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Key Issues

***Spotlight on Brexit:* Milestones to create and follow along the way to a successful Brexit (p. 3)**

Global Economics – The Big Picture (p. 7)

- *The improvement in global economic activity continued in February, but unevenly.*
- *The rise in inflation and the improvement in activity may support a change in tone among central bankers.*

Global Economic Forecast Table (p. 8)

United States (p. 9)

- *Mixed data over the past month, consistent with GDP growth of around 2% in the first quarter of the year.*
- *Our 2017 GDP growth forecast remains unchanged.*
- *The president, Donald Trump, may struggle to implement some economic plans.*
- *Inflation rose further, driven by base effects.*
- *Headline inflation may moderate in the second half of the year as the effects of transitory factors fade.*
- *We expect two additional hikes in 2017, with a gradual pace of hikes thereafter.*
- *The Fed's hawkish tone supported a rise in yields-to-maturity over the past month.*
- *Yields are expected to rise further, but moderately.*

Euro Area (p. 13)

- *Economic activity improved further in February.*
- *Q1-2017 GDP growth may accelerate. Financial institutions' 2017 GDP growth forecasts were revised upward.*
- *Political risks may weigh on growth during 2017.*
- *The divergence between the headline and the core inflation indices is expected to continue in the short-run.*
- *No change in policy, but the tone may become more hawkish if political risks recede.*
- *The spread between German bunds and their eurozone counterparts may fall further if the rise in political risks will be contained.*

Milestones to create and follow along the way to a successful Brexit

Dr. Gil M. Bufman

The ongoing political processes in Europe may complicate Brexit negotiations, as some of the most important governments are headed for elections. The political uncertainties in the EU should serve as a signal to Britain that it must focus its independent efforts on its role towards a successful Brexit. While most of the attention has been on the future of trade between Britain and the 27 EU countries, it appears that creating the setting for a successful Brexit depends heavily on domestically oriented policies in the UK.

The following points attempt to mark out some milestones that could be suggestive of a "well managed" Brexit with ample attention to domestic policies. Moreover, setting explicit targets and attaining them could be indicative of an increase in the odds of Britain emerging in the long run as a stronger economy than it is within its current membership in the EU. This could also help to assuage some of the worries regarding uncertainties during the transition period.

1) **Solving permanent resident status** – Creating a framework that will enable non-UK, EU citizens, to remain, and work, legally in Britain. In tandem, creating a framework that will enable UK citizens to remain, and work, legally in the EU.
2) **"Smart" immigration** – Establish control of immigration to Britain from Europe in a way that enables Britain to access all the labor and human resources that it needs in order to ensure its growth. Favor immigration, especially high-skilled immigration, but control the number of people who come to Britain from Europe.
3) **Maintain a top-10 standing in "Ease of Doing Business" and strive for a top-5 standing** – A global Britain must remain the best place for science and innovation and also be a country that looks to the future. A top-notch score on the **"Ease of Doing Business"** survey (by the World Bank) is imperative. Moreover, supporting cutting-edge research and innovation in the UK is a must. An agreement to continue to collaborate with European partners on major science, research, and technology initiatives is important. A reduction of

Britain's corporate tax rate is important as well, along with further streamlining of bureaucratic processes.

4) **Create inclusive growth targets for Britain** – Investment in education and skills is particularly important to ensure that workers have the capacity to learn new skills, to make the most of digitization and to adapt to changing technologies and working conditions. Accordingly, the following targets should be set:
    a. At least 75% of the 20-64 year-olds to be employed;
    b. At least 3% of Britain's GDP to be invested in civilian R&D;
    c. Reducing the rates of early school leaving to below 10%;
    d. At least 40% of 30-34 year-olds completing third level education;
    e. Fighting poverty and social exclusion;
    f. Setting a quantitative target for the reduction of the number of people in or at risk of poverty and social exclusion.

