Global Macroeconomic Monthly Review

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Dr. Gil Michael Bufman, Chief Economist

Yaniv Bar, Economist

Gili Ben-Avraham, Economist

Bnayahu Bolotin, Economist

Economics Department, Capital Markets Division

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Key Issues and Table of Contents

- *The rapid spread of the Wuhan coronavirus (COVID-19), primarily across China, represents a central risk in the short-term to the growth of the Chinese economy, and consequently also to the global economy.*
- *According to most estimates, in the baseline scenario a sharp, yet temporary, decline is expected in economic activity, primarily in China and in the country's main trade partners, which apparently will be offset later on when the situation comes under control.*

- *In the fourth quarter of 2019 GDP increased by a rate similar to that of the two preceding quarters, led by net external trade, due to weakness in imports, as well as private consumption despite a slight slowdown.*
- *GDP is expected to increase in the first quarter of 2020 by a moderate rate of 1.5% - 1.7%, yet in the second half of the year, economic activity is expected to accelerate with a selective rise in business sector investments and an additional improvement in productivity.*
- *The US Federal Reserve (the Fed) kept its interest rate unchanged within a range of 1.50% - 1.75% against the backdrop of low inflation.*
- *The coronavirus may affect the interest rate path if the US will be substantially affected directly and/or indirectly.*
- *The yield on 10-year US government bonds is expected to climb back towards 2%, when the spread of the coronavirus is stopped.*

- *The growth rate in the fourth quarter of 2019 was relatively weak and below expectations, apparently against the backdrop of weakness in local demand. At this stage, the coronavirus is likely to subtract 0.1-0.2 percentage points in quarterly terms from the growth rate of the first quarter of 2020.*
- *The leading indicators in January strengthened compared to December and reflect a growth environment similar to that in the fourth quarter of 2019, yet they do not reflect the implications of the coronavirus.*
- *Inflation increased in January, but is expected to moderate in the coming months against the backdrop of a decline in energy prices, and a moderating effect from the coronavirus on import prices.*
- *The January interest rate decision did not include any changes in policy. The coronavirus pushed the yields-to-maturity of government bonds of the big 4 in the euro bloc downward; in Italy a relatively sharp drop was registered against the backdrop of the regional elections that were held at the end of January.*

*Leumi Global Economic Forecast, As of February 2020**

	2017	2018	2019E	2020F	2021F
GDP – Real Growth Rate					
World	*3.8%*	*3.5%*	*2.8%*	*2.9%*	*3.4%*
USA	*2.4%*	*2.9%*	*2.3%*	*1.7%*	*1.9%*
UK	*1.9%*	*1.3%*	*1.3%*	*1.1%*	*1.1%*
Japan	*2.2%*	*0.3%*	*0.8%*	*0.3%*	*0.9%*
Eurozone	*2.7%*	*1.9%*	*1.2%*	*1.2%*	*1.6%*
South East Asia (ex. Japan)	*5.2%*	*5.0%*	*4.4%*	*3.8%*	*5.0%*
China	*6.8%*	*6.6%*	*6.1%*	*5.4%*	*5.7%*
India	*7.1%*	*6.8%*	*4.9%*	*6.1%*	*6.2%*
Latin America	*1.9%*	*1.7%*	*0.8%*	*1.1%*	*2.3%*
Israel	*3.6%*	*3.4%*	*3.3%*	*3.0%*	*3.5%*
Trade Volume, Growth (%)					
Global	*5.8%*	*3.7%*	*0.8%*	*2.2%*	*3.4%*
CPI, Annual Average (%)					
USA	*2.1%*	*2.4%*	*1.8%*	*1.8%*	*1.9%*
UK	*2.7%*	*2.5%*	*2.0%*	*2.1%*	*2.2%*
Japan	*0.5%*	*1.0%*	*0.4%*	*0.7%*	*0.9%*
Eurozone	*1.5%*	*1.7%*	*1.2%*	*1.2%*	*1.6%*
Israel	*0.4%*	*0.8%*	*0.8%*	*0.5%*	*0.8%*
Interest rates, Year End					
US Fed	*1.25-1.50%*	*2.25-2.50%*	*1.50%-1.75%*	*1.25-2.25%*	*1.25-2.25%*
Bank of England	*0.50%*	*0.75%*	*0.75%*	*0.50-1.50%*	*0.50-1.50%*
Bank of Japan-Policy Rate	*-0.10%*	*-0.10%*	*-0.10%*	*0.00%*	*0.00%*
ECB-Main Refi	*0.00%*	*0.00%*	*0.00%*	*0.00%*	*0.00%*
Israel	*0.10%*	*0.25%*	*0.25%*	*0.1-0.5%*	*0.1-0.5%*

*** The forecasts in this table are based on the baseline scenario, according to which the Coronavirus will come under control by the end of the first quarter of 2020.**

The Global Economy – Overview

The rapid spread of the Wuhan coronavirus, primarily across China, represents a central risk in the short-term to the growth forecasts of the Chinese economy, and consequently also to the global economic forecasts. According to most estimates, in the baseline scenario a sharp, yet temporary, decline is expected in economic activity, primarily in China and in the country's main trade partners, which apparently will be offset later on when the situation comes under control.

