Global Economics Monthly Review

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Key Issues

Global Economics – The Big Picture (p. 3)

- *Global 1Q17 GDP growth might be weaker than what economic surveys imply.*
- *Inflation continues to rise on base effects but may moderate in the second half of the year. Underlying inflationary pressures are still muted in some of the major advanced economies.*

Global Economic Forecast Table (p. 5)

United States (p. 6)

- *GDP growth may moderate more than previously expected. Consensus growth estimates were revised downward.*
- *Inflation expectations fell recently. Headline inflation is expected to moderate in the second half of the year.*
- *Interest rate expectations fell lately. Nonetheless, Fed members continue to communicate hawkish messages.*

Euro Area and the Political Risk in the UK (p. 8)

- *Further acceleration in economic activity in March.*
- *Political risk will keep weighing on activity in the short-run (at least).*
- *Decline in the inflation environment.*
- *The tightening cycle is not expected to start soon.*

Country Review: Spotlight on Japan (p. 10)

Global Economics – The Big Picture

***Global 1Q17 GDP growth might be weaker than economic surveys imply*:** Based on recently released economic surveys, global economic activity continued to grow in March, continuing an upward trend, ending the first quarter of the year on a positive note. The global manufacturing PMI held steady in March at its highest level in more than five years. On a quarterly basis, the average reading over the first quarter as a whole was the best outcome since 2Q11, and points to an acceleration in industrial production activity in the first quarter of the year. The global services PMI also rose in March. The expansion was broad-based across sub-sectors. All in all, the PMI and other surveys suggest that global economic expansion improved in 1Q17. The expansion was broad-based by nations, but was mostly notable in the major developed economies, particularly in the euro area.

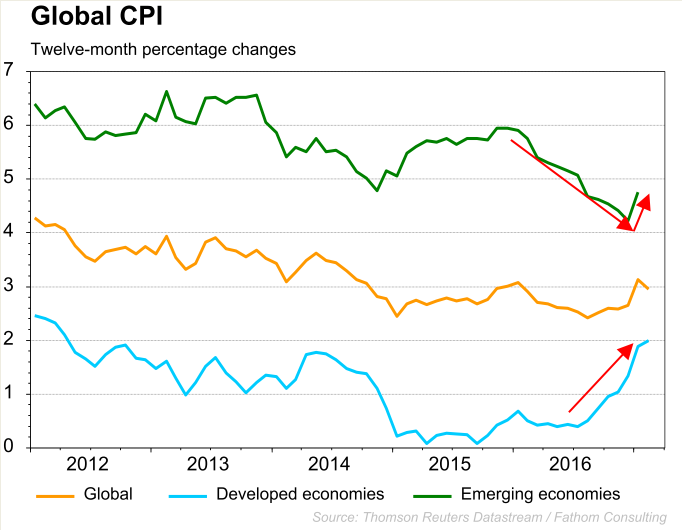
In contrast to the positive survey results, it should be noted that the recent "hard economic data", such as industrial production, retail sales, and domestic demand, have been less encouraging than what the "soft data" business surveys suggest. Hence, we cannot rule out that the surveys' results are overly optimistic and GDP growth data might be somewhat weaker than implied by the national business surveys.

Among the emerging markets, the economic recovery in Russia has continued in the first quarter of the year after registering positive growth rate in 4Q16. India is overcoming the turbulence caused by the banknote demonetization last year, and Brazil is still in a contractionary growth environment, but the pace of contraction on a y/y basis has slowed in the past few quarters and it may reach a positive territory in 2017.

Looking forward, leading indicators, such as job creation and rising new order inflows, continue to suggest that the economic recovery may continue also in the coming months. We maintain our global GDP growth forecast for 2017 at 3.4%, compared to 3.0% in 2016. The risks to our forecast stem mainly from heightened uncertainty, against the backdrop of, among other things: political risks in Europe; uncertainty surrounding US fiscal and trade policies under the Trump administration; financial stability risks in China; continuing weakness in some major emerging economies such as Brazil; and, geopolitical risks in the Middle East and other parts of the world.

