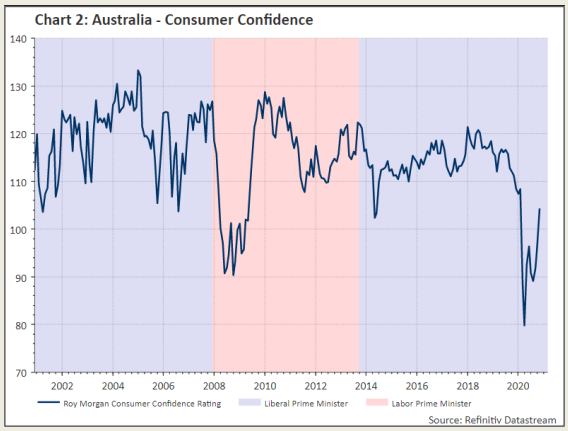
**Economic activity: the global economy continues to recover, but there are large differences among the regions of the world resulting from the rise in morbidity along with tightening restrictions again in some countries. Global GDP is expected to contract 4.1% this year, but in 2021 it is expected to recover to the extent that depends on achieving "living alongside the coronavirus".**

- Stricter economic shutdowns in some countries against the backdrop of rising morbidity have led to substantial differences in the degree of recovery in economic activity among different regions and countries. Preliminary indicators point to US GDP growth, both in the manufacturing and in the services sectors, despite tighter restrictions in a number of states with respect to restaurants and entertainment venues. In the euro bloc, on the other hand, preliminary indicators point to a contraction in economic activity, particularly in the services sector, due to the tightening of restrictions and even the implementation of a partial closure in a number of euro bloc member states. In China, India, and other developed countries in Asia, economic activity continues to recover and economic indicators point to continued GDP growth.
- In Britain, GDP increased 15.5% (q/q) in the third quarter, primarily due to a recovery in private consumption, following a sharp drop in the second quarter of this year (see Chart 1). However, in September, GDP increased only 1.1% (m/m), indicating a slowdown at the end of the third quarter even before the implementation of tighter economic restrictions and social distancing in the country. In our opinion, the imposition of the second shutdown in Britain over a period of four weeks will make it very difficult for the recovery in economic activity to continue, and GDP is likely to contract during the fourth quarter of 2020 by 3.5%. Retail sales increased 1.2% (m/m) in October, and they are currently 6.8% above the level from before the coronavirus outbreak. However, the tightening of restrictions across Britain is expected to reduce private consumption, and it is likely that as part of this, November retail sales will contract as well.
- The consumer confidence index in Britain declined in November, following a more substantial drop in October, and it is now almost at the low it was at back in April-May this year. This development supports the estimate that private expenditures are expected to contract in November. The composite PMI of Britain fell in September to below 50 points, due to a decline in the PMI of the services sector, which offset the rise in the PMI of the manufacturing sector. These PMI data indicate a contraction in economic activity resulting from the tightening of restrictions in the country, with the bulk of the damage expected to be felt in the services sector. We note that Britain has started to provide vaccinations against the coronavirus, earlier than in other countries. This move is likely to help the country to renew economic activity at an earlier stage next year, and this is likely to raise the expectations for growth in British GDP in 2021.
- In Australia, consumer confidence increased over the last three months (see Chart 2), suggesting an improvement in the condition of households with the return of economic activity. Retail sales in the country increased 1.6% (m/m) in October with the lifting of the government-imposed shutdown on the state of Victoria, which led to a sharp 5.2% increase

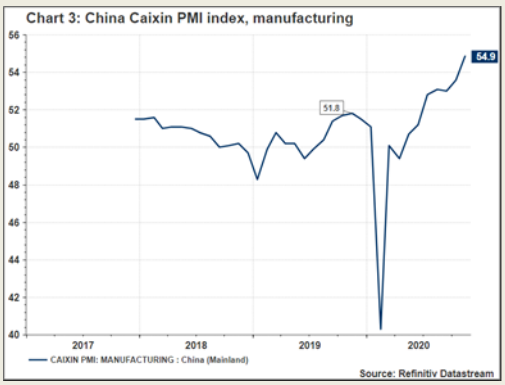
in retail sales (m/m) in the state in October. However, retail sales remained 4.7% lower in annualized terms in the state, thus indicating there is still room for an additional uptick in retail sales in Victoria. This increase occurred following two months in which retails sales contracted against the backdrop of the shutdown imposed on the state.