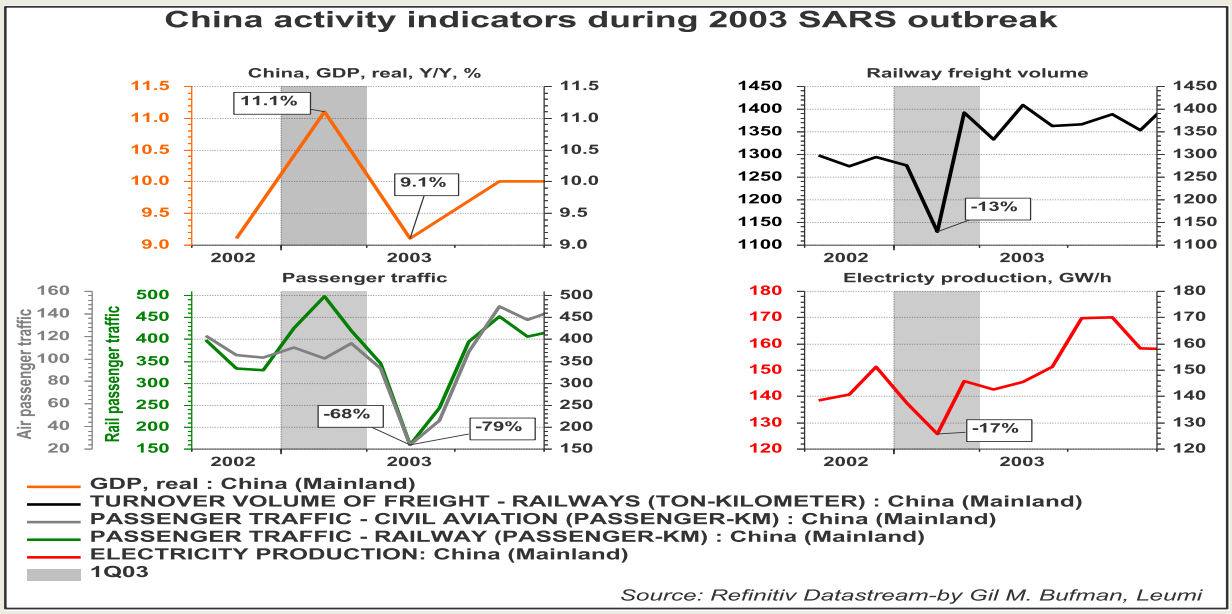
- The backdrop and the current situation – the Wuhan coronavirus has spread to 28 countries. Except for two deaths outside of China, the spread of the virus around the world is still on a very small scale, and the decisive majority of infected individuals reside within China. The spread of the coronavirus has been significantly faster than the spread of the SARS epidemic in 2003. However, the coronavirus seems less fatal than the SARS epidemic in 2003. It appears the reaction of the authorities in the different countries of the world was substantially quicker than that at the time of the SARS epidemic, and this may have contributed to the containment of the crisis mainly in China, while reducing the scope of global expansion.

- The time it will take for the Chinese economy to return to full operations, both in terms of manufacturing and in terms of services, remains unclear. It is uncertain whether Chinese factories have enough inventory to supply customers until production resumes, and thus there is concern regarding a supply disruption of Chinese output to the rest of the world. For now, it is expected that the manufacturing and output of China will be substantially hurt in the first quarter of 2020 (see details regarding quantitative estimates later in this survey). In the event this incident will turn out to be temporary, as was the case in 2003, then China and its trade partners will be able to close the gap that has been created in short time. In the event this incident will turn out to be extended, then there are likely to be substantial negative consequences related to the financial stability of China and global financial markets. On this regard, we note that the global economy is much more exposed to the crisis in China than in the past. This is due to the substantial increase in the importance of the Chinese economy to global economic activity, which is reflected in the substantial rise in the proportion of Chinese GDP out of the global economy since 2003 (from 4.5% to 17.0% today).

- The outbreak of the SARS virus in 2003 as a case study – In 2003 the economic disruption ended quickly and economic growth returned to the level from before the SARS outbreak after just three months from the peak of the epidemic. The SARS epidemic caused a decline of two percentage points in China's annual economic growth rate (Y/Y) in the most affected quarter, and afterwards the economy recovered at a relatively rapid pace. Overall, the damage to Chinese GDP growth in 2003, when there was a sharp drop in activity during one quarter with a quick recovery afterwards that narrowed the gaps, stood at only 0.5%. However, it is important to note that the macro-economic environment in 2003 was better than the case today, as economic growth in China was faster back then in light of, among other things, the entrance of China into WTO agreements. Currently, China is dealing with a trend involving a structural slowdown (structural changes that are slowing growth over time) and a cyclical

slowdown (weakness in global demand) both at once, and therefore the current recovery is likely to take a much longer time.