5) **Spell out explicit policies for higher productivity in Britain** – Productivity is the ultimate engine of growth in the global economy and is probably the most important factor in engineering a successful Brexit. Raising productivity is therefore a fundamental challenge for countries going forward and Britain must set explicit targets, timelines, and programs. There is much scope to boost productivity and reduce inequality simply by more effectively allocating human talent to jobs. Key factors to follow:
    a. Global connections need to be extended, via trade, FDI, participation in global value chains (GVCs), and the international mobility of skilled labor;
    b. Firms – especially new entrants – should be encouraged by policymakers to experiment with new technologies and business models;
    c. Economies need to make the most of scarce resources by enabling labor, capital, and skills to flow to the most productive firms;
    d. Investment in innovation, including R&D, skills, and organizational know-how, to reap the full benefits of new technologies must be made a national priority with measurable targets.

6) **Build a truly global Britain** – Putting emphasis on countries and types of trade that would lead to UK trade growth with the highest possible added value. A

global Britain must be free to strike trade agreements with countries from outside the EU, and Britain needs to increase significantly its trade with the fastest growing export markets in the world. Quantitative targets and timeframes should be set for the creation of draft agreements with all countries that Britain has an indirect relationship through the EU's agreements. Emphasis must be on countries like India, China, Brazil, Gulf States, Australia, and New Zealand. Britain should strive to be a priority for a trade deal with the United States.

7) **Pursuing a bold Free Trade Agreement with the EU** – This agreement should allow for the freest possible trade in goods and services between Britain and the EU's member states. It should give British companies the maximum freedom to trade with and operate within European markets – and let European businesses do the same in Britain. Trade with Europe must be as frictionless as possible and this puts emphasis on a minimization of non-tariff barriers that are likely to be important for many sectors.

8) **Ensuring deep trade agreements** – Creating modern world trade agreements that are increasingly 'deeper' in the sense that they cover many regulatory issues and policy areas that go beyond tariffs such as: services, investment, competition, and intellectual property rights protection. The depth of trade agreements is measurable and the data can be found at the World Bank. Agreements should cover the full range of non-tariff barriers and intellectual property protection. A shallower agreement may have a stronger negative impact on Britain's services and GVC trade, which have relied on the deep arrangements of the EU.

9) **Special attention to the agreements that pertain to sectors that are subject to non-tariff barriers, and protecting them as much as possible –** The new UK-EU agreement may take in elements of current Single Market arrangements in certain areas – on the export of pharmaceuticals and automobiles for example, or the freedom to provide financial services across national borders – as it makes no sense to start again from scratch when Britain and the remaining Member States have adhered to the same rules for so many years.

10) **The future of London as a global financial hub** --The UK Prudential Regulation Authority will have to decide under what circumstances European banks can retain access to Britain. The UK could unilaterally grant access for

EU financial institutions in order to retain London's attractiveness as a financial center. A transition period could ease the pressure on financial institutions. Furthermore, it could support a smooth relocation process by taking pressure off both supervisors and banks.

11) **Preparing for a change in the financial services landscape and grooming alternate sectors** – Financial services are an especially complex area. So far, the EU has never fully integrated finance in its free trade agreements with third countries. It seems unlikely that clearing of euro denominated derivatives contracts will remain in Britain and this means that Britain will have to grow other areas of activity instead. In the case of Britain, and London specifically, it appears that policy steps that would effectively transform Britain into a fast growing global innovation center could be a valuable alternative for many parts of the UK business services sector and its real estate.
12) **Full transparency and forward guidance** – Establishing a transitional deal, or "phased process of implementation", in order to avoid a Brexit "cliff-edge" in April 2019.

Global Economics – The Big Picture

Further improvement in trade and manufacturing. Services sector growth slightly moderated in February: Recently released economic reports suggest the global economic recovery continued in February, albeit unevenly sector-wise and geographically. Based on February global PMI data, the manufacturing index rose to its highest level since mid-2011. The rise was driven by jobs creation, new orders, and export orders. Based on the Netherlands' CPB Bureau for Economic Policy Analysis, which collects trade data from a variety of official international sources, global trade volume is on an upward trend, driven mainly by emerging markets, led by China and other emerging Asian economies.

A geographic breakdown of the PMI survey shows that the improvement in manufacturing was led by some of the major economies, including the eurozone, China, Japan, and Australia. On the other hand, continuing weakness was noticeable in Greece, Korea, Brazil, Turkey, and Indonesia. US manufacturing data were mixed, but trend data attest to a further recovery in activity. The Global PMI services index edged down in February from the 17-month high in January; but the current level still points to a solid pace of growth.