- In Japan, GDP increased 5% in the third quarter of the year (q/q), with the bulk of the rise stemming from an increase in private consumption. However, business investments continued to contract in the third quarter, declining 3.4% (q/q) after having declined sharply in the second quarter. Net exports contributed as well to GDP, resulting from a sharp increase in exports and a drop in imports. In addition, retail sales and industrial manufacturing increased in October. Retail sales are now above their level from before the outbreak of the crisis, and for the first time since January they increased by a positive rate also in annualized terms. In our opinion, retail sales are not expected to continue to increase at the same high rate, particularly against the backdrop of the spread of the third wave of the coronavirus, which has led to new peaks in the number of daily virus infections and in the number of active cases.
- GDP growth of the developing countries is expected to continue, with an emphasis on continued growth of the industrial manufacturing sector. Preliminary indicators show that the bulk of the growth of the developing countries is expected to occur in Asian countries and in some Latin American countries. In the developing countries of Europe there are expected to be differences in the growth data among the different countries. The Czech Republic is expected to continue to grow at a rapid pace, and Poland is expected to continue to grow at its current pace, whereas the growth of Turkey and Russia is expected to slow. In South Africa, growth of the industrial sector is expected to continue, yet at a lower rate. This comes against the backdrop of a decline in morbidity over the past month in the Czech Republic and in Poland and the return of economic activity, in contrast to Russia where morbidity has been in an uptrend since the end of September and is currently at a peak. Turkey, in addition to a sharp rise in morbidity, suffers as well from other economic problems related to the economic management of the country and also its monetary policy, which has led to sharp depreciation in the local currency. In South Africa, the recovery in economic activity stems from a government decision to prioritize the economy over the health situation, despite the rise in morbidity and the start of a second wave of the virus in the country.



- In India, third quarter GDP remained approximately 9% below its level prior to the spread of the coronavirus. In our opinion, India's GDP will contract 9.8% this year, and will grow next year by 6.9%. However, delivery of a vaccine during 2021 is likely to raise the growth forecast for India in the coming year, particularly if the vaccine being produced by Oxford / AstraZeneca, with whom India has supply agreements, will turn out to be safe and efficient, while receiving marketing approvals. It is important to note that even after achieving approvals for a vaccine, it is expected to take a long time until each Indian citizen will receive vaccination. Nonetheless, a substantial portion of economic activity will apparently be able to return even before the vaccination of a large portion of the Indian population. However, the absence of sufficient fiscal support, together with weakness in the country's banking sector, is expected to continue to weigh on economic activity. The PMI of the manufacturing sector fell slightly in November, after reaching its highest level over the past decade in October, yet it remains at a very high historic level and this indicates the continuation of industrial growth. Furthermore, the index of the services sector also fell slightly, yet it still indicates continued growth in services.
- Economic activity in China continued to recover in October, with the assistance of government fiscal incentives, which encourage investments and industrial manufacturing, while at the same time economic activity in the services sector returned to the level it was at prior to the outbreak of the coronavirus. Industrial manufacturing and investments in capital assets increased in October, against the backdrop of an increase in infrastructure investment. The PMI of the industrial sector increased in November, reaching its highest level in the past decade, 54.9 points (see Chart 3). This increase indicates continued positive momentum in the Chinese industrial sector. All of the components in the index increased in November, while the employment component increased to its highest level since 2011 and thus indicates a continuing recovery in the labor market. The index of the services sector increased as well, and thus indicates continued growth of this sector.
- In Latin America, the most recent data show that Brazil suffered less than other countries in the region. Brazil's GDP increased 7.7% (q/q) in the third quarter and remains only 4.1% below its level from year-end 2019. In Mexico, the GDP increased 12.1% in the third quarter (q/q) after the second quarter, which was the fifth consecutive quarter in which GDP declined, saw the country's GDP contract 17% (see Chart 4). Currently, Mexico's GDP is 9% below its level from the end of the first quarter of 2019. Mexico's current account is generally characterized by deficits; however, in the third quarter this year there was a substantial surplus due to a strong recovery in Mexican exports that offset the rise in imports. In our opinion,




the surplus in Mexico's current account is expected to be maintained also in the final quarter of 2020; however, it is expected to be smaller than that of the third quarter, as suggested by the surplus registered in the trade of goods in October. This surplus indicates strength in exports, together with weakness in local demand that is expected to weigh on the rapid recovery of imports. In Columbia, GDP increased 8.7% in the third quarter (q/q) and remained 9% below its level from before the outbreak of the virus. Finding a vaccine for the virus is indeed expected to help also the economic activity of Columbia, yet the absence of sufficient fiscal support is expected to weigh on the return of economic activity to its pre-crisis level.