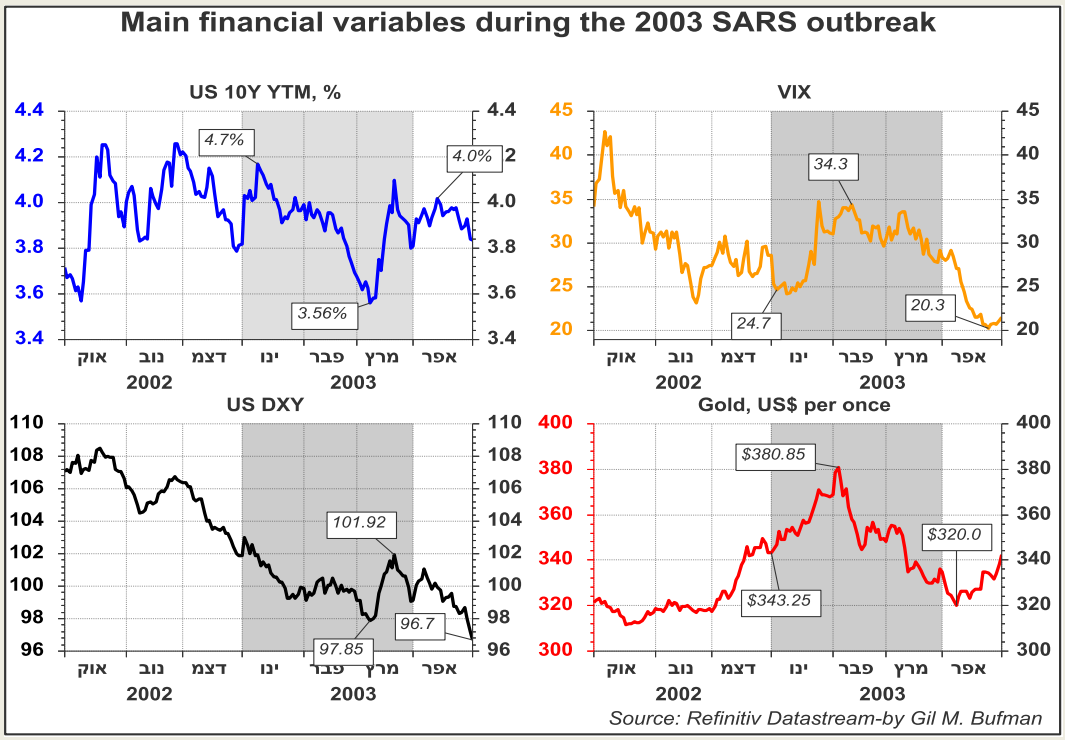
- The data from 2003, during the period of the SARS epidemic, show a rapid decline in economic activity over an order of magnitude of one to two quarters (the first quarter of 2003 is marked in grey in the accompanying chart below). The developments included: a temporary decline in China's GDP growth; a decline of 70%-80% in aircraft and train passenger traffic and afterwards a return to original levels; a temporary 13% drop in cargo volumes on trains; a temporary 22% decline in air cargo transport volumes (excluding passengers); and a notable, yet temporary, decline in electricity consumption. That is to say, the negative potential, in the short-term, in terms of the Chinese economy is substantial, but afterwards a rapid period of recovery is expected, with a narrowing of the gaps. The spread of the virus is expected to hurt growth rates during the first quarter of 2020 also in other regions of Asia (primarily Hong Kong and Thailand) that will suffer from a decline in Chinese tourism revenues, a situation that is likely to temporarily remove 1.5-2.0 percentage points from GDP growth in these countries in the first quarter. Consequently, it appears the GDP growth of EM countries in Asia will temporarily slow in the first quarter of this year.



- The sharp decline in tourism from China was only the first economic channel through which the virus spread to the rest of the region. Most of the countries in Asia implemented limitations on Chinese tourists, and the Chinese government is directing its citizens not to travel to other countries, such that tourist entries from China are falling sharply. Accordingly, Cambodia, Thailand, and Hong Kong are the most vulnerable. If the closure of Chinese factories will continue, purchasers from Asia and from the rest of the world will be compelled to find alternative suppliers. Due to the trade war between the US and China, exports from countries such as Vietnam, Taiwan, and Thailand to the US have spiked at the expense of China. This was not an immediate reaction, but this is illustrative that in the medium-term

the supply chains are able to adjust to changes in demand. Still, at this time the situation will cause damage to global growth in the short-term, with an emphasis on EM countries in Asia.

- Beyond Asia, the situation involves primarily indirect effects that are able, in theory, to be substantial on a temporary basis, mostly in the financial markets in the initial stage. Thus, commodities prices and the currencies of EM countries in Asia fell, and on the other hand there was an increase in safe haven asset prices such as US government bonds, gold, and the US dollar. However, as long as the spread of the virus is contained and does not substantially spread globally, then it is expected that commodities prices will climb once again in the remainder of the year. It will be the same regarding the decline in yields-to-maturity of US government bonds, which are expected to correct upwards in the remainder of the year. Because the declines in EM currencies have been moderate until now, the central banks of EM countries, except for China, are not expected to continue to substantially lower interest rates in the coming months. On this regard, we note that the central Bank of China (PBOC) lowered the interest rate that it collects from banks for short-term liquidity. Taking into consideration the rapid pace at which the coronavirus is spreading, additional interest rate cuts in China are expected in the coming months.



- The accompanying chart above presents the development of a number of key financial variables from the time of the SARS epidemic in 2003. Thus, the yield-to-maturity of US government bonds declined by a substantial degree during the 2003 incident, from 4.7% to 3.6%, against the backdrop of a notable rise in demand. However, after the passage of the incident the bond price fell and the yield increased in return to a level of 4.0%. Also now, there was a decline in the yield from 1.9% a number of weeks ago to a current level of 1.5% - 1.6%. In the event the current virus situation will be temporary, it appears this decline in the yield-to-maturity will turn out to be temporary and the yield on 10-year US government bonds will return toward the direction of 2.0%. During the 2003 SARS epidemic the US dollar

strengthened around the world, the price of gold increased, and volatility increased in the US equity markets, as measured by the VIX index. All these developments turned out after time to be temporary increases. At this time, in the current situation an increase has been registered in these variables, and it remains to be seen if and when there will be a decline in them later on.