Looking forward, leading indicators such as job creation and rising new order inflows suggest the current upturn may continue also in the coming months. We maintain our global GDP growth forecast for 2017 at 3.4%, compared to 3% in 2016. The risks to our forecast stem mainly from heightened uncertainty, against the backdrop of, among other things, the political risks in Europe, US fiscal and trade policies under the Trump administration, financial risks in China, continuing weakness in some major emerging economies such as Brazil, and geopolitical risks in the Middle East and other parts of the world, and more.

The rise in inflation and the improvement in activity may support a change in rhetoric among central bankers: The aggregate inflation rate has risen sharply in advanced economies, reaching 2.0% in January from 1.6% in December, while in emerging markets inflation has decreased. The rebound in headline inflation in the developed economies is mostly due to previous falls in oil prices falling out of the year-on-year comparison. The rise in inflation in the developed economies was accompanied by an increase in inflation expectations in some of the economies.

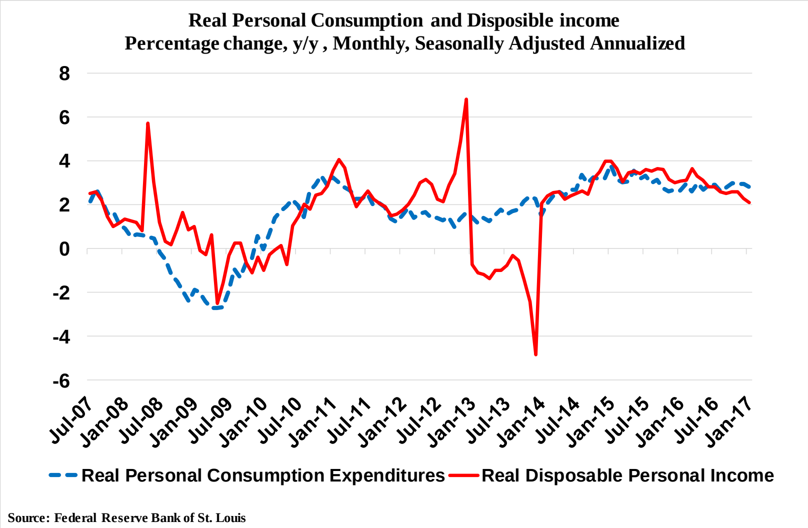
The current inflation rate in some of the major developed economies, such as the US, the eurozone, and the UK, is now at or above the central banks' 2% inflation target. That said, it should be noted that the underlying price pressures are still insignificant. Based on leading indicators, we expect headline inflation to continue to rise, at least in the upcoming months, but may somewhat moderate in the second half of the year as the contribution of base effects fade out of the comparison. The rise in inflation, in tandem with the continuing improvement in economic activity, may drive central bankers in the developed economies to cautiously change their rhetoric with regard to monetary policy toward the hawkish side.

Leumi Global Economic Forecast, As of March 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%*	*1.5%*
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%*	*0.6%*
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%*

