Global Economics Monthly Review

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Key Issues

- The global recovery continues.
- Markets try to gauge the economic effects of the new unified tax proposal.
- In the euro area, economic developments continue to be positive led by domestic demand.
- The improvement in advanced economies' demand has supported an improvement in commodity-exporting economies.
- However, there are some potential risks that may weigh on growth.
- Inflation remains low. Is the Fed becoming less concerned?
- Despite various risks to the inflation outlook, the Fed is determined to increase the interest rate one more time this year, followed by three additional hikes next year.

Global Economics – The Big Picture

The global recovery continues: After accelerating during the second quarter, global economic activity is on track for another positive quarter. The recent improvement in economic activity has been supported by both private consumption and business investment, mainly in the advanced economies. The US economy continues to expand at a moderate rate, albeit steadily, at a pace of about 2% year-over-year. The damages caused by the recent hurricanes are expected to weigh on third-quarter growth, but we expect this to be offset during the following quarters.

The White House released its unified tax proposal last week. The new proposal includes the following: a decrease of the corporate tax rate from 35% to 20% (in the previous proposal the reduction was to 15%), which is below the 22% average of the OECD economies; allowing businesses to immediately and fully write-off the cost of new investments for at least five years; reducing the number of marginal tax brackets for individuals from seven to three or four; doubling the standard deduction and increase child tax credits for individuals; and more. Part of the plan will be financed by taxing US firms on repatriation of profits earned abroad, part will be covered by a reduction of tax allowances and part by an expected increase in economic activity following the implementation of the plan.

As we expected, the new proposal which has increased chances of bewing approved with some additional changes. The plan is expected to somewhat boost economic growth, in tandem to an initial increase in the budget deficit over the next few years. Based on the timing and scope of the approved plan, we may revise our growth outlook. Overall, the US economy is expected to grow on average slightly above 2% in 2017 and 2018.

In the euro area, economic developments continue to be led by domestic demand, as the unemployment rate recorded recently its lowest rate since the beginning of 2009. Purchasing Managers Indices (PMI) and European Commission business and consumers' surveys attest to further solid growth during the second half of the year. The depreciation in the exchange rate of the euro and the global economic recovery are expected to support external demand in the short-run at least. the euro-area economy is expected to grow by about 2% in 2017, above its potential, and gradually moderate during the following years. The Japanese economy also seems to be on a positive track, and growing above its potential output, driven by both expansionary monetary and fiscal policies. The decision of Prime Minister Abe to hold early elections on October 22nd, may suggest further fiscal stimulus measures which will support further economic recovery in the short-run.

The improvement in advanced economies' demand has supported an improvement in commodity-exporting economies. Based on data from Netherlands Bureau for Economic Policy Analysis, world trade growth is near its fastest pace since 2011. The improvement in advanced economies' external demand helped lifting economic growth both in emerging commodity-exporting economies, such as Brazil, Russia and also in other Asian open economies such as South Korea, Malaysia and Thailand. Based on recently released business surveys, leading indicators, and the improvement in the employment situation, we expect the global economy to continue to expand at a steady pace in the short-run. We forecast the global economy to grow by 3.4% in 2017, following 3.2% growth in 2016, and to slightly accelerate in 2018 to 3.5%.

However, there are some potential risks that may weigh on growth. As we wrote in our September review, some of the risks are political and geo-political, and they include: the uncertainty regarding Trump's administration economic policy (the final, approved, form of the new tax reform, trade policy, etc.); military tensions around North Korea. Political uncertainty has risen again in Europe following: the state of the Brexit negotiations; the expected weakened and fragmented coalition of the new government in Germany; the rise in popularity of the Eurosceptic parties in Italy and; the rising tension in Spain regarding the Catalonians wishes to separate from Spain. Another risk to our growth outlook is the uncertainty regarding the future of China's economic policy, after the expected political reshuffle in the Communist Party in the 19th National Congress on October 18th.