- The effects of the virus on public transportation are already being felt across China. Already on the first day of the Chinese new year (January 26, 2020) the number of passenger journeys on trains was 42% lower and the number of passenger journeys on buses was 25% lower compared to the first day of the Chinese new year in the preceding year. In the event the spread of the virus will continue unabated, the demand for public transportation may decline further, both from the concerns of Chinese citizens regarding the risk of infection by other travelers on public transportation, and due to prohibitions put in place by the Chinese authorities. Furthermore, the demand for airplane fuel is expected to decline by 300,000 barrels per day, resulting from a decline in the demand for flights and due to prohibitions put in place by other countries forbidding incoming flights from China, a step taken until now by 62 countries, including Israel. The percentage of airplane fuel consumption in China in 2017 was 12% of total global airplane fuel consumption (compared to only 4% in 2003 at the time of the outbreak of the SARS epidemic). Thus, the demand for airplane fuel is expected to be substantially hurt compared to 2003, and the price of airplane fuel is expected to decline. The current estimate is that in the short-term the demand for crude oil by China is expected to decline by 3m barrels per day. This decline reflects a 20% drop in the Chinese demand for oil. The expectation is that the Chinese demand for oil will drop this year, particularly with a substantial drop in demand in the short-term. The main impact of the virus on the Chinese economy will be seen at the end of the extended holiday period for the Chinese New Year. In the event the epidemic will not be stopped by February 20, 2020, it will be difficult to move hundreds of millions of Chinese workers back to their jobs. As a result, China's economy is likely to suffer damage and oil demand will decrease.

- Macro-economic forecasts of international institutions – Currently, there is a high level of caution regarding estimates of the impact of the virus on the Chinese economy and on the global economy:

  1) The chairperson of the International Monetary Fund (IMF) spoke about the damage in the first quarter of 2020 in China (it is worthwhile to remember that the province affected by the virus accounts for 4.5% of China's GDP) without any quantitative estimates on the global consequences. It is likely that as we approach the meeting of G20 treasury ministers on February 22-23 quantitative estimates will be released with regard to the effects on the global economy.

  2) A number of financial institutions (Barclays, Capital Economics) estimated that China's growth rate in the first quarter of the year will decline. However, they forecast that over the year the GDP level will not be substantially different than the level that was forecast without the effects of the virus, such that these forecasts imply the expectation that there is a short-term negative impact that will be offset later on (after the situation will come "under control").

3) The research division of The Economist Intelligence Unit (the EIU) presented four scenarios on the effects of the virus on China, broken down according to the potential date when the disease will come under control (see accompanying table): the end of February (optimistic), the end of March (the baseline scenario), the end of June (pessimistic), and continuing beyond 2020 ("nightmare scenario"). In the baseline scenario the damage to the Chinese economy is expected to amount in 2020 to a decline in the growth rate from 5.9% to 5.4%, while this scenario assumes substantial fiscal expansion by the Chinese government. Furthermore, the central Bank of China has already acted to implement monetary expansion. The global economy is expected to grow in this scenario, which has a 50% probability, by less than 2%, compared to the original forecast of 2.3%.

4) In our estimation, there is a tight relationship between the rate of change in the volume of world trade and global GDP growth. This involves a correlation of close to 80%. Since most of the economic impact on the world resulting from the virus, which predominantly involves a major closure on China and its economy, is expected to be through the realm of foreign trade, it is highly relevant to examine the relationship between the expected slowdown in global trade volumes, and even its decline, and the expected slowdown in global growth, and from this the slowdown in growth in Israel in the pessimistic scenario. According to the quantitative relationship between the annual growth rate of global trade volumes and global GDP, in a quarter when world trade volume decreases 2-3%, which is expected to be the case in the first quarter of 2020, global GDP growth is expected to slow to 2.0-2.5%. This compares with a current rate of about 3% per year. The longer the virus persists, the longer its negative impact on world GDP, and it will have a slowing impact on global growth over extended periods of time.

Projected economic impact of coronavirus (2019-nCoV)

Scenario	Date by which the coronavirus outbreak comes under control within China	Probability	China's revised real GDP growth, 2020 (%)
Optimistic	End-February	25%	5.7
Baseline	End-March	50%	5.4
Pessimistic	End-June	20%	4.5
Nightmare	The outbreak is not contained in 2020.	5%	<4.5

Source: The Economist Intelligence Unit.

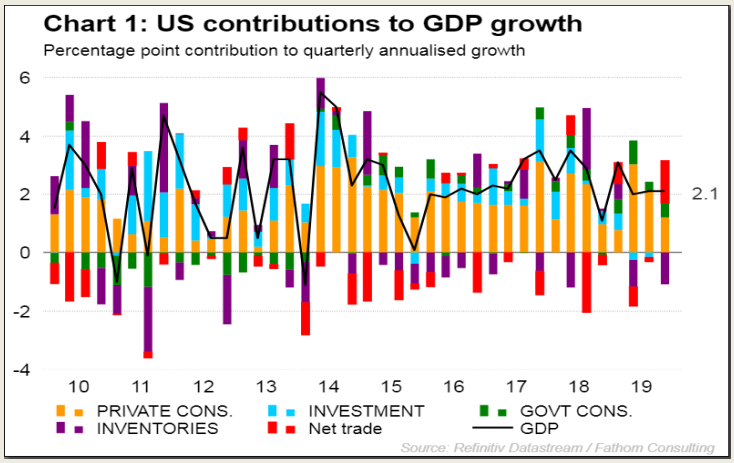

Global trade volume and global world GDP
Twelve-month percentage change
Global GDP, %, Y/Y
Global trade, %, Y/Y
WORLD TRADE VOLUME, Y/Y, %
Global GDP, Y/Y, %
-1.1
2011
2012
2013
2014
2015
2016
2017
2018
2019
1Y % change of (EXPORT VOLUME, WORLD +IMPORT VOLUME, WORLD)/2
1Y % change of GDP (CON) : Global World International
1Y % change of GDP (CON) : Global World International - Forecast
Source: Refinitiv Datastream-by Gil M. Bufman, Leumi