- The Regional Comprehensive Economic Partnership (RCEP) is a free trade agreement signed by 15 Asia-Pacific nations, including China, Japan, Indonesia, Australia, and Thailand. These countries are among the 20 largest economies of the world. Together, these countries represent approximately one-third of the world's GDP and a similar portion of the world's population. The agreement deals primarily with the removal of import tariffs and the reduction of customs fees, which are already very low in the region. New cuts in tariffs under the terms of this agreement will be brought into force gradually. Furthermore, the agreement deals with the development of trade in the region by simplifying processes vis-à-vis the customs authorities and increasing transparency vis-à-vis the authorities in all matters related to foreign trade. However, the agreement does not deal in all matters related to local liberalization reforms, fair trade, and the protection of workers' rights, and thus it is prevented from dealing with the points of which there are global expectations China needs to fulfill. Currently, India has not signed onto the agreement, since the country is trying to prevent a flood of cheap Chinese imports into its market that will hurt the Indian manufacturing sector; consequently, India imposes higher import tariffs than those seen in other countries in Asia. In the event the efforts to bring India into the agreement will succeed, this will likely increase global trade and the global impact of this agreement.
- The recent announcements on the discovery of a vaccine are encouraging the markets. In the event an effective, safe, and marketable vaccine is indeed produced soon, it is expected to be distributed first in the US and within developed countries, which are expected to receive the vaccine widely throughout 2021. However, it will take longer for the vaccine to be distributed to developing and poor countries. Developing countries in Europe are expected to be among the first developing countries to receive the vaccine, and then the vaccine is expected to reach South America and India, with an emphasis on the regions in India that have a purchase agreement with pharmaceutical companies.
- African countries, and especially sub-Saharan nations, are likely to receive the vaccine at a later stage. It is important to note that most developing countries do not have agreements with Pfizer and Moderna, but instead with other companies in the third development phase of the vaccine. These companies use different technologies from Pfizer and Moderna, so many more tests are needed for these vaccines and it will take longer for a vaccine to reach the developing countries, some of which are experiencing a rapid spread of morbidity. In addition, even after receiving all the permits and approvals, it will still take a long time until the entire population in the developing countries is vaccinated. According to estimates, vaccination of all the citizens of India is not expected before the end of 2024. Furthermore,

in some developing countries, sub-Saharan Africa, south Asia, and some Latin American countries, there is currently no ability to market the vaccine throughout the country due to the special logistical requirements for storing some vaccines, and there will be a need to find a solution to this challenge. This means the coronavirus is still expected to have an impact on the global economy at least until the end of 2021 and may even affect economic activity throughout 2022-2023.

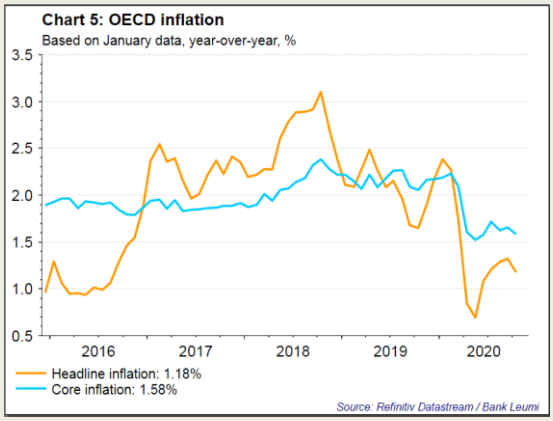
- Looking ahead, global GDP is expected to contract 4.1% this year and in 2021 it is expected to increase 4.4% provide that the pandemic does not continue to weigh heavily on economic activity. Meanwhile, India, Britain, the euro bloc, and Latin America are all expected to be hurt more substantially than other regions, yet within the euro bloc there are also expected to be large differences in the declines in GDP among the different countries. In contrast, China is expected to be the sole country among the larger economies of the world that will post positive growth in 2020, as the country is expected to grow 1.8% this year, with 7.3% growth expected in 2021.

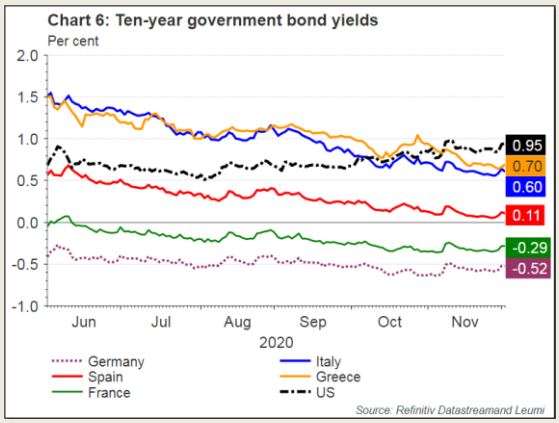
**Inflation and monetary policy: the inflation rate declined in October in the developed countries, except in the euro bloc where it remained unchanged at a negative level. The Fed and the ECB hinted about increasing monetary support. Long-term government bond yields in the US have been in an upward trend in recent months, whereas the yields of euro bloc long-term government bonds have been in a moderate downward trend.**