Inflation continues to rise on base effects, but may moderate in the second half of the year. Underlying pressures are still muted: The aggregate inflation rate continued to rise in February in the advanced economies, reaching 2.0% in February from 1.9% in January, while in emerging markets inflation rose after a downward trend in the previous months which was driven, among other things, by falls in food prices. The rebound in headline inflation among the developed economies in the past year is mostly due to transitory effects such as the recovery in oil prices, which was accompanied by a rise in inflation expectations. However, the inflation environment in advanced economies is expected to decline as the transitory effects fade away. Moreover, it should be noted that the underlying price pressures, as reflected in core inflation levels, are still muted in most of the developed economies.

All in all, against the backdrop of the improvement in economic activity, in tandem with the subtle underlying pressures in most of the developed economies (excluding the US where core inflation is at the Fed's inflation target), we believe that central bankers in the developed economies may cautiously change their tone towards a less dovish approach. Nonetheless, they are unlikely to be in a hurry to take significant tightening actions in the short-run and will look carefully at accelerated inflation figures.



Leumi Global Economic Forecast, As of April 2017

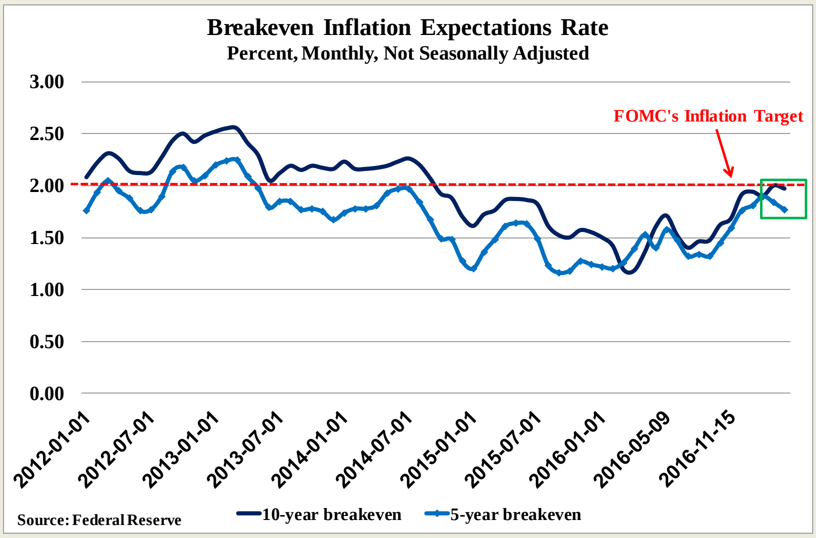
GDP – Real Growth Rate	**2015**	**2016E**	**2017F**
World	*3.3%*	*3.0%*	*3.4%*
USA	*2.6%*	*1.6%*	*2.3%*
UK	*2.2%*	*2.0%*	*1.7%*
Japan	*1.3%*	*1.0%*	*1.0%*
Eurozone	*2.0%*	*1.7%*	*1.5%*
South East Asia (ex. Japan)	*4.4%*	*4.6%*	*4.7%*
China	*6.9%*	*6.7%*	*6.4%*
India	*7.7%*	*7.1%*	*7.2%*
Latin America	*0.1%*	*-0.6%*	*1.7%*
Israel	*2.5%*	*4.0%*	*3.4%*
Trade Volume, Growth Rate			
Global	*2.8%*	*1.8%*	*2.7%*
OECD	*4.6%*	*2.0%*	*2.6%*
Non-OECD	*-0.4%*	*1.2%*	*2.6%*
CPI, Rates of Change, % Annual Average			
USA	*0.1%*	*1.3%*	*2.5%*
UK	*0.1%*	*0.7%*	*2.6%*
Japan	*0.5%*	*1.0%*	*2.3%*
Eurozone	*0.8%*	*-0.1%*	*1.2%*
Israel	*-0.6%*	*-0.5%*	*0.5%*
Interest rates, Year End			
US Fed	*0.25-0.50%*	*0.50-0.75%*	*1.25-1.50%*
Bank of England	*0.50%*	*0.0-0.25%*	*0.0-0.25%*
Bank of Japan-Policy Rate Bal.	*0.00%*	*-0.10%*	*-0.10%*
ECB-Main Refi	*0.05%*	*0.00%*	*0.00%*
Israel	*0.10%*	*0.10%*	*0.25%*