Inflation remains low. Has the Fed became less concerned? Despite the ongoing global expansion, inflation pressures remain relatively low as wage growth is still subdued in most major economies. Recently released data on inflation suggested that both headline and core inflation hardly changed in August in the major economies, and remained below the major central banks' inflation targets. Although the US Federal Reserve revised down its 2017 core PCE projection to 1.5% from 1.7%, based on Federal Reserve (Fed) Chair Janet Yellen's latest speech, the Fed continues to anticipate that inflation will rise and stabilize at about 2% over the medium term.

It should be noted that the FOMC's outlook depends significantly on longer-run inflation expectations being stable for years at a level consistent with PCE price inflation of about 2% over the next two or three years. This outlook could be challenged eventually by an environment of roughly full employment and by a wide range of possible future shocks that have been disregarded. Accordingly, in Chair Yellen's speech she notes: "there is a risk that inflation expectations may not be as well anchored as they appear and perhaps are not consistent with our 2 percent goal".

Despite various risks to the inflation outlook, the Fed is determined to increase the interest rate one more time this year, followed by three additional hikes next year. Moreover, the Fed announced in its September meeting that the balance sheet reduction program will start in October, as expected. The Bank of England is also expected to deliver a rate hike soon, probably in the November meeting, as was suggested surprisingly in the last monetary statement and currently priced in the financial markets. That said, the tightening cycle in the UK is expected to be much slower than in the US due to the political and economic uncertainty regarding the impact of Brexit among which the moderation in growth. The ECB's normalization process is also expected to be slower than in the US. The central bank is expected to announce some changes to its QE program in the October meeting (see further details in out September review).

The latest "Fed-speak" may be indicative of the Fed implicitly focusing on multiple targets that are currently not yet included explicitly in its charter. This has led to a break between the low inflation rate and the Fed funds rate projection, now pointing to further rate hikes. This silent shift in policy focus may possibly be strengthened by the next Fed Chair, interested in bringing and implementing new views on the role of monetary policy, and thus could further modify the link between the rate of inflation, the inflation outlook and monetary policy steps.

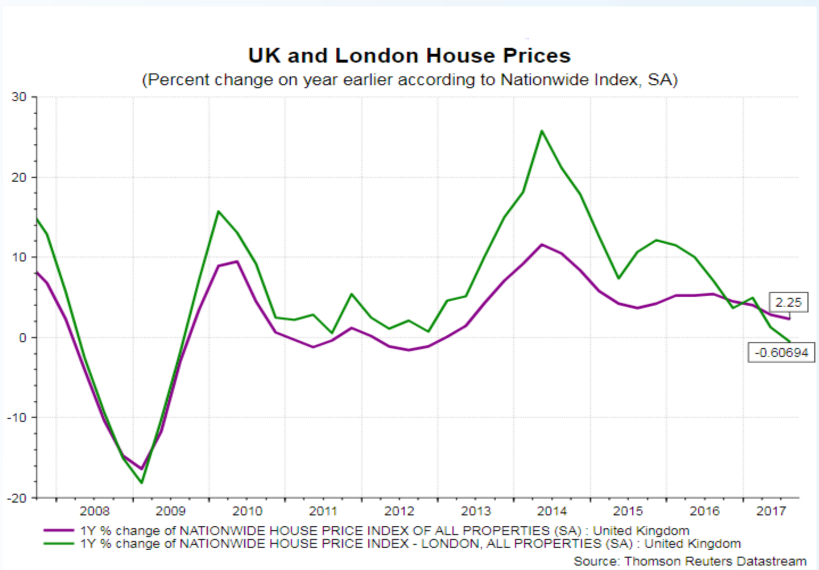
Leumi Global Economic Forecast, As of October 2017