- The inflation rate in the developed countries declined in October, except in the euro bloc where the inflation rate remained unchanged at a negative level of -0.3%, due to the weak demand stemming from the rise in morbidity. The annual inflation rate in the OECD fell in October from 1.3% to 1.2% (see Chart 5) due to a decline in the energy component by a higher rate than that in September, and thus offset the rise in food prices. This decline comes following four consecutive months of increases, which raised the inflation rate from the low registered back in May this year. The core inflation rate, excluding food and energy, in the OECD declined in October from 1.7% to 1.6% in annualized terms, thus indicating the weakness in demand also in core goods.
- The inflation rate in Turkey increased in November sharply, from 11.9% to 14.0%, against the backdrop of a strengthening of the Turkish lira, following the sharp depreciation in the currency this year. The increase in inflation in Turkey was broad, but stemmed primarily from a rise in food and transportation prices.
- The central bank of Turkey (CBRT) raised the interest rate 475bps to a rate of 15.00%, with the goal of halting, or at least slowing, the depreciation of the Turkish lira. In the interest rate decision, the central bank of Turkey confirmed it will provide liquidity to the commercial banks only via the one-week repo interest rate and not via other facilities as it has done since mid-July.
- The Governor of the central bank of Turkey was dismissed after less than 18 months on the job, and was replaced by the former Treasury Minister, who happens to be close to the president of Turkey, Recep Tayyip Erdogan. The reasons for the dismissal relate to the failure to deal with the substantial currency crisis. It is also possible the dismissal occurred due to the efforts of the Governor to raise the interest rate, against the wishes of Erdogan, and efforts

to tighten monetary conditions in order to help in working against a speculative attack on the Turkish lira. The previous Governor was dismissed as well last year, due to his refusal of acquiesce to the demands of the president to lower the interest rate from the high level it was at during the time. The incoming Governor is considered to have a conservative approach to economic policy, and he declared upon his taking of position that the main goal of the central bank is to return to a condition of price stability and that the central bank will adopt more conservative policies.

- Both the Fed and the ECB hinted about the possibility of increasing monetary support, against the backdrop of the spread of morbidity and the tightening of restrictions in some states of the US and in the European Union (EU). The members of the Monetary Committee of the Fed stated that the central bank will continue purchasing assets "at least" at the current pace, and they discussed additional ways to increase support for the economy. We note the members of the committee do not currently see the need to change the composition of its purchases, yet they do not rule out the possibility that in the future there may be a need to make a change to the composition. The ECB is expected to increase monetary support by means of broadening the Pandemic Emergency Purchase Plan (PEPP) or by means of broadening its Targeted Long-Term Refinancing Operations (TLTRO), or through a combination of both these facilities. In the following chapters we will discuss in detail each of the possible expansion plans in the US and in the euro bloc.
- Yields-to-maturity on the medium- and long-term government bonds of the US shave been in an upward trend over the last four months, whereas in the euro bloc the yields on long-term bonds of the larger economies of the euro bloc have been in a downward trend, against the backdrop of ECB support in the markets (see Chart 6). An increase in monetary support by the Fed and/or the ECB will support a decline in the yields-to-maturity of US government bonds as well as of the euro bloc, respectively. In the event the central banks will concentrate their bond purchases to the medium- and long-terms, this is likely to have a moderating effect on the steepness of the yield curve.



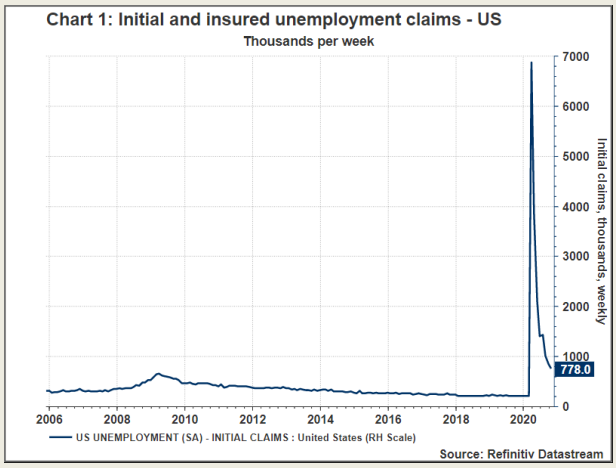
## United States

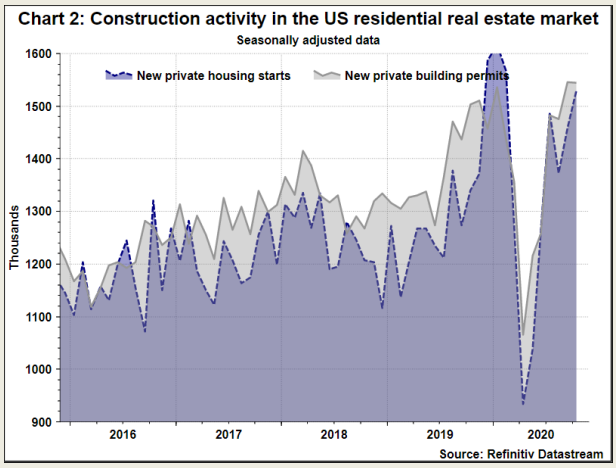
**Economic activity: growth in economic activity in the US continues despite rising morbidity and the spread of a third wave of the virus, which has led to tightened restrictions in a number of states. Economic activity is expected to continue to grow during the final quarter of 2020 at a moderate positive rate. An increase in the number of initial unemployment claims may attest to the fragility of the degree of economic recovery, and the signs of the impact of tightening restrictions within the market.**