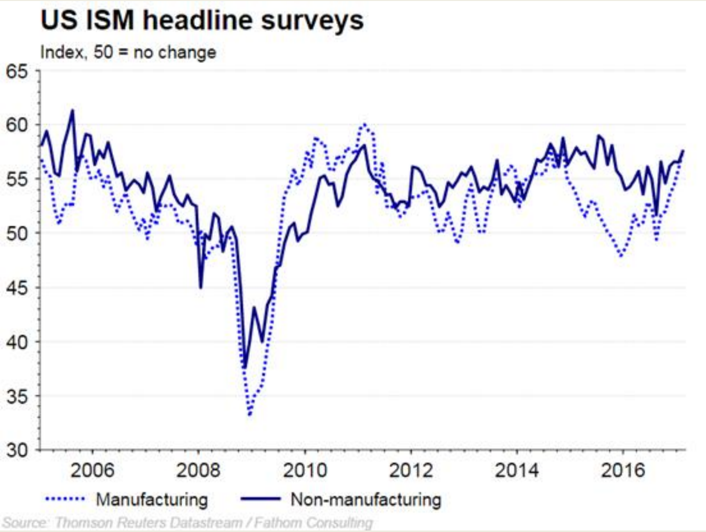
United States

Mixed data over the past month, consistent with GDP growth of around 2% in the first quarter of the year. The president, Donald Trump, may struggle to implement some of his economic plans: The recently released economic data are mixed. Regarding households, personal income grew solidly in January, but nominal personal spending data were soft. The weakness in spending was due to, among other things, the warm weather that generated a decrease in utilities spending, and also probably due to the general increase in prices. Moreover, it should be noted that despite the apparent weakness in consumer spending at the start of the year, consumer goods imports increased significantly, which may suggest that the weakness in January was just a blip. On a year-on-year basis and after adjusting for inflation, real consumption rose 2.8%, slowing somewhat from December, while real disposable income growth moderated further.



The moderation in real disposable income growth started in the first half of last year, mainly due to the rise in the inflation environment, driven by transitory base effects and services prices. Real disposable income may stabilize after the effect of the transitory factors on inflation will fade out. At the present time, the moderation in real income may somewhat weigh on real spending, creating noticeable downside risks to the Q1 GDP growth forecast. We expect the continuing improvement in the labor market and consumer confidence to continue to support private consumption. Nonetheless, without adequate clarification of economic policy steps to actually be implemented, such as a reduction in personal tax rates and a clear alternative to the Affordable Care Act (ACA), household and consumer confidence is likely to weaken.

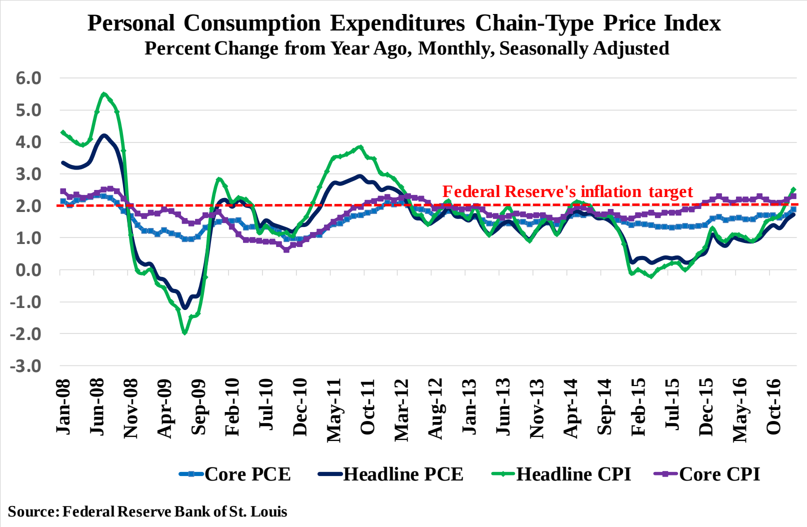
Additionally, the February PMI and ISM surveys showed different results. While the ISM indices rose to multi-month highs, the PMIs somewhat decreased. It should be noted that PMI data in February also saw a sharp pull-back in business optimism regarding the outlook over the next 12 months, which may suggest that companies have become more cautious about spending, investing, and hiring, against the backdrop of the increase in the degree of uncertainty regarding the new administration's economic policy. However, even with the February fall, based on the PMI's historic data, the index remains at a level broadly consistent with the economy growing at a 2.0%-2.5% annualized rate in the first quarter, yet the case for downside risks has intensified.



We expect the US economy to grow around 2% (annualized) in the first quarter of the year, but the risks are tilted to the downside due to the recent weakness of some data and disappointing reports on private spending. For 2017 as a whole, our forecast has remained unchanged at 2.3%. One of the main risks to our forecast involves the economic policies that will be introduced and approved by the Trump administration later on this year. In his first speech to a joint session of Congress on March 1st, the president talked about some of his main campaign themes, but he offered mainly general statements and unclear details about specific economic policies, especially on the tax side, and the exact timing of the infrastructure investment plan, which according to the president, is expected to amount to one trillion dollars.