	2015	2016	2017F	2018F
GDP – Real Growth Rate				
World	3.3%	3.2%	3.4%	3.5%
USA	2.9%	1.5%	2.2%	2.3%
UK	2.2%	1.8%	1.6%	1.4%
Japan	1.3%	1.0%	1.5%	1.1%
Eurozone	2.0%	1.7%	2.1%	1.8%
South East Asia (ex. Japan)	4.5%	4.5%	5.9%	5.8%
China	6.9%	6.7%	6.7%	6.3%
India	7.9%	7.1%	7.1%	7.3%
Latin America	0.1%	-0.8%	1.1%	2.4%
Israel	2.5%	4.0%	2.9%	4.0%
Trade Volume, Growth (%)				
Global	2.5%	2.1%	4.0%	3.9%
CPI, Annual Average (%)				
USA	0.1%	1.3%	2.0%	2.0%
UK	0.1%	0.7%	2.7%	2.6%
Japan	0.5%	1.0%	0.5%	0.7%
Eurozone	0.8%	-0.1%	1.5%	1.4%
Israel	-0.6%	-0.5%	0.2%	0.5%
Interest rates, Year End				
US Fed	0.25-0.50%	0.50-0.75%	1.00-1.50%	1.50-2.00%
Bank of England	0.50%	0.25%	0.50%	0.50-0.75%
Bank of Japan-Policy Rate	0.00%	-0.10%	-0.10%	-0.10%
ECB-Main Refi	0.05%	0.00%	0.00%	0.00%
Israel	0.10%	0.10%	0.10%	0.25%

The Real Estate Market in Britain

The residential market in Britain has been in a standstill in recent months, reflected in volume of transactions and mortgage approvals. The moderation in activity is led by BTL (Buy to Let) and by homeowners upgrading their housing, both of which are showing reduced demand for home purchases. In addition, the weakness in recent months is concentrated in the market for existing homes, while it appears the market for newly built homes is continuing to enjoy relatively strong demand.

Against the backdrop of the standstill in Britain's residential market, there are several factors: There is heightened uncertainty in the British economy in light of Brexit; the economy is facing an economic slowdown, which is lowering the purchasing power of the public; low affordability levels and tax changes, implemented in recent years, are lowering the demand for housing purchases by households and BTL buyers. Also a low supply of homes available for sale is contributing to the low number of transactions, stemming from, at least partially, the desire of many homeowners to withhold their properties from sale until there is an improvement in market conditions.



Most of these underlying factors are substantial especially in regards to the residential market in London; therefore, the activity indices in London stand out negatively compared to the other regions of Britain. Following the standstill in activity in the residential real-estate market in Britain, a significant slowdown in housing prices growth has also occurred. The slowdown in London is especially severe, and according to part of the indices there, the moderation in price growth has turned into slight price declines in recent months (particularly with regards to properties in the upper tier of the market). In contrast, in the Midlands region the rate of housing price increases has slowed only slightly.

On the supply side, the rate of housing construction starts in London is at an historical low level, following a substantial decline last year (particularly in central London). Yet, the rate of housing starts in Britain overall is actually increasing, reaching recently (year-on-year) the highest level since the financial crisis. Future growth of housing starts might be constrained by a growing shortage in manpower and raw materials, as well as by negative trends in sales, which apparently is beginning to permeate into the expectations of contractors (particularly in London).

Looking forward – the standstill in Britain's residential market is expected to continue in the coming year, against the backdrop of on-going economic uncertainty surrounding Brexit, and expectations in the market for a continuous weak demand (especially in London). However, any declines in housing prices, if they occur, will be relatively moderate, in light of the limited available supply of housing for sale, particularly in London.

Despite negative underlying conditions (economic uncertainty, slower economic growth, and a moderation in office-based employment growth), the office market in London is showing relative resilience at the moment. Office take-up rates have recently begun to climb again. Office vacancy rates have stabilized in recent months and rent prices are relatively stable (with regional differences in price trends). Office take-up in recent months has been led by the City, West End, and

Southbank areas, and by ready-to-occupy space. At the same time, the rapid growth of flexible office providers (serviced offices and co-working space, such as WeWork) is continuing.

Looking forward, the negative trend in the British economy and in office-based employment growth is expected to continue in the coming year, in a manner that is expected to weaken the demand for offices in London and could negatively influence activity indices there. However, the resilience of the London office market, which is seen in relatively high pre-leased rates of space under construction, represents a stabilizing factor for the market. In the medium-term, the performance of the office market will be strongly influenced by the Brexit process, particularly if this process will accelerate relocation of international financial centers to outside of London.