- The US economy continues to recover, as retail sales continued to rise in October, now 4.7% higher than pre-crisis levels and 5.7% higher than in the same period last year; in addition, industrial production growth remains 5.7% below the pre-crisis level. However, the increase in the number of initial unemployment claims, from approximately 711,000 in the second week of November to about 778,000 in the fourth week of November, is a warning sign that the spread of the epidemic, along with tightening restrictions on restaurants and leisure in some states, is beginning to affect the market. This development may lead to a weakening in the recovery of economic activity. This level is low in relation to the number of initial unemployment claims throughout the current crisis, but is very high in relation to historic levels. For the sake of comparison, at the peak of the financial crisis of 2008-2009 the number of initial unemployment claims equaled 665,000 (see Chart 1).
- According to the US employment report, the increase of the non-farm payroll employment in November was significantly lower than expected and increased by 245,000 compared to expectations of 469,000-475,000. The U-6 unemployment rate also indicates a slowdown in the recovery while the labor force participation rate fell in November. The tightening of mobility restrictions, by choice or by order, is expected to continue to weigh on employment also in December. The University of Michigan's consumer confidence index fell from 81.8 to 77.0 points in November. Most of the decline is due to a drop in the expectations component, due to the combination of the fear of rising morbidity along with the uncertainty that accompanied the US presidential election, although the election is not expected to have an impact on private consumption in the short-term.
- The preliminary indicators for November indicate continuing economic growth in the fourth quarter of the year, despite the rise in morbidity. The PMI of the US increased in November, reaching a five-year peak. The increase stems primarily from an increase in the PMI of the industrial sector, but also the index of the services sector increased. This increase in the index indicates a continuing recovery in economic activity, in both the industrial and the services sectors, despite the spread of a third wave of the coronavirus throughout the US. The increase in the index of the services sector is surprising, against the backdrop of the tightening in restrictions in a number of states with respect to restaurants and places of entertainment. Durable goods orders increased 1.3% in October (m/m), mainly due to a rise in orders for defense goods, and business investments continued to recover as well, which indicates a recovery in economic activity in the beginning of the final quarter of the year.
- The number of construction starts in the US increased 4.9% in October (m/m) and is now approaching the peak level it was at before the crisis, thus indicating the rapid recovery of the

construction sector. Furthermore, the number of construction approvals is also at a high level, thereby indicating the growth in the number of construction starts is expected to continue (see Chart 2). A portion of the increase stems from a continuation in the recovery in the construction starts of single family homes, which increased 6.4% in October (m/m) whereas construction starts of multi-family units has not changed substantially since August. New home sales declined in September after four consecutive months of increases, but increased once again in October. The NAHB index, which measures the market conditions for single-family homes, is at a peak level, reaching 90 points in November, thus indicating that sales of single-family units are not expected to fall substantially in the near-term.

- Looking ahead, we estimate US GDP will grow modestly in the fourth quarter of the year. For the full year, GDP is expected to contract 3.8% in 2020, and to grow 3.2% in 2021. Meanwhile, in 2022 GDP is expected to reach its level from 2019, and perhaps even higher.



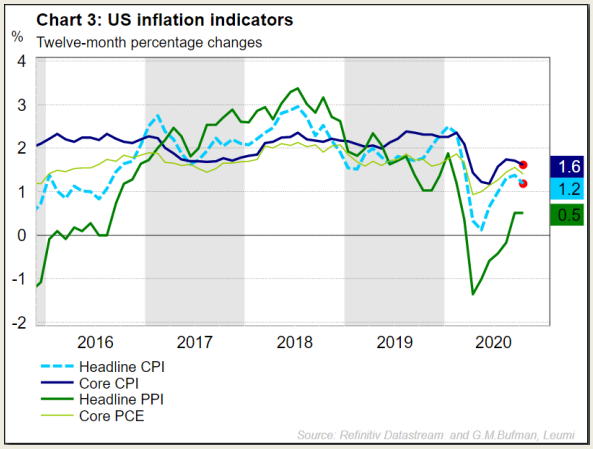

**Inflation and monetary policy: at the last FOMC meeting, there were several signs there may be an expansion in monetary support. The consumer price index (CPI) declined in October and reflects the weakness in demand also in core goods.**