United States

GDP growth may slow more than previously expected. Consensus growth estimates were revised downward: Since our latest March monthly report we have received additional data and survey information suggesting that 1Q17 GDP growth may be lower than the upwardly revised 4Q16 rate (2.1% q/q annualized). Real personal spending edged down in February for the second month in a row, and industrial production was flat after slightly decreasing in January. The weakness in activity was due to, among other things, the warm weather that generated a transitory decrease in utilities production and spending. Additionally, recently published survey data were mixed. The composite Markit Purchasing Managers' Index (PMI) pointed to some deceleration in activity growth driven by a moderation in both the services and manufacturing sectors lately. Based on the average indices of January-March compared to October-December, economic activity growth probably slowed in 1Q17 compared to 4Q16.

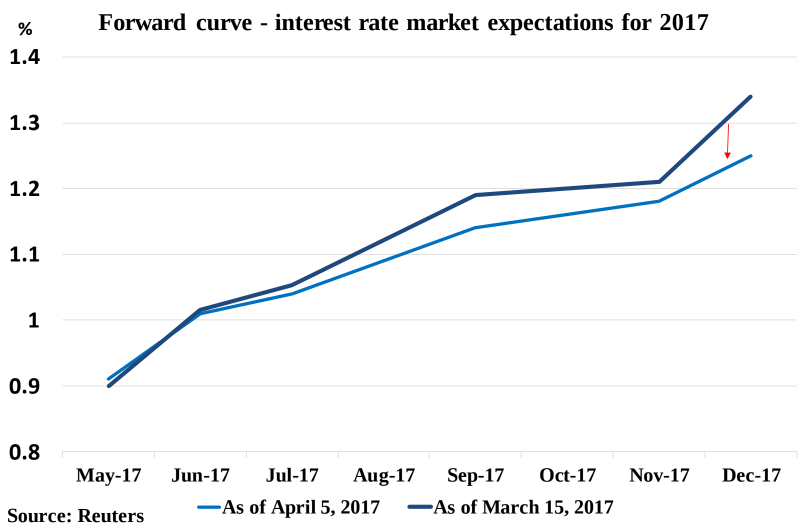
Due to the mixed and, to some extent, disappointing data that were published lately, in tandem with uncertainty regarding the formation of the Trump administration's economic policy, some financial forecasters have revised down their 2017 GDP growth forecasts. Based on the Consensus Forecasts Survey, 2017 GDP growth was revised to 2.2% in March from 2.3% in February's survey. We expect domestic demand, and private consumption in particular, to continue to positively contribute to economic activity, while external demand's contribution is expected to be muted. For 2017 as a whole, our growth forecast has remained unchanged at 2.3%. As we mentioned previously, one of the main risks to our forecast involves the uncertainty regarding the economic policy that will be carried out by the Trump administration (*see our March global economic review*).

Inflation expectations fell recently. Headline inflation is expected to moderate in the second half of the year: Headline PCE inflation rose further in February to 2.1% y/y from 1.9% in January, while core inflation remained unchanged at 1.8%. The data suggest that food and durable goods prices remain a drag on headline inflation, while the drag from energy is over. Moreover, inflation expectations fell recently due to, among other things, the increase in uncertainty regarding future fiscal policy. The fall was notable mainly in the medium-term, as expectations fell below the Fed's inflation target.