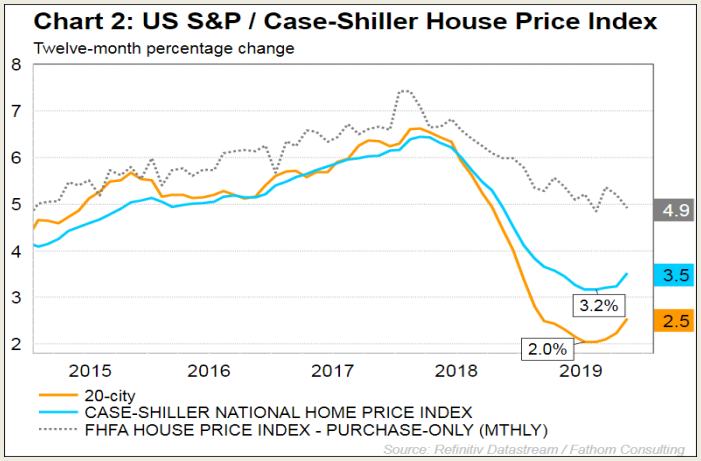
United States

Economic activity: in the fourth quarter of 2019 GDP increased by a similar rate to that in the two preceding quarters, led by net external trade, due to weakness in imports, as well as private consumption despite a slight slowdown. GDP is expected to increase in the first quarter of 2020 by a moderate rate of 1.5% - 1.7%, yet in the second half of the year, economic activity is expected to accelerate with a selective rise in business sector investments and an additional improvement in productivity.

- According to the initial estimate of the US Department of Commerce's Bureau of Economic Analysis (BEA), in the fourth quarter of 2019 US GDP expanded by a rate of 2.1%, in annualized terms, similar to the growth rate in the two preceding quarters. The growth in GDP stemmed from two main factors. First, net external trade increased, caused by a decline in fourth quarter imports resulting from a correction to advanced purchases of importers in the third quarter, before the tariff hike on imports from China. Second, private consumption continued to expand, even though its contribution to GDP growth declined relative to the second and third quarters in 2019 (see Chart 1), due to, among other things, a slowdown in the rate of increase in real disposable income. With the rise in consumer confidence, which is at an historic high level against the backdrop of rising wages, a continued relatively substantial increase in the number of employment positions, and low unemployment, the situation of households remains good. Thus, private consumption is expected to continue to grow in the coming quarter at an annual rate of 2%, and to support US GDP growth going forward.
- Data on fixed capital investment reflect a mixed trend in the fourth quarter. Investment in non-residential construction declined substantially in the fourth quarter of 2019 and there was also a small decline in investments in equipment against the backdrop of uncertainty stemming from the trade war between the US and China. However, investment in residential construction and also in software, computer equipment, and intellectual property increased in the last quarter compared to the third quarter of 2019. Residential construction starts continued to climb in December against the backdrop of a rise in home prices (see Chart 2); however, the sentiment relating to home purchases increased only slightly due to a tightening in mortgage conditions. Looking ahead at investments, the cessation of the production of the 737Max airplane by Boeing Corporation is expected to hurt investments and industrial activity in the first quarter of 2020, and to slow economic growth.
- For the time being, the coronavirus is not spreading to the US, although several people were diagnosed with it. Damage from the virus in the US is likely to be indirect, by means of damage to global trade and in the external accounts of the US. China is the largest exporter to the US (US imports from China are equivalent to 21.6% of American GDP) and an important destination for American exports (8.4% of US GDP). In the event the epidemic will not be stopped by February 20th, it will be difficult to transport hundreds of millions of Chinese workers back to their places of work; and the foreign trade of the US and China is expected to be hurt in the current quarter. However, in the second quarter of the year, foreign trade is expected to return to normal levels, this in accordance with the baseline scenario that by the end of the current quarter the spread of the coronavirus will be stopped.

- Looking toward all of 2020, economic growth in the US is expected to be below the potential growth rate (expected growth of 1.7%, representing no change from our previous survey). This is based on a list of preliminary indicators, such as purchasing managers' indices (PMI, ISM) and labor market data (a decline in new jobseekers, and a slowdown in the growth rate of average hourly wages). The slowdown is expected to occur primarily in the first two quarters of 2020. At the moment, it appears the effects of the coronavirus on annual growth in the US will not be substantial, as long as the virus does not spread substantially throughout the world. Furthermore, in the second half of the year, a recovery is expected in US economic growth, with the effects of the first phase of the trade agreement signed with China, the expected increase in durable goods orders, and also an expected rise in investments in equipment, and an improvement in business sector productivity.