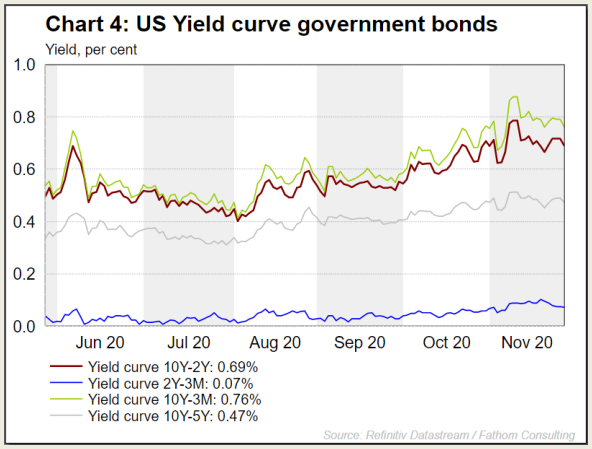
- In the Fed notes from November it appears there was a broad discussion among the monetary committee members regarding which measures the central bank must implement going forward with respect to monthly asset purchases. A large number of the participants claimed the Fed must increase its asset purchases, which likely suggests changes that may occur in the December interest rate decision. Currently, the Fed's government bond purchases amount to approximately US$80bn per month, with the purchases spread out across the entire yield spectrum. In addition, the Fed purchases approximately US$40bn each month of mortgage-backed securities (MBS). The members of the monetary committee committed to continue the asset purchases in the coming months, "at least" at the current pace.
- In addition, they discussed three ways to increase support for the economy: increasing the rate of monthly purchases; concentrating the purchases within long-term bonds; and guaranteeing to continue the purchases for a longer period, beyond "the coming months". Most of the participants were in favor of changing the dependence of forward guidance within a specific timeframe, and instead conditioning continued purchases on their impact on the market and on the progress towards achieving the price stability and employment targets.

From the committee discussion, it appears the committee members do not currently see a need to change the composition of purchases, but they do not rule out a future possibility that the conditions will change and there will be a need to make adjustments in the composition of assets.

- The US Treasury decided not to extend its participation in most of the programs intended for granting emergency loans by the Fed beyond the end of 2020. The purpose of these loans was to rapidly restore confidence in the US financial markets, while creating the conditions for the return of significant volumes of bond issues to the US corporate bond market. This decision reflects the fact that these loan facilities, in which the Treasury participated by means of creating the equity, did not actually add significant sources of credit to the economy, as the Fed actually granted loans of only US$25bn out of a possible US$2tn. With the return of funds to the Treasury at the end of the year for its share in these emergency loan programs, it is likely the Fed will choose to act through other instruments, such as increasing the rate of monthly purchases or targeting long-term bond purchases.
- President Elect Joe Biden announced the appointment of Janet Yellen, former Chair of the US Federal Reserve, as Treasury Secretary of the US. In our opinion, Yellen is expected to conduct close work relations with the current Chair of the Fed, Jerome Powell, and she is expected to defend the independence of the Fed in its policies to return the inflation rate to its target and to maintain price stability. Furthermore, Yellen is not expected to pressure the Fed to conduct monetization of the government debt, which means financing the government debt through the printing of money (as suggested by modern monetary theory). We note that since the beginning of the crisis, Yellen has supported large fiscal expansion, and as an academic specializing on the topic of the labor market, she is expected to implement policies what will return people to the labor market and lower the unemployment rate.
- The CPI declined in October from 1.4% to 1.2% in annualized terms (see Chart 3), due to a decline in prices of goods and services that offset a rise in food prices. The rise in food prices suggests that restaurants are still succeeding to transfer onto customers some of the increased costs originating from the spread of the coronavirus. The decline in prices of goods stems primarily from a decline in used automobile prices, which fell for the first time following increases for three consecutive months, and also clothing prices, which fell 1.2% in October (m/m) and a decline in pharmaceutical prices. The decline in services prices stems from a decline in prices of medical services that was caused primarily due to a decline in health insurance prices and the cost of hospital services. The annual core inflation rate declined in October from 1.7% to 1.6%. This decline reflects the weakness in local demand, not only in the services sector, but also in demand for core goods. The continued spread of the coronavirus across the US is expected to create deflationary pressures in the near-term, and the inflation rate is expected to remain below its target rate.
- The yields-to-maturity on medium- and long-term government bonds have been in an upward trend since August. This comes against the backdrop of the recovery in economic activity and positive expectations with respect to the launch of a vaccine. US government 2-year bond yields are also in an upward trend, yet more moderate than that evidenced in the longer terms, and thus the yield curve has steepened. Looking ahead, in the event the Fed will decide

to change the composition of its purchases and will concentrate on long-term bonds, this will likely have a moderating effect on the continuing rise in the degree of steepness of the yield curve. In our opinion, the Fed's intervention in the government bond market has kept the yield-to-maturity on 10-year bonds by about 100bps less than that consistent with the fundamental underlying conditions, particularly a significant increase in the budget deficit, in the face of a continued increase in investment in fixed assets in the US.