All in all, the main inflation indicators are close to, or above, the Fed's inflation target. We expect some moderation in headline indices in the short-run as the base effect from energy prices will fade. That said, inflation is expected to remain close to the 2% target.

Interest rate expectations fell lately. Fed members continue to communicate hawkish messages: Due to the mixed data on economic activity, in tandem with the decrease in inflation expectations and the heightened uncertainty regarding the Trump administration's policy, the probability for rapid hikes this year has declined. Currently the market is fully pricing an additional hike in September, while the probability for a third hike this year is just partly priced in the market. In contrast to market expectations, some Fed officials communicated that the interest rate should rise two additional times this year. The president of the Boston Fed, Eric Rosengren, called for four hikes this year, while the president of the Dallas Fed, Robert S. Kaplan, said that three hikes will be a good base case.



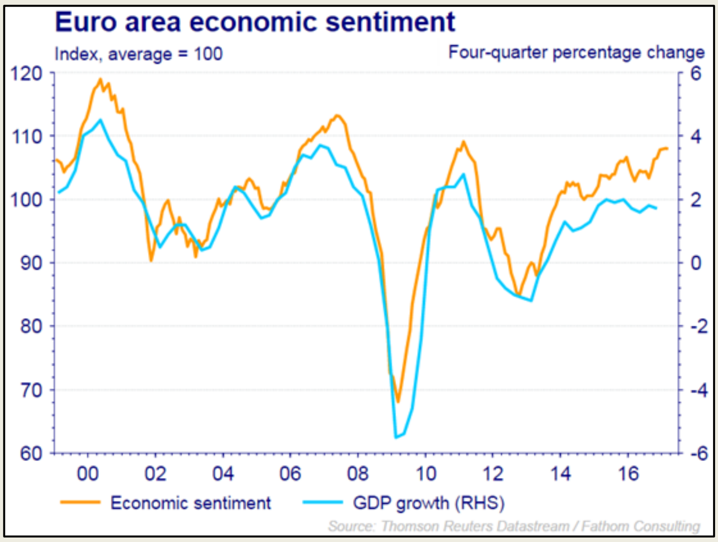
Source: Reuters

We expect two additional rate hikes this year. However, uncertainty regarding the scale of the fiscal stimulus being planned, and actually implemented, by the Trump administration is one of the factors that may affect the magnitude and timing of the interest rate hikes. Moreover, a decline in economic sentiment, as a result of disappointing economic policy progress, may lead to a more gradual rate hike path. On the other hand, further improvement in activity, in tandem with an increase in inflationary pressures, may lead to more rapid hikes than we currently expect.

Based on the central scenarios within our macro-economic forecasts, we expect the yield curve to rise over the upcoming months, in tandem with some flattening of the curve, mainly due to the continued uncertainty regarding the Trump administration's economic policies. We expect the yield-to-maturity of the 2-year Treasury bond to rise to 1.4%-1.7% by the end of 2017 (fourth quarter average). The yield of the 10-year bond is expected to reach 2.5%-2.8% by the final quarter of 2017.

Euro Area and the Political Risk in the UK

Further acceleration in economic activity in March: Recently published economic data and surveys suggest that economic growth in the eurozone accelerated in March. The Eurozone PMI Composite index rose further in March, reaching the highest level since April 2011. In tandem, the economic sentiment index (ESI) edged down in March, but still remained close to its highest level since April 2011. Both PMI and ESI results in 1Q17 as a whole point to acceleration in GDP growth in 1Q17 to around 0.6% q/q. The acceleration in growth at the end of the quarter, as well as improving trends in new business and an increased appetite to hire, suggest that economic activity may grow further in the next quarter. As a result of the latest positive data, growth forecasts by financial institutions were revised upward in the past few months to 1.6% (current forecast) compared to 1.4% in the beginning of the year. Our 2017 GDP growth forecast has remained unchanged at 1.5%. We cannot rule out an upward revision if consumer and business confidence improve further, supporting domestic demand, in tandem with a further recovery in external demand.