Moreover, there are disagreements among the Republicans with regard to some of the policies' issues, including proposed tax reforms and the ACA. These disagreements may delay the execution of some of the president's economic plans, which are also subject to change. All in all, there is still heightened uncertainty regarding the 2018 budget, and more specifically regarding the size and composition of the infrastructure investment, trade policy, tax reforms, regulatory reforms, and more. Failure to meet the high expectations that have been set and that have already positively affected the financial markets, may weigh on business and consumer confidence and hence might impede economic growth in 2018.

Inflation rose further, but may moderate in the second half of the year: Headline inflation continued to rise in February. Headline CPI inflation rose to 2.7% year-on-year from 2.5% in January, despite the fall in energy prices after five consecutive months of increases. Analyzing the inflation data over the past year suggests that the recovery in oil prices was the main contributor to headline inflation. Core inflation decreased slightly to 2.2% year-on-year from 2.3%. Both Headline and core PCE inflation rose in January. All in all, the main inflation indicators are close to or above the Federal Reserve's inflation target. At the same time, market-based inflation expectations stabilized recently close to the Fed's longer-run inflation target of 2%.

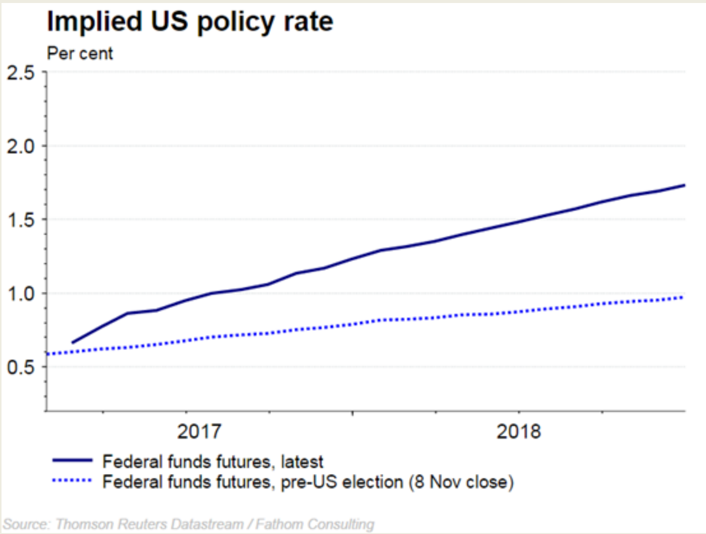


Source: Federal Reserve Bank of St. Louis

We expect some moderation in headline indices after the energy prices' base effect will fade, but still inflation is expected to remain close to the 2% target, fulfilling one of the Fed's dual mandates, while the second mandate is also headed in the right direction.

We expect two additional hikes in 2017, with a gradual pace of hikes thereafter:

The Fed decided to raise the interest rate at the March meeting, by 25bp to a range of 0.75%-1.00%, as expected. In tandem, the Fed maintained the median policy rate forecast unchanged (the "dots"), suggesting two additional rate hikes this year, in line with our expectations. However, it should be noted that the central tendency ranges were lifted, albeit marginally, as some members lifted their projections from two hikes to three hikes. We do not rule out further upward revisions.



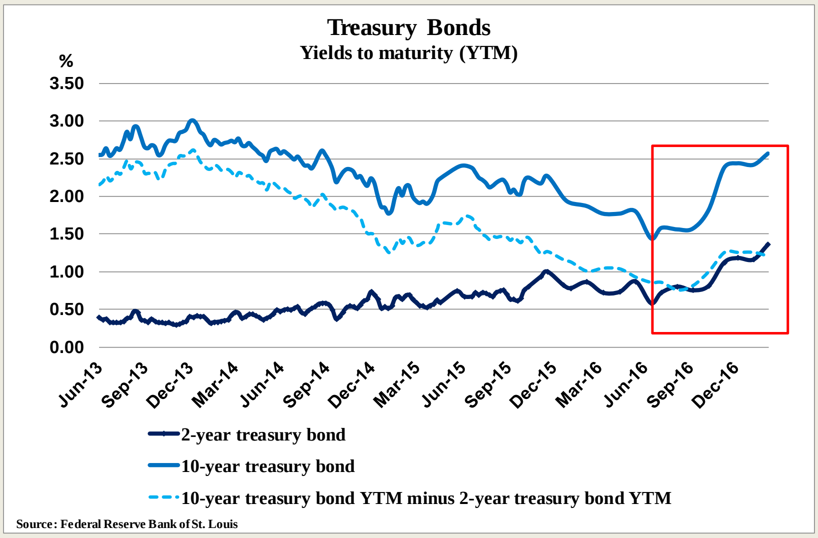
Source: Thomson Reuters Datastream / Fathom Consulting