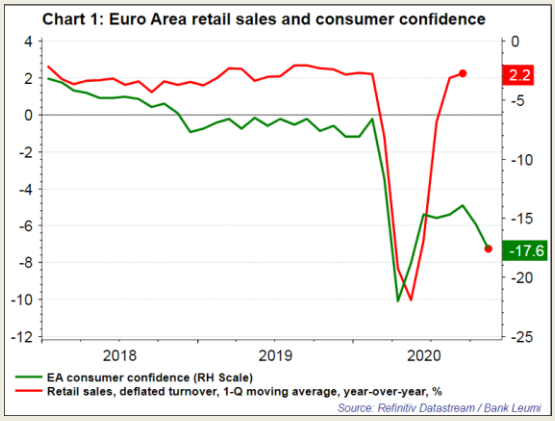

## The Euro Bloc

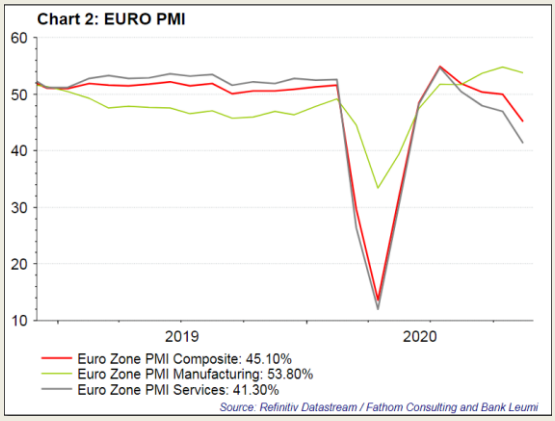
**Economic activity: euro bloc GDP is expected to contract in the final quarter of 2020 due to tightening restrictions on economic activity, with the German economy expected to contract by a lower rate than the other large economies in the bloc. For all of 2020, euro bloc GDP is expected to contract 8.0%, and to increase 4.9% in 2021.**

- The third estimate for euro bloc GDP growth in the third quarter is slightly different from the second estimate, indicating 12.5% growth (q/q), and GDP remains approximately 4.4% below its level from the last quarter of 2019. However, there are large differences in the growth rates of the different countries. For example, the GDP of the Netherlands is only about 3% below its level at the end of 2019, whereas the GDP of Spain is approximately 9% below its level from the last quarter of 2019.
- In our opinion, euro bloc fourth quarter GDP is expected to contract due to tightening restrictions, with these restrictions expected to stay in effect within a large number of countries. Consumer confidence in the euro bloc fell in November (see Chart 1), as we observed last month. This indicates that the announcement of the impending vaccine has failed to restore consumer confidence, due to the rapid spread of the coronavirus that has led to tightening restrictions.
- The tightening of restrictions has led to a halt in the rise in the morbidity rate and even a decrease in the daily number of coronavirus infections in a number of euro bloc member countries, including Austria, Italy, Belgium, Greece, Spain, and France. However, the number of active cases remains at a record high, except in Austria in which the number of active cases has started to decline. In the event the restrictions on social distancing will be

removed before the morbidity levels will further substantially decrease, then there will be a renewed increase in morbidity.

- The slowdown in industrial manufacturing and construction in the euro bloc during the summer, following the sharp recovery in May-June, together with the decline in industrial manufacturing and retail sales in September, in monthly terms, indicate the recovery in economic activity started to slow even before the tightening of restrictions in the final quarter of the year. The composite PMI of the euro bloc has been declining since August (see Chart 2), due to the decline in the PMI of the services sector in recent months, which offset the increases in the PMI of the manufacturing sector that continued to rise until November. This indicates that the economic recovery had weakened even before the recent tightening of restrictions in a number of euro bloc member countries. In November, this index fell below 50 points, due to declines in both the manufacturing and the services sectors, indicating a decline in economic activity stemming from the tightening of restrictions. In our estimation, the tightening of restrictions in the major euro bloc economies is expected to lead to a contraction in euro bloc GDP in the fourth quarter of 2020 by approximately 3% (q/q), with the GDP rates of the four largest economies of the euro bloc, Italy, Germany, Spain, and France, all expected to contract during the quarter. However, we estimate that Germany's GDP will suffer less than the other three major euro bloc economies.
- Finding a safe, effective, and marketable vaccine in the near future may bring back global and domestic European tourism, especially if European countries receive a sufficient number of doses of the vaccine during 2021. Vaccination of the European population is expected to help the countries that rely on tourism, with an emphasis on inter-European tourism. Spain's economy is expected to be one of the main beneficiaries of vaccination of Europe's population and the return of tourism, mainly inter-European, since tourism represents a major share of its GDP, with about 80% of Spain's incoming tourism coming from other European countries.
- The IFO business climate index for Germany declined slightly in November, after having declined also in October, indicating the economic recovery has lost momentum. The ZEW index for analyzing overall economic sentiment in Germany fell as well in October-November. However, during each of the last four months the ZEW index of Germany was greater than the index figure for the euro bloc, which declined as well in the last two months. This development supports our estimation that the German economy is expected to suffer less in the final quarter of 2020 compared to the other economies of the euro bloc.
- Looking ahead, we estimate that euro bloc GDP will contract in the final quarter of the year by 3% (q/q), while in all of 2020 the GDP is expected to contract 8.0% and to increase in 2021 by 4.9%. The GDP of France is expected to contract 9.5% this year and to grow 5.9% in 2021, while German GDP is expected to contract 5.8% this year and to increase next year by 4.6%. The GDP of the euro bloc is expected to return to its level from 2019 in 2022; however, the GDP of France is expected to return to its level from 2019 only in 2023.