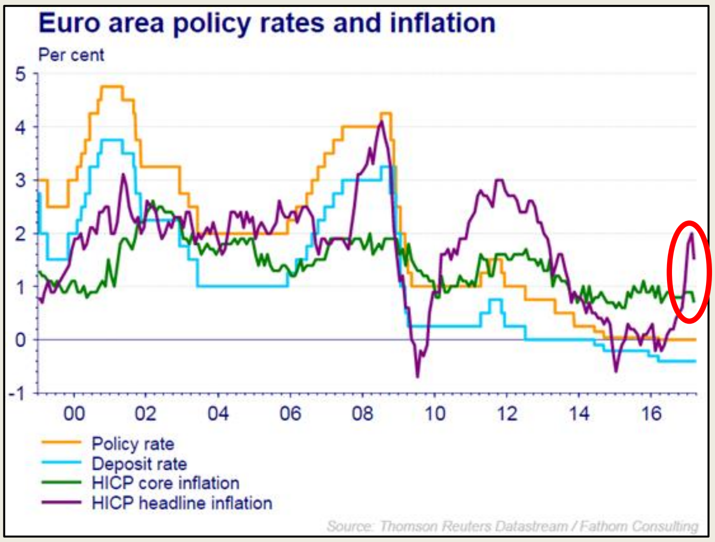


Political risk will keep weighing on activity in the short-run (at least!): The recent upward revisions for eurozone economic growth were driven primarily by the euro area (EA) countries: Spain, the Netherlands, and to some extent Germany. Upward revisions were also registered in Italy. That said, it should be noted that political risk and the level of uncertainty in Italy are on the rise, as reflected in the CDS spreads, which are at their highest levels since the last quarter of 2013. We believe that the level of uncertainty in Italy may rise further once the focus of financial markets turns from France's elections to Italy's economic and political setbacks.

Another source of uncertainty comes from the two-year Brexit process, as the UK triggered Article 50. In her letter to the EU, the prime minister of the UK, Theresa May, stressed Britain's desire to pursue a "deep and special" partnership with the EU, focusing primarily on a free-trade agreement, while at the same time she stressed both economic and security cooperation. Recently, the EU chief negotiator, Mr. Michel Barnier, suggested that over the next few months negotiations will be spent on the "exit bill" (how the UK extricates itself from the EU), reciprocal rights of EU citizens living in the UK (and vice versa), and probably the Irish border issue. Later on, the UK and the EU are expected to negotiate a new trade deal agreement.

All in all, the process is probably going to be long and complex. The negotiations need to be wrapped up by Q3/Q4-2018 to allow the European parliament time to ratify any deal. Due to time constraints, we cannot rule out an extension of the process. Uncertainty and speculation during the Brexit process may weigh on European business and consumer confidence, and also cause an increase in volatility in the financial markets.

***Decline in the inflation environment. A tightening cycle is not expected to start soon*:**



March advanced estimates show that headline inflation declined from 2% y/y to 1.5%, and core inflation decreased to 0.7% from 0.9%. The slowdown in eurozone headline inflation was partly driven by the decline in oil prices in March, which contributed to a fall in energy inflation. We expect headline inflation to average 1.2% in 2017, which is lower than the current level. Moreover, core inflation may rise, albeit moderately and gradually during the year.

Due to the low core inflation and the divergence among the EA economies with respect to the levels of inflation that are expected to persist, we expect that the ECB will not start a tightening cycle soon, despite the positive developments in economic activity. That said, the tone among some of the ECB's officials may become more hawkish in the upcoming months as economic activity continues to improve.