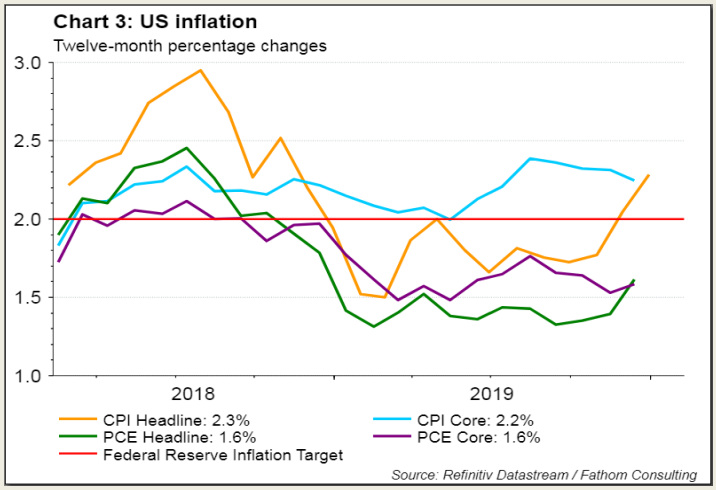


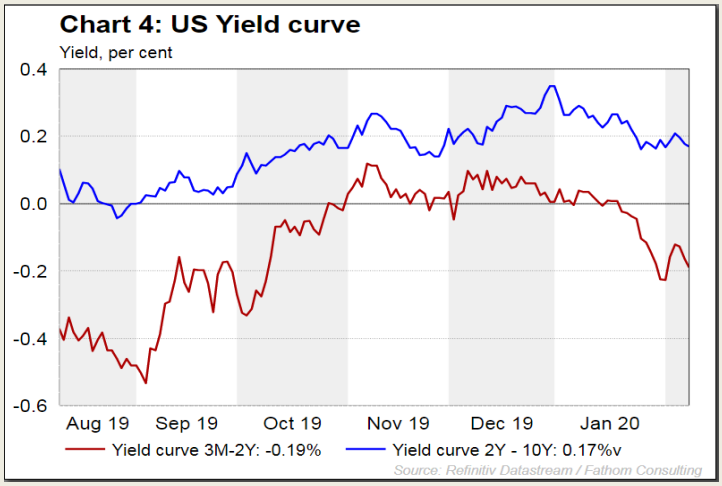
Inflation and monetary policy: the US Federal Reserve (the Fed) kept its interest rate unchanged with a range of 1.50% - 1.75% against the backdrop of the low inflation. The coronavirus will affect the interest rate path only if the US will be substantially affected directly and/or indirectly. The yield on 10-year US government bonds is expected to climb back toward the direction of 2%, this in the event the spread of the coronavirus will be stopped.

- Core inflation in the US economy, which is derived from the consumer price index (CPI) and private consumption expenditure (PCE), slowed in the last quarter of 2019 (see Chart 3). The core index of the CPI (Core CPI), which has been in a downtrend over recent months, ended up increasing 2.3% in all of 2019, and the core index of the PCE remained last year distinctly below 2%. The moderate pricing pressures that reflected the low impact of the placement of tariffs on Chinese imports hint to the idea that the signing of the first phase in the trade deal between the US and China will not affect inflation.
- The US Fed (in its decision from January 29) kept the interest rate unchanged with a range of 1.50% - 1.75%, and raised the interest rate on excess reserves (IOER) to 1.60% in order to cause an increase in the effective interest rate toward the middle of the range. In the interest rate announcement, the Fed placed an emphasis on private consumption, which increased moderately, this in contrast to the statement in the previous interest rate announcement in

which the Fed emphasized the strong growth of private consumption. According to the estimates of the Fed, the economic impact of the coronavirus currently does not demand an additional interest rate cut. The chairman of the Fed, Jerome Powell, indeed said at the press conference following the interest rate announcement that the spread of the virus is a "serious matter", yet in his words the virus will impact the interest rate path only if the US will experience effects of the virus directly and/or indirectly in a substantial manner. While GDP and particularly consumption growth slowed last year, the recent trade truce with China and signs of improvement in the global economy had reduced some of the uncertainties around the outlook.

- The chairman of the Fed, Jerome Powell, noted at the press conference accompanying the interest rate announcement, that starting from the second quarter of the year, the Fed will begin to reduce its government bond purchases and repo tenders, which are intended to guarantee liquidity in the market in the short-term without affecting long-term interest rates. The Fed is expected to reduce its government bond purchases from US$60bn per month to US$10-15bn per month. There has been no information on the outcome of the Fed's ongoing policy review, due to conclude in the summer. Nevertheless, the signs are that officials are increasingly open to the idea of allowing inflation to run above the 2.0% target, even if they stop short of explicitly adopting some form of average inflation target. Moreover, as Thursday's Senate confirmation hearing for Fed nominees Judy Shelton and Christopher Waller will highlight, the Fed is also now being pushed in a more dovish direction by President Donald Trump.
- Concerns regarding the economic impact of the coronavirus created expectations among investors for an interest rate cut, and thus market expectations currently are pricing almost two additional rate cuts through the end of 2020. Consequently, the yields on US government bonds fell following the interest rate announcement of the Fed. These expectations caused an inversion at the shorter end of the yield curve (3 months to 2 years), and also the beginning of a flattening at the longer end of the curve (2 years to 10 years, see Chart 4). We are reminded that the temporary inversion of the yield curve in the summer of 2019 was a factor behind the Fed's decision to cut the interest rate starting from July 2019. In our opinion, in the event the spread of the coronavirus will be stopped, then the yield on 10-year US government bonds will return toward the direction of 2%.