The retail real-estate sector in Britain has been in a negative trend in the past year, which can be seen in the decline in demand for retail space, a rise in vacancy rates, and a severe slowdown, to the point of standstill, in rent prices growth. This trend is the result of not only negative trends in the British economy recently, but also of additional factors – oversupply in sections of the market and the on-going move of consumers to electronic purchases. In relation to other retail spaces, the retail activity in the main streets of central London is notably positive. In these areas rental prices are continuing to climb at a relatively rapid pace and the rise in vacancy rate is relatively limited.

Looking forward, the negative trend in British retail real-estate market is expected to continue, in light of expectations for a continuation of the negative underlying conditions. This may occur with geographical differences and outperformance of central London main streets. A mitigating factor expected to influence the market is the decline in construction of new retail space, which reduces, over time, the excess supply in the market.

Chile – Country Review

Population (2016)	18.2m
GDP (2016)	US$247bn
GDP per capita PPP (2016)	US$24,113
CDS (Sep. 29, 2017)	59.0bp
Credit rating (S&P) Rating downgrade – July 2017	A+ Stable
Credit rating (Moody's) Rating outlook downgrade – August 2017	Aa3 Negative
Credit rating (Fitch) Rating downgrade – August 2017	A Stable

	2012	2013	2014	2015	2016	2017E	2018F
GDP growth, %, change	5.3	4.0	2.0	2.3	1.6	1.7	2.3
CPI inflation,%, average	3.0	1.9	4.4	4.3	3.8	2.8	3.0
Govt. balance, % of GDP	0.7	-0.5	-1.5	-2.1	-2.9	-3.2	-2.6
Govt. Debt, % of GDP	11.9	12.7	14.9	17.4	21.2	24.8	27.4
CA balance, % of GDP	-4.0	-4.1	-1.7	-1.9	-1.4	-1.4	-1.7

Source: IMF, April 2017.

Main Findings

- The Chilean economy is heavily dependent on the development of global copper prices. Copper is the country's primary export sector, responsible for 20% of total government revenues.
- The GDP growth rate in Chile has declined over recent years. This is the result of a combination of low copper prices, a decline in demand from the country's main trade partners, and negative business sentiment.
- These factors led to an extended period of moderate growth, a decline in government revenues, a rise in the government debt/GDP ratio, deterioration in the country's positive macro-economic profile, and an increase in the Chilean economy's sensitivity to external shocks. Against this backdrop, Chile's credit rating was downgraded recently.
- However, it is important to note that the Chilean economy has been characterized over the years by very positive underlying macro-economic factors, and by responsible economic policy, as well as a high degree of macro-economic stability. Furthermore, Chile stands out positively compared to most Latin American economies.
- The combination of low copper prices and negative business sentiment limits the growth forecasts on the Chilean economy. These forecasts are expected to remain relatively low also in the coming years.
- There has also been a decline in Chile's potential growth rate, this against the backdrop of factors such as: an aging population, infrastructure bottlenecks, low labor productivity, and more.
- Against the backdrop of the recent decline in inflation, and with the goal of supporting economic activity, the central bank gradually lowered the monetary interest rate from 3.50% in December 2016 to 2.50% in June this year. Additional rate cuts are expected.

Strengths:

- A tradition over many years of macro-economic stability and notable economic performance compared to most Latin American countries.
- Stable and credible dedication to the rule of law. Low levels of political risk and corruption compared to other countries in the region (ranked 24 in the world out of 176 countries).
- A reasonable level of foreign currency reserves, estimated at US$40bn, which is equivalent to six months of imports.