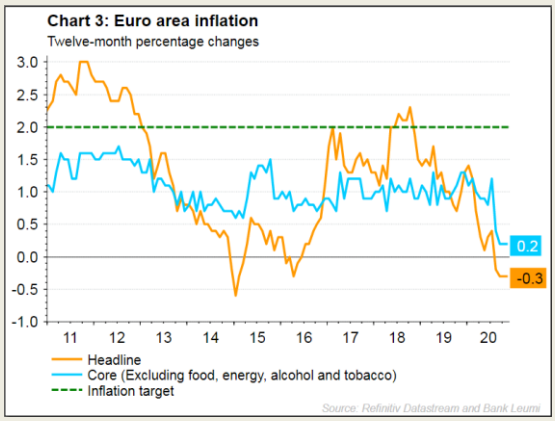


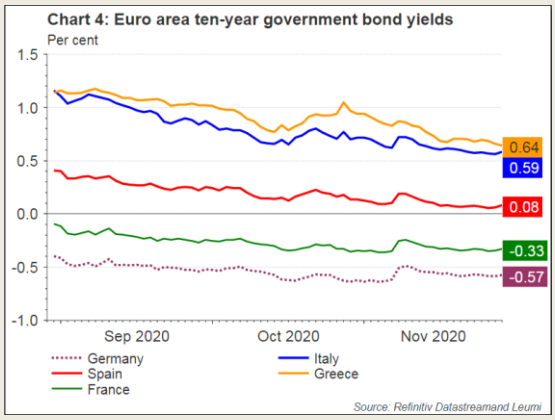




**Inflation and monetary policy: the ECB is expected to broaden its monetary support in order to support the market at the time when economic restrictions are being tightened. The Harmonized Index of Consumer Prices (HICP) remained unchanged and the annual inflation rate remained at a negative level for the third consecutive month, indicating the weakness in local demand.**

- The ECB is expected to expand its monetary support in the markets against the backdrop of tightening restrictions in some euro bloc countries. In our view, the expansion of monetary support can be through the expansion of one of the two main programs: the Pandemic Emergency Purchase Program (PEPP), or the Targeted Longer-Term Refinancing Operations (TLTRO) program. Also, the support can involve any combination of the two programs. Possible courses of action for the ECB to expand the PEPP program include: increasing the emergency procurement program from €1.35tn to €2.00tn; extending the duration of the program beyond the existing target date for continuing purchases "at least until the end of June 2021, and in any case until the coronavirus crisis passes"; furthermore, the bank can also expand the volume of weekly purchases, but this step is less expected as government bond yields are currently low.
- In addition, the ECB may expand TLTRO through four methods, or any combination of them: extending the loan term beyond the four years it is currently granted for; increasing the number of TLTRO loan stages beyond the seven stages planned from the launch of the TLTRO III program in September 2019 to June 2021; reducing the average interest rate on TLTRO loans, even below 0%; increasing the amount of loans each bank can take within the framework of the TLTRO program.
- The inflation rate in the euro bloc, as measured by the Harmonized Index of Consumer Prices (HICP), remained unchanged in November at an annual rate of -0.3%, and the core inflation rate also remained unchanged at an annual rate of 0.2% (see Chart 3). This comes after both the general and the core inflation rates remained unchanged also in October. The low core inflation rate indicates the weakness in demand is broad and also the demand for core goods is weak. This is in contrast to the thinking at the beginning of the quarter that the weakness in demand stemmed from temporary factors such as the cut in the VAT rate in Germany and the weakness in the clothing component in the index that stemmed from end-of-season sales.

- The inflation rate in the euro bloc has been negative for four consecutive months and we expect it will remain at a negative level in the near-term due to the decline in local demand against the backdrop of the tightening restrictions in a number of euro bloc member countries, especially in the stronger economies. We estimate that by the second quarter of 2021, the euro bloc inflation rate in annualized terms is expected to return to positive territory, due to the expectations for a recovery in energy prices and a partial recovery in the tourism sector, especially if final approval will be granted such that there will be a safe, effective, and marketable vaccine.
- Yields-to-maturity on long-term government bonds in the major economies of the euro bloc continued to decline during November (see Chart 4). There was a slight uptick in yields in the first half of the month, but these subsequently returned to the downtrend they have been in over the past half-year against the backdrop of the ECB support in the markets after the sharp rise in yields that occurred with the outbreak of the coronavirus. The decline in yields in the second half of November was more moderate among the long-term government bonds of Germany and France, such that for the full month their yields-to-maturity increased. In contrast, the yields of the long-term government bonds of Italy, Greece, and Spain declined in the full month period. In the event the ECB will decide to increase the PEPP, this event is likely to support a continued decline in the yields-to-maturity of government bonds.



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