Country Review: Spotlight on Japan

Population (2016)	126.8m
GDP (2016)	$4,730bn
GDP per capita – PPP (2016)	$38,894
CDS (March 13, 2017)	23.9bp
Credit rating (***S&P***) Ratification: September 2016	A+ Stable
Credit rating (***Moody's***) Ratification: August 2016	A1 Stable
Credit rating (***Fitch***) Updated: June 2016	A Negative

	2012	2013	2014	2015	2016E	2017F	2018F
GDP growth, %, change	1.5	2.0	0.3	1.2	1.0	1.2	1.0
CPI inflation,%, average	-0.1	0.3	2.8	0.8	-0.2	0.5	0.6
Govt. balance, % of GDP	-8.8	-8.6	-6.2	-5.2	-5.2	-5.1	-4.4
Govt. Debt, % of GDP	238.0	244.5	249.1	248.0	250.4	253.0	254.9
CA balance, % of GDP	1.0	0.9	0.8	3.3	3.7	3.3	3.3

****Source:* *Growth data taken from the Central Bureau of Statistics of Japan (due to data revisions), and growth forecasts from "Consensus Forecast" (from March 2017). Remaining data were taken from the IMF, while the forecasts and estimates are from October 2016.***

The Japanese economy is the third largest in the world (excluding the euro bloc and the European Union). It is competitive and broadly diversified, with reliable and strong government institutions, and has been characterized by political stability over the years. Over recent decades Japan has been characterized by low defense expenditures as a percentage of GDP (1% on average); however, a slight increase occurred in the security budget in 2017, against the backdrop of heightened Chinese presence in the South China Sea and missile tests by North Korea. In addition, Japan boasts a stable financial system and Japanese households are strong, with high GDP per capita and high savings rates, that are able to overcome economic crises.

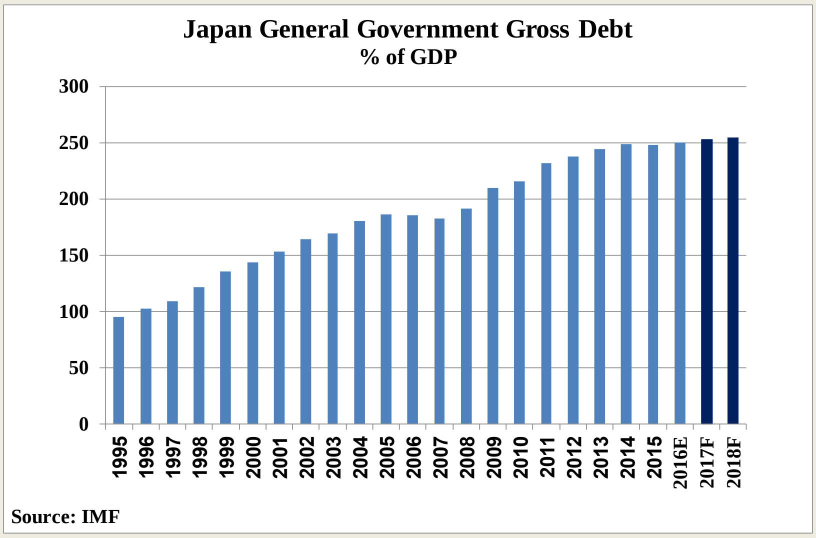
However, Japan holds the world's highest government debt as a percentage of GDP, and this represents a credit risk that must be monitored closely. The increase in government debt occurred as a result of the bursting of asset bubbles, in the stock market (at the end of 1989) and in the housing market (starting from 1991), while only in recent years there has begun to be a stabilization in housing prices, which have been in an upward trend since 2013. In addition, the global financial crisis in 2008-2009 and the earthquake that hit the country's eastern shore in 2011 led to very high fiscal deficits that caused the debt/GDP ratio to continue to rise in recent years. The deterioration in Japan's fiscal position led to a cut in its credit rating (by one level) by the three leading international credit rating agencies during 2015, this in continuation of the downward trend in the country's credit ratings since the beginning of the millennium, back when Japan was rated AAA.