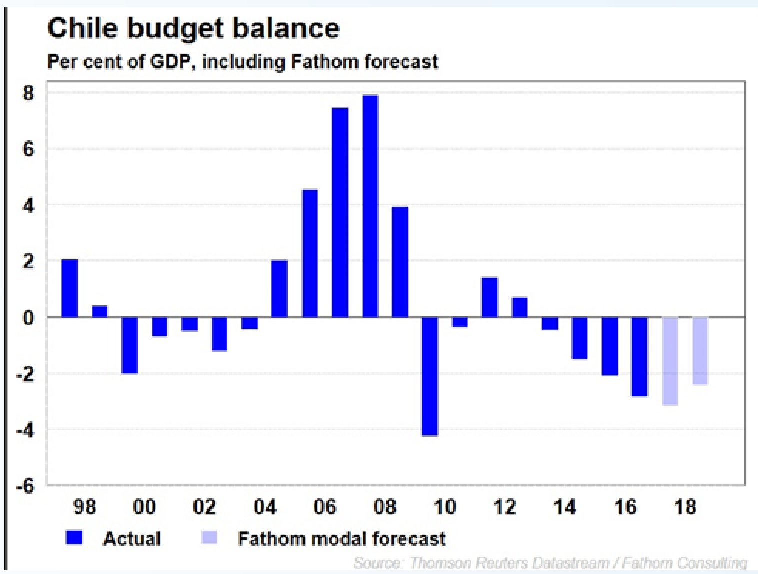
Weaknesses:

- Heavy dependence on revenues from the production and export of copper. Therefore, there is a very high sensitivity to external shocks.
- An extended period of moderate economic growth led to a decline in government revenues, a rise in government debt as a percentage of GDP, and to credit rating downgrades.
- An aging population is expected to weigh on increases in the workforce and the potential growth rate in the coming years.

Economic Review

In recent years there has been a decline in Chile's GDP growth rate, this the result of a combination of low copper prices, a decline in demand from the country's main trade partners, and negative business sentiment. On this regard, it is important to note that the Chilean economy is heavily dependent on the development of global commodities prices, and primarily copper, which represents the main export sector of the country and which is responsible for 20% of total government revenues. The aforementioned factors led to an extended period of moderate economic growth, which led to a decline in government revenues, a rise in the government debt/GDP ratio, a downgrade in the country's positive macro-economic profile, and also a rise in the Chilean economy's sensitivity to external shocks.

These are the main factors that led the S&P international credit rating agency to downgrade its rating on Chile from AA- to A+ (in July this year), and the Fitch rating agency to lower its rating on the country from A+ to A (in August this year). A 'stable' rating outlook at both rating agencies, as well as fiscal adjustments and a gradual recovery in economic activity are expected to help the economy return to a better standing.



At the same time, we note that also the Moody's credit rating agency reacted to the economic developments in Chile recently when it lowered (in August) its rating outlook on Chile from 'stable' to 'negative', while confirming its Aa3 rating on the country. It is important to note that despite the rating downgrades, Chile still holds the highest credit rating among Latin American countries, a fact that underscores the strength of the Chilean economy compared to the other countries in the region.

The Chilean economy has been characterized over the years by very positive macro-economic fundamentals and a high degree of macro-economic stability. The country has shown stable and credible dedication to the rule of law, and at the same time political risk and the degree of corruption are relatively low. In addition, there is a tradition of discipline and an obligation to the economic policy framework. Chile stands out positively in relation to countries in the region in a number of indices, such as: low government debt as a percentage of GDP (even though it has been in an upward trend in recent years), a relatively low current account deficit, the lowest CDS among countries in the region, substantially low political risk compared to most Latin American countries, and the highest ranking in the region in the competitiveness index (ranked 33 out of 138 countries).

However, we note that Chile has a relatively high level of external debt (more than 60% of GDP); yet, as a counter to this the country holds a comfortable level of foreign currency reserves (US$40bn, which is equal to six months of imports).

Also, the country maintains a very high degree of accessibility to international financial markets.