In addition, Fed officials left their macro-economic projections almost unchanged. The Fed expects the economy to continue to grow at approximately 2% annually in 2017-2019, the unemployment rate is expected to average 4.5% during the forecast horizon, and headline and core inflation are expected to be near the Fed's inflation rate target level. Consistent with the recent tone adopted by the FOMC members, the main message of the statement and the press conference is that economic developments have evolved in line with the Fed's expectations, and the current environment justifies three rate hikes this year, with a similar pace in 2018 and 2019. With regard to the balance sheet, the Federal Reserve's Chair, Janet Yellen, said that the committee discussed the issue, but reached no conclusion yet. We do not forecast any changes in the balance sheet this year, but discussions may continue in order to start building expectations toward the medium-term.

Looking forward, the uncertainty regarding the scale of the fiscal stimulus being planned by the Trump administration is one of the factors that may affect the timing of the interest rate hikes.

We expect two additional rate hikes this year. Based on interest rate expectations, the second hike this year is expected to be in the September meeting, which will be accompanied by the Fed's projections, and the last one in December. However, a drop in consumer and business confidence, for example as a result of disappointing economic policy progress, may lead to a more gradual rate hike path. That said, further improvement in activity, in tandem with an increase in inflationary pressures, may lead to more rapid hikes than we currently expect.

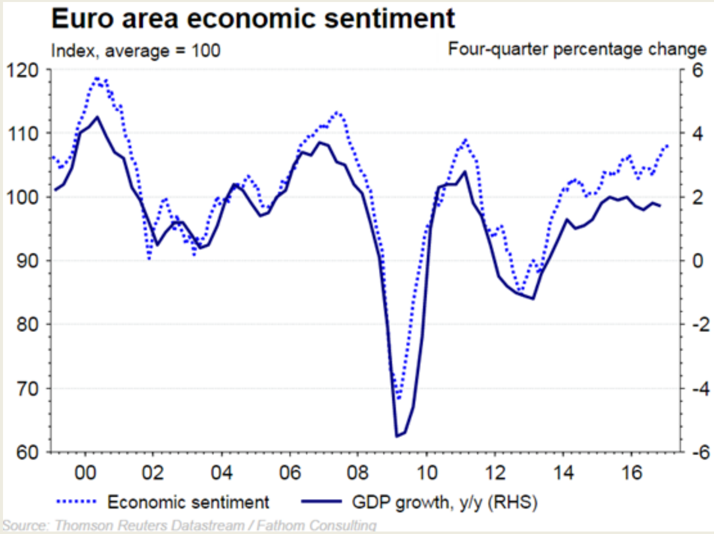
Yields are expected to rise further, but moderately: The yields-to-maturity along the Treasury bonds' yield curve rose in the past month as the probability for a rate hike in March was on an upward trend. The yield-to-maturity of the 2-year Treasury bond rose to 1.30% (March 16th) from 1.20% (February 16th). In tandem, the yield-to-maturity of the 10-year Treasury bond rose to 2.51% from 2.44%.