In June 2016 Fitch lowered its credit rating forecast for Japan from "stable" to "negative", primarily against the backdrop of the postponement of a planned hike in the consumption tax (from 8% to 10%) from April 2017 to October 2019, and this after an earlier postponement from the original initiation date of October 2015. The credit rating agency noted that the postponement was not accompanied by alternative fiscal restraints, and this indicated, in their opinion, an absence of any obligation on the part of the Japanese government to lower the debt/GDP ratio.

Simultaneously, the government continues to pursue "Abenomics" (the "three arrows" plan) that was declared in June 2013. Yet, this plan has still not shown any substantial impact on data on economic activity. The plan incorporates three main components: ***massive monetary expansion***, primarily through quantitative and qualitative monetary easing; ***fiscal expansion,*** which involves encouraging investment in the economy, a cut in corporate taxes, and more; and ***structural reforms*** in various areas, such as: the energy sector (reducing regulation) and reforms in the labor market in order to increase workforce flexibility and to create additional employment positions. It is important to note that data on economic activity (with an emphasis on local demand) do not indicate any substantial positive impact resulting from the plan, this primarily due to the difficulties in implementing structural reforms.

During 2016 the government declared three additional fiscal incentive packages to encourage economic activity. These steps, together with the postponement of the consumption tax rate hikes, are expected to keep the fiscal deficit close to around 5% of GDP over the next two years. Looking over the longer-term, the credit rating agencies emphasize the uncertainty regarding the government's ability to lower the high deficit rates and to reduce the government debt in the coming years. This is due to the moderate growth environment (average annual growth of 1.0% in 1995 – 2016) and the near-zero inflation rates (0.1% per year in 1995 – 2016) over the years, and also due to the country's aging population, a situation causing a continuous increase in national insurance expenditures.

The International Monetary Fund (IMF) believes the government debt/GDP ratio is expected to continue to climb in the coming years, reaching a very high level of 255% of GDP in 2018. It is important to note that a portion of Japan's debt is held by the central bank of Japan and government investment funds; however, also when excluding these, the government debt is still high. Therefore, the government is compelled to deal with high financing expenditures (despite low interest rates), and this reduces the ability of the government to support economic activity through fiscal policy, both now and in the event of a future crisis. We note that Japan's high deficits and the government's very high debt rate reflect credit risk; and therefore it is important to monitor very closely the country's fiscal developments.

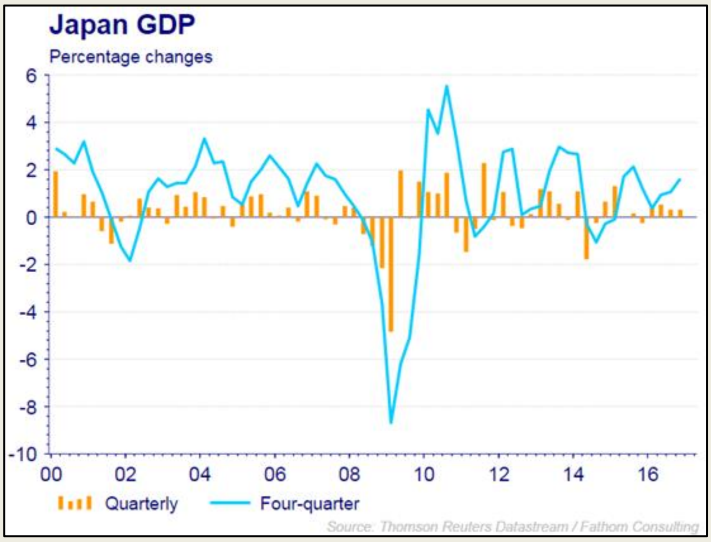


Due to the high government debt, Japan is one of the most indebted countries in the world. Total debt currently stands at more than 350% of GDP (see accompanying chart). However, private sector debt in Japan (households and the business sector) remains around 150% of GDP, which is similar to the level from five years ago. It is worth noting that the debt is relatively high, yet it remains stable and is not growing.