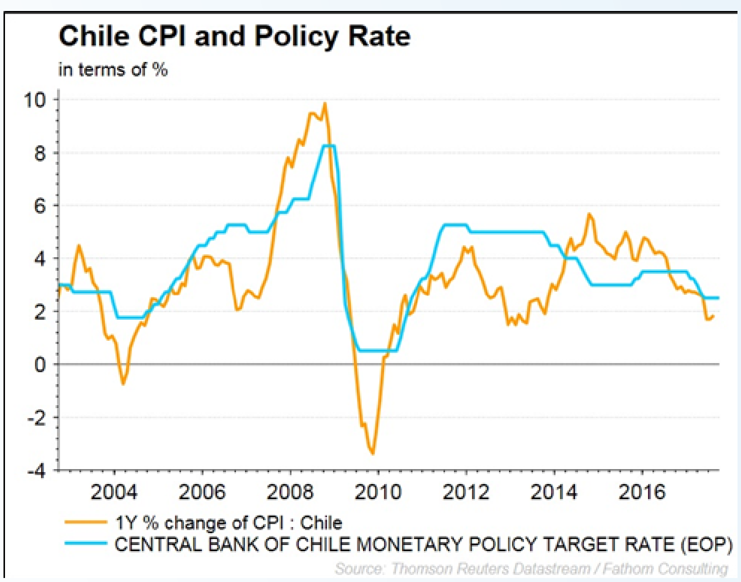
The relatively slow pace of growth is continuing also in 2017, this as a result of an extended strike that occurred in the mining sector. In addition to the strike, there were additional factors that weighed on growth. These factors include the fall in demand for commodities (copper), slow growth among the country's trade partners (with an emphasis on China and Brazil), and a decline in investments against the backdrop of low business confidence. On the other hand, private consumption contributed to growth against the backdrop of an increase in wages and a relatively low unemployment rate, which equaled 6.6% in August this year. At the same time, we note that the participation rate was below the OECD average, and the aging of the population is expected to weigh on growth also in the coming years.

The combination of low copper prices and negative business sentiment is expected to continue to weigh on private consumption and investments, and limit the growth forecasts on the Chilean economy. These forecasts are expected to remain relatively low also in the coming years. The IMF expects Chile's GDP to grow 1.7% this year and 2.3% next year, compared to 4.5% average growth during the years 2000-2013. These growth rates reflect 1% per capita growth, in light of the country's 1% population growth rate.

Looking over the longer term , we note that the IMF estimates Chile's potential growth rate to be slightly below 3.0% (compared to 5.0% in previous years), with this dependent on the degree of success of the economic policy makers in their dealing with the external and also the domestic challenges that stand before the country, such as: the aging population, infrastructure bottlenecks, low labor productivity, and more.

Following an extended period in which inflation was above the 3.0% target (plus/minus 1%), annual inflation began to decline during the second half of 2016 (see accompanying chart). The decline continued also during 2017 and as of August inflation (over the last 12 months) stands at 1.9% (slightly below the lower border of the target range). Against the backdrop of the decline in inflation and with the goal of supporting economic activity, the central bank gradually lowered the monetary interest rate from 3.50% in December last year to 2.50% in June this year (the lowest level since September 2010), and additional interest rate cuts are expected (to a slightly negative real interest rate environment).

Regarding the exchange rate, the currency experienced a sharp depreciation until the beginning of 2016, which came primarily against the backdrop of the drop in copper prices that hurt the Chilean economy. However, since then there has been a change in direction and the currency has experienced a slow, gradual process of appreciation that is expected to continue.



Government policy, including the 2017 state budget that was confirmed by the congress, is consistent with clear and unequivocal fiscal responsibility – a low budget deficit and a low debt/GDP ratio. The risk premium for the country continues to be among the lowest among developing markets, and is at historical lows. However, it is important to note that in recent months there has been a moderate rise in political risks (according to the EIU), this apparently against the backdrop of approaching elections (November – December 2017).

At the same time, the government has advanced the implementation of its agenda in the area of improving Chile's human capital, together with a gradual process of implementing reforms for strengthening public education. A number of developments that have been carried out are likely to assist in improving production and efficiency in the short-term, including: encouraging investment in conventional energy as well as in renewable energy projects; capital market reforms; banking law proposals that will adopt the principles of Basel III; the establishment of an infrastructure fund; and more.

In summary, it appears that the macro-economic stability that has characterized Chile over the years, together with responsible economic policy, will help the country to slowly and gradually exit from the economic slowdown it is currently experiencing. However, in order to return to the high rates of economic growth the country saw in the past, the Chilean economy must act to lower its heavy dependence on the copper sector, while developing additional sectors of activity and revenue channels.