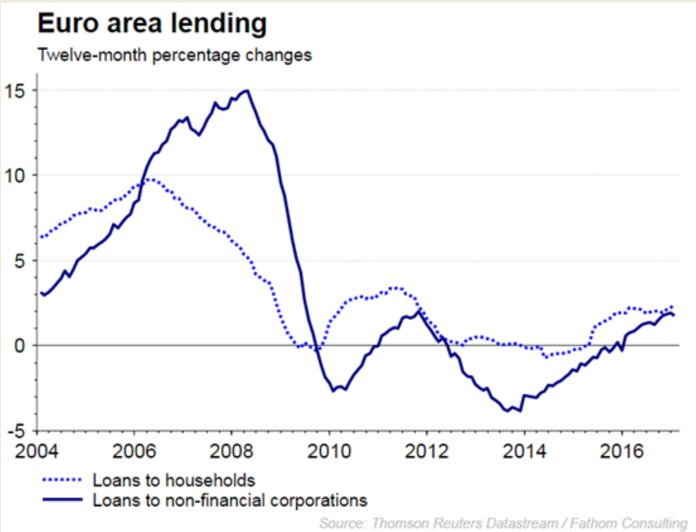
Looking ahead, based on our macro-economic forecasts, we expect the short-end of the curve to rise over the short-run, but not significantly, due to the continued uncertainty regarding the Trump administration's economic policies. We expect the yield-to-maturity of the 2-year Treasury bond to rise to 1.5%-1.8% 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

Economic activity improved further in February: Recent economic surveys suggest economic growth in the eurozone accelerated further in February. The European Commission's Economic Sentiment Indicator (ESI) rose in February to its highest level since March 2011. The rise in the ESI reflected improvements in industrial and service sector confidence. The former points to a sharp rebound in production growth after December's drop, perhaps due to the weak euro. The Composite PMI survey pointed also to an improvement in February as growth accelerated in both manufacturing and services to rates not seen since early 2011, with the manufacturing sector continuing to recover solidly.



Moreover, several leading indicators hinted that the improvement is expected to continue in the upcoming months. Job creation was the best seen in nine and a half years, order book growth picked up, and business optimism moved higher. Additionally, the improvement in economic activity is also reflected in the lending data, both for households and corporations, suggesting that the ECB's monetary policy transmission is effective, at least to some extent, and is supporting the improvement in economic activity.

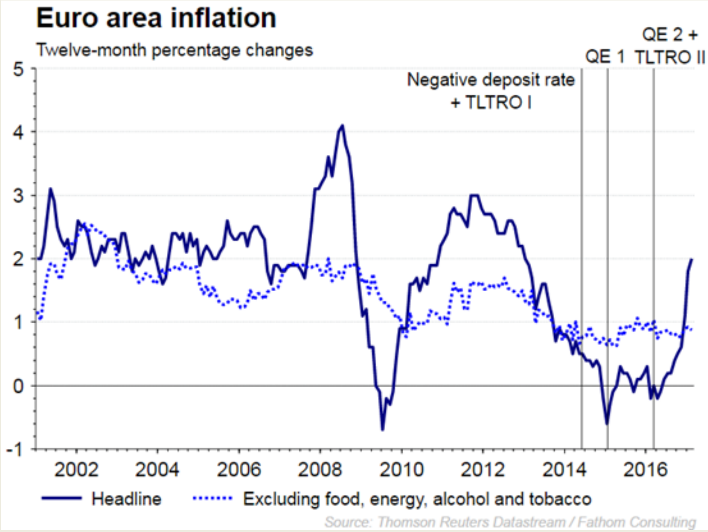


Q1-2017 GDP growth may accelerate. Financial institutions' 2017 GDP growth forecasts were revised upward: Based on historical data, the ESI and PMI, which are highly positively correlated with GDP growth, attest to some acceleration in economic growth in the first quarter of the year (under the condition that the economic recovery will continue in March). Economic activity is expected to grow 0.5%-0.6% in the first quarter of the year compared to 0.4% in the previous quarter. Due to the continuing improvement in economic activity, financial forecasters revised upward their 2017 GDP growth forecast to 1.6% from 1.4% in January's survey. By country, the most significant upgrades were recorded in Spain, the Netherlands, and to some extent Italy.

We expect GDP growth to decelerate to 1.5% in 2017 (unchanged from our previous forecast last month) from 1.7% last year.

As we mentioned in past months, one of the factors likely to weigh on domestic demand in the short-run is the environment of heightened political risks in 2017 (please read Leumi's December 2016 Global Economics Review). The rise in European political risks is a result of the increase in uncertainty surrounding the upcoming national election outcomes in Europe (more on the next page).