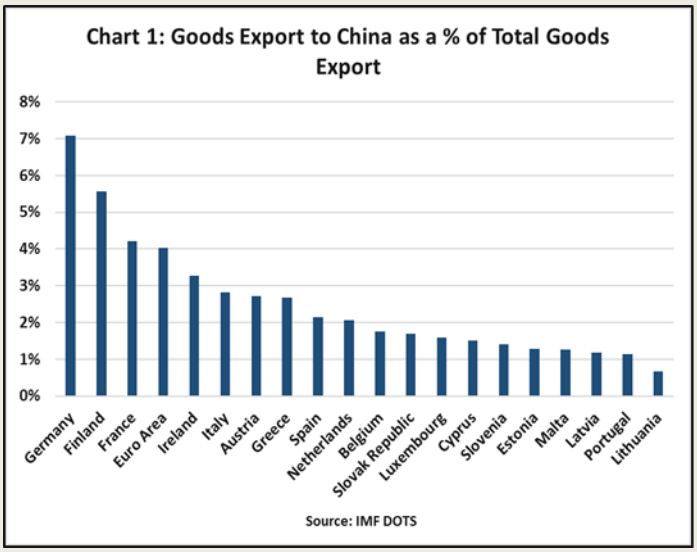
The Euro Bloc

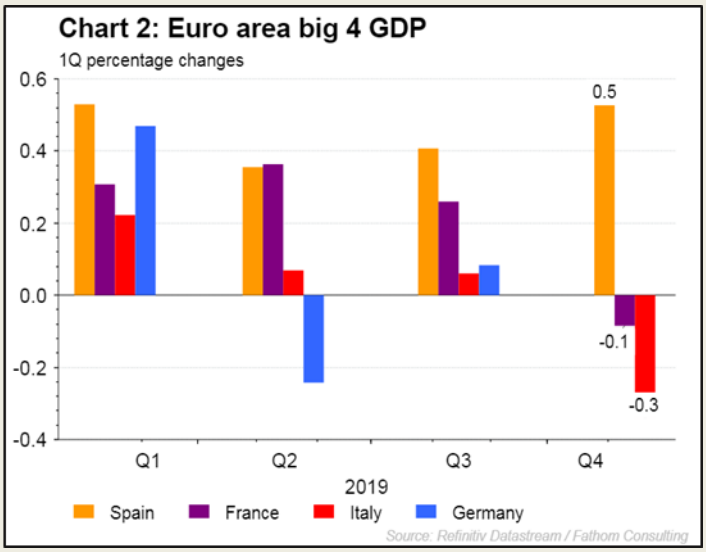
Economic activity and forecasts: the growth rate in the fourth quarter of 2019 was relatively weak and below expectations, apparently against the backdrop of weakness in local demand. At this stage, the coronavirus is likely to subtract 0.1-0.2 percentage points in quarterly terms from the first quarter of 2020 growth rate. The leading indicators in January strengthened compared to December and reflect a growth environment similar to that in the fourth quarter of 2019, yet it is possible that they do not fully reflect the implications of the coronavirus.

- The growth rate in the fourth quarter of 2019 surprised in its weakness, equaling 0.1% (q/q), this compared to 0.3% in the preceding quarter and compared to the 0.2% consensus estimate. Even though the growth data broken down according to the components have not been released yet, it can be estimated that domestic demand was weak in this quarter, based on what is known about France and Spain, and private consumption indicators such as retail sales that remained unchanged during the quarter. Looking ahead, economic activity in 2020 is expected to be based primarily on local demand, against the backdrop of the strong labor market, favorable financial conditions, and supportive fiscal policy. On the other hand, following moderation in the geo-political risks originating from Brexit and the trade confrontation between the US and China, the risks posed to growth in the eurozone include an increase in the tendency of households to save and a decline in the profitability of companies, to which an additional risk has been added – the coronavirus.
- The initial assessment with respect to the virus is that as long as the infections in Europe remain isolated and restrained in other areas of the world, the impact on the economic activity of the euro bloc will be minor and temporary. According to various estimates this situation is expected to subtract 0.1-0.2 percentage points from the growth rate in the first quarter of 2020, while there will apparently be a correction in the subsequent quarter. Exports to China represent 4% of total goods exports from the euro bloc, and 1.5% of GDP, with Germany having the most exposure (Chart 1). The impact on the tourism sector in the euro bloc is expected to be moderate. Even though the proportion of Chinese out of total tourist entries into the euro bloc stands at 10%, the percentage of overnight stays of Chinese tourists out of total overnight stays at hotels and tourist sites in the euro bloc stands at only 1%, and the tourism sector accounts for 5% of the GDP of the euro bloc. Finally, damage to international supply chains is likely to be felt as a result of shortages in raw materials produced by China – European car manufacturers have already alerted that shortages are likely for certain parts. However, it appears that the economies with the most exposure are the smaller economies in the euro bloc such as Slovakia and Estonia, and thus their overall impact is low.
- At the national level, the growth rate in **France** surprised on the downside (Chart 2), and was the lowest registered since the second quarter of 2016. It appears that at least some of the decline can be explained by the strikes and protests carried out in the country starting from December 2019 that weighed on private consumption. However, it appears that another contribution was made from weakness in exports and declining inventories, one-off in nature, caused by, among other things, adjustments made in the automotive industry to new regulations with respect to pollution, and apparently also partly due to protests. Also in **Italy**

economic activity contracted, the registered quarterly growth rate was the most negative since 2013, against the backdrop of a slowdown in local demand and weakness in manufacturing. On the other hand, the growth rate in **Spain** strengthened and was above forecasts, this primarily due to positive developments in net exports, while in contrast domestic demand was weak, with a decline in investments and a standstill in household consumption. The growth rate in **Germany** will be released only later in the month, and taking into consideration the data from the other countries, it appears the growth rate was positive yet minimal. However, the decline in industrial manufacturing in Germany in the fourth quarter of 2019 places a downside risk on this early assessment.

- The composite PMI index for the euro bloc increased in January, a fact that may attest that the coronavirus had no impact on activity in the euro bloc during this month; however, this is because the survey was conducted at a relatively early stage of the spread of the virus. The level of the index reflects a growth rate ranging between 0.1% - 0.2%. The PMI index for the industrial sectors still indicates contraction, yet its level is approaching a point that indicates stability and it is at a nine-month high. Furthermore, also the level of orders from the industrial sectors still indicates contraction, but is approaching a point that indicates stabilization. In contrast, the PMI for the services sectors weakened compared to December 2019. It is important to note that also the ESI index of the European Commission increased sharply in January 2020.