However, the Japanese economy is characterized by relatively strong fundamental factors. Japan has strong external accounts. Thus, the current account has been in surplus for more than 30 years, and has risen above 3% of GDP since 2015, and it is expected to stay at this level also in the coming years. It is important to note that between 2011-2014 there was a decline in the current account surplus due to a surplus of imports over exports against the backdrop of, among other things, an increase in energy imports following the 2011 earthquake. In addition, Japan is characterized by a surplus in foreign currency assets over liabilities (a positive NIIP position equal to 70% of GDP), and by a very high level of foreign currency reserves (25% of GDP). Unemployment has been in a downward trend over the past decade and currently stands at 3%. At the same time, the workforce participation rate increased slightly recently, equaling around 60%.

These data attest to the relatively high financial resilience of the country. Furthermore, the CDS spread (five years) has been in a downward trend since 2011 when it equaled more than 100bps, while currently it stands at 25bps. However, in recent years there has been a slight deterioration in the business environment in Japan. Thus, the country is ranked 34 in the World Bank's index on the ease of doing business, alongside countries such as: Spain, Slovakia, Romania, and Belarus. This is primarily due to Japan's relatively low ranking in ease of opening new businesses and in the granting of credit. We note that Japan is at its lowest ranking in this index, while it was ranked 13 in 2008.

According to the updated growth forecasts, in the last two quarters of 2016 Japan's GDP registered 1.2% growth (annualized), following faster growth in the first half of the year. It is notable that the fourth quarter of last year marked four consecutive quarters of positive growth in Japan, for the first time since 2010. Overall, 2016 concluded with 1.0% GDP growth, following 1.2% growth in 2015. The slowdown in the growth rate occurred against the backdrop of a standstill in private consumption in the fourth quarter of the year and a slight weakness in local demand for consumption and investments during 2016. On the other hand, the weakness in the Japanese yen (depreciation of more than 20% from the end of 2014 through the end of the third quarter of 2016, since then the trend stopped and in recent months there has been a slight appreciation) supported a recovery in exports, primarily in the second half of 2016, and contributed to economic growth.



The future trends in Japanese exports will be affected by economic and political developments among the country's main trade partners, with an emphasis on the US and China. The possibility of the implementation of trade defense policies by the new Trump administration in the US represents a risk to the Japanese economy, as Japan's foreign trade is exposed to trade barriers from the US. Japanese export to the US accounts for 20% of total exports and is equivalent to approximately 3% of GDP. **Looking forward, the Japanese economy is expected to continue to grow at a moderate pace in the coming years (approximately 1%).** The main contribution to growth is expected to come from private consumption, while a continued recovery in global trade is expected to support exports and investments in the private sector, which are supported also by the low interest rate environment and investment encouragement by the government.

The central bank of Japan (the BoJ) declared during the fourth quarter of 2016 a change in its policies, such that it will incorporate two new central components. The first component is an obligation to overshoot inflation, or in other words, the central bank commits to increase the money base until inflation will rise above the 2% price stability target and will remain above this target over time. This is in contrast to the previous policy of achieving the price stability target. The main goal of the change is to support an increase in inflation expectations in an effort to reduce the real interest rate and thus encourage economic growth in the country.

The second component involves control over the yield curve, involving both short-term as well as long-term rates. The central bank declared it will continue to acquire government bonds, "more or less" at the current pace (an annual rate of increase of 80 trillion yen), such that the yield on government bonds will remain "more or less" at the current level (close to a zero percent yield). Through this measure the central bank's goal is to prevent an additional decline in interest rates on loans in the business sector (by preventing a flattening of the yield curve), which is likely to hurt the profitability of financial institutions. This development is not desirable since it has the ability to negatively impact business and household confidence, and consequently economic activity.

Looking forward, it appears that recently the BoJ is slightly more optimistic regarding growth and inflation, such that during 2017-2018 there will likely be changes in policy towards being less expansionary, with the use of non-interest rate instruments, such as for example an increase in the ceiling on 10-year yields or a reduction in quantitative expansion.

Happy Holidays!!

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