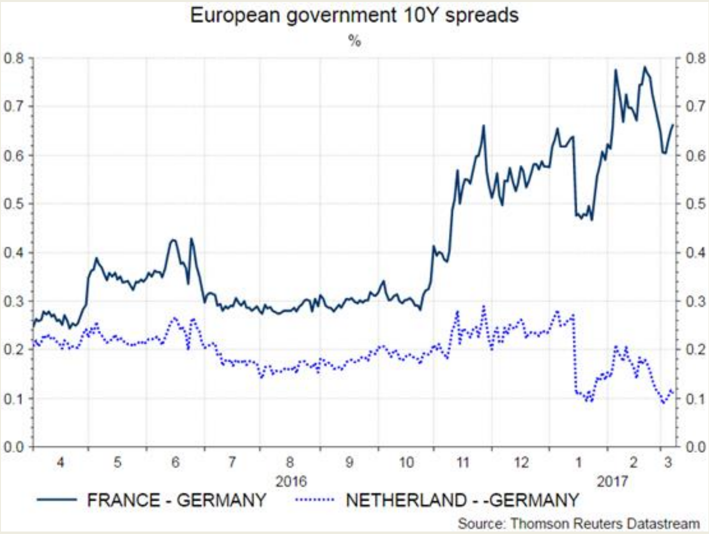
The divergence between the headline and the core indices is expected to continue in the short-run: Headline HICP inflation hit the ECB target in February, rising to 2.0%, while core prices (excluding food, alcohol, tobacco, and energy) were unchanged at 0.9%, just slightly above our forecast of 0.8%. The volatile components (energy and food prices) continue to drive headline inflation, while underlying pressures remain muted. Looking ahead, the ongoing headline versus core inflation dichotomy is expected to persist, with headline inflation likely to be around the ECB target in the upcoming months, before moderating in the second half of the year as the base effects from energy fade and as the unprocessed food prices rally loses momentum. Core inflation will remain on a moderate recovery trend in the short-medium term.



No change in policy, but the tone may become more hawkish if political risks recede: At its last meeting on March 9th, The ECB left its monetary policy unchanged, as expected. This is despite the continuous improvement in economic activity and the rise in inflation, which was driven though by transitory effects. In tandem, the ECB lifted its GDP and inflation projections. Moreover, the tone in the press conference that followed the publications of the monetary policy statement and the projections was somewhat more hawkish. The bank stated that the balance of risks has improved. In addition, the sentence "the sense of urgency to act in case of renewed weakness" was dropped from the statement. It should be noted that the Governing Council had already held an initial discussion about the opportunity to remove the downside bias on rates from the forward guidance, but a majority considered that it was preferable to keep it.

All in all, the tone among the ECB's officials may become more hawkish in the upcoming months as economic activity continues to improve, and if the inflation environment fulfills the expectations to remain close to the ECB's inflation target. However, we do not expect to see a change until core inflation establishes a sustainable upward path. The change might be in the form of forward guidance on interest rates or the asset purchasing program. Moreover, we do not rule out further tapering steps, albeit at a gradual pace, until the end of this year. One of the main risks to this estimation is a rise in European political risks.

The spread between German bunds and their eurozone counterparts may fall further if the rise in political risks will be contained: According to the main exit polls from the Dutch elections that were held yesterday (March 15th), the largest party in Parliament (VVD), led by the current prime minister, is heading toward a victory, while the populist euro-skeptic party (PVV), led by Geert Wilders, fell short of expectations. The current polls' results may suggest that the rise in eurozone populism had been contained.



Most polls in France for the first round (April 23rd) still put Marine Le Pen (from the far-right National Front party) ahead of the other candidates, including Emmanuel Macron (social-liberal, independent) and Francois Fillon (from the center-right Republicans party). However, those same surveys consistently see Le Pen losing a run-off by a wide margin to any of the major candidates.

These results suggest that the political risk has somewhat decreased in France as well, and it was reflected in the government bond spreads between Germany and France. Now, after the election results in the Netherlands, market participants may start drawing conclusions for the upcoming elections in France, sending the spread between German bunds and their eurozone counterparts, which were characterized by heightened political risks, further down.

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