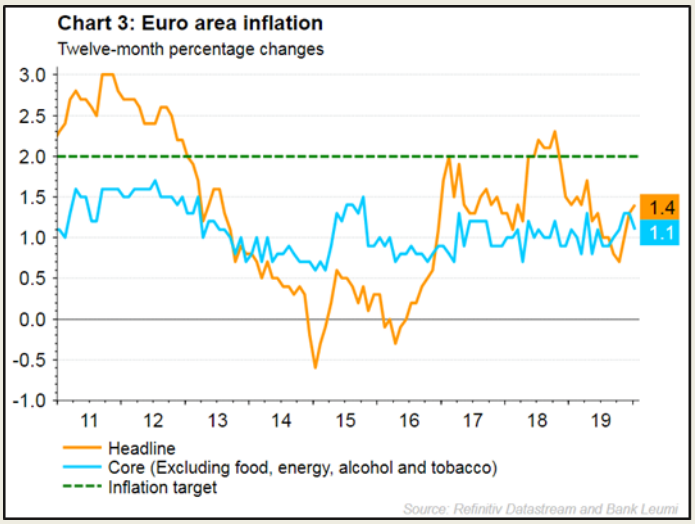


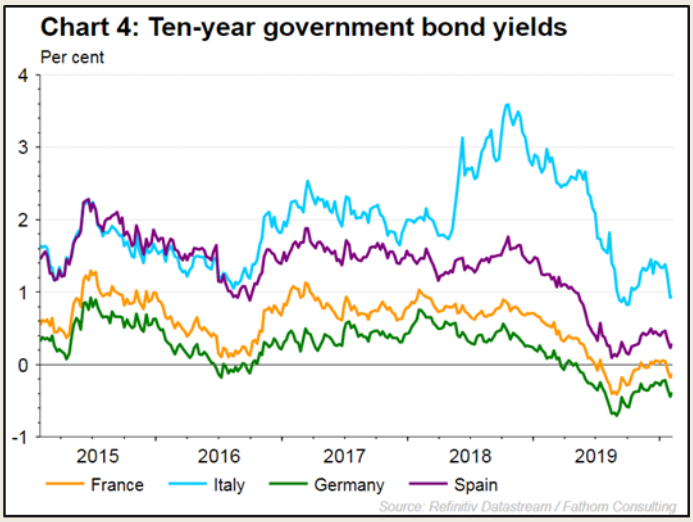
Inflation and monetary policy: inflation increased in January, but is expected to moderate in the coming months against the backdrop of a decline in energy prices, and a moderating effect from the coronavirus on import prices. The January interest rate decision did not include any changes in policy. The coronavirus pushed the yields-to-maturity of government bonds of the big 4 in the euro bloc downward, in Italy a relatively sharp drop was registered against the backdrop of the regional elections that were held at the end of January.

- The annual rate of inflation in the euro bloc increased 0.1 percentage point in January, according to the initial estimates, bringing it to 1.4% (Chart 3). This was due to the relatively volatile components, as energy prices remained high and food and tobacco prices strengthened in January. Core inflation, which excludes food, alcohol, tobacco, and energy prices, declined to an annual rate of 1.1% against the backdrop of a decline in services prices. Looking ahead, the decline that occurred in energy prices around the world in the beginning of 2020 is expected to trickle into inflation of the euro bloc through April this year. The implications of the coronavirus are likely to have a moderating effect on inflation in the short-term, primarily through import prices. This comes as the forecasts on inflation and core inflation of the euro bloc for 2020 remain far from the price stability target of the ECB (below but close to 2%).
- The first interest rate decision of 2020, made in January, did not bring much news with it, and monetary policy remained unchanged. The central bank president noted that the stream of recent data and surveys indicates some stabilization, yet the risks to the outlook remain biased downward, although less pronounced than previously given the partial dissipation of global trade uncertainty. In her words, the first phase agreement between China and the US has both positive and negative implications for the euro bloc, with the net effect being unclear. Positive effects involve support of business confidence and investment, while the negative effects involve possible shifts in trade between regions that may hamper eurozone exports. In addition, the president noted she was not concerned about a scenario of escalation in EU-US relations, as evidenced by the discourse between the president of the European Commission and the president of the US. In addition, she referred to a slowdown in lending to non-financial companies in the business sector and reduced the fear of this slowdown going forward, and attributed it mainly to a slowdown in recent economic activity.
- The coronavirus led to a decline in yields of safe haven assets, among these being the yields of government bonds of the large economies of the euro bloc (Chart 4), against the backdrop of concerns among investors and perhaps also an adjustment in estimates with respect to expected changes in monetary policy. Looking ahead, it appears that developments in the political realm will play a central role in changing the government bond yields of the large economies in the euro bloc in the near future:
  - In Italy, the right-wing Lega party, which is hawkish toward the EU, still leads in public opinion polls; however, the stability of the incumbent coalition seems to have strengthened against the backdrop of Lega's defeat in important regional elections in January and secured another term for a candidate identified with the PD coalition party.

Apparently, this development has played a major role in the relatively sharp decline in Italy's bond yields relative to the decline in yields in the other major European economies.

- The protests that broke out in France due to the proposed pension reform have raised the level of political uncertainty in the country; however, it seems the reform will be approved in parliament because the controlling LREM political party holds a majority of seats in the parliament. Approval of the reform will support investor confidence because the plan has the potential to reduce fiscal pressure on the French government in the future.
- The new coalition in Spain hangs by a thread – the government is a minority government that relied on abstentions by Catalan and Basque members of parliament, and such the establishment of the government has led to some reduction in political uncertainty. However, government stability is not particularly high and developments regarding Catalonia's future could lead to changes in the yield on Spanish government bonds.





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BANK LEUMI LE-ISRAEL, THE CAPITAL MARKETS DIVISION
The Economics Sector, P.O. Box 2, Tel Aviv 61000
Ph: 972-76-885-8737, Fax: 972-77-895-8737, e-mail: Gilbu@bll.co.il
http://english.leumi.co.il/Home/