Turkey – Country Review

Population (2016)	79.8m
GDP (2016)	US$857bn
GDP per capita PPP (2016)	US$24,912
CDS (Sep. 29, 2017)	184.2bp
Credit rating (S&P) Rating outlook downgrade – Jan. 2017	BB Negative
Credit rating (Moody's) Rating outlook downgrade – March 2017	Ba1 Negative
Credit rating (Fitch) Rating downgrade – Jan. 2017	BB+ Stable

	2012	2013	2014	2015	2016	2017E	2018F
GDP growth, %, change	5.3	4.0	5.2	6.1	2.9	2.5	3.3
CPI inflation,%, average	3.0	1.9	8.9	7.7	7.8	10.1	9.1
Govt. balance, % of GDP	0.7	-0.5	-1.7	-1.2	-2.3	-3.0	-2.0
Govt. Debt, % of GDP	11.9	12.7	28.7	27.6	29.1	29.8	29.8
CA balance, % of GDP	-4.0	-4.1	-4.7	-3.7	-3.8	-4.7	-4.6
Source: IMF, April 2017.							

Main Findings

- A number of events occurred in 2016 that led to a slowdown in the economic growth rate, which was the lowest since 2009, and is expected to be even lower for full year 2017. These developments led to a very sharp depreciation in the lira, double-digit inflation, a rise in unemployment, and an expansion in the current account deficit. Against this backdrop, the leading credit rating agencies lowered their credit ratings and rating outlooks on Turkey.
- Since the beginning of 2017 there has been a slight acceleration in activity, supported by a number of temporary factors. The growth rate is expected to moderate in the coming years and the risks to the growth forecasts are skewed downwards.
- Weakness in the external accounts: despite the decline over recent years, the current account deficit remains relatively high; external debt is relatively high and in an upward trend; and the country is heavily dependent on external financing.
- Fiscal risk is relatively low, despite the increase in the government deficit in 2016. The fiscal deficit and government debt rates are expected to decline gradually in the medium-term, while their current levels permit a certain degree of flexibility in fiscal policy.
- At the end of 2016 the central bank raised the interest rate to 8.00%, despite political pressures to cut rates. These pressures may disrupt the normal functioning of monetary policy management.

Strengths:

- A large, diversified economy that is broadly distributed across sectors.
- A relatively young population (average age of 29, compared to 40 in the EU) that is growing at a pace of 1.0% per year. Over the longer term this will have a positive effect on Turkey's labor market and its growth potential in the event the country will succeed to prevent negative migration of educated youth.
- Government debt as a percentage of GDP is not high, thus permitting flexibility in fiscal policy.
- A high degree of regulatory supervision over the financial sector, and the banking system is much more stable today compared to the crisis period of 2001.

Weaknesses:

- A history of instability due to domestic factors (politics, banking, and social tensions) and geo-political developments that shake the confidence of local and foreign investors.
- Weak external accounts and high foreign currency sensitivity to shocks in capital flows.
- High political risk (ranked 55 in the EIU index) alongside an increase in the corruption index in recent years – Turkey is ranked 75 in the world (after being ranked 53 in 2013), together with Bulgaria, Kuwait, and Tunisia.
- Difficulty in conducting business in the country: ranked 69 in the world (after being ranked 51 in 2014), alongside countries such as Morocco and Panama.
- A relatively low workforce participation rate and a high unemployment rate, and low workforce productivity.

Economic Review

Despite the shocks that have occurred in the country in recent years, including: political and security instability, social tensions, the deterioration in the economic situation, capital flight, and more – until 2015 economic growth in Turkey remained high. Thus, between the years 2010-2015 the average annual GDP per capita growth rate equaled 6.0%, similar to the growth in the years prior to the breakout of the global financial crisis (2002-2007), when Turkey grew at an average annual per capita growth rate of 5.9%. These are high growth rates compared to countries with similar credit ratings, and particularly to central-eastern European, Middle Eastern, and African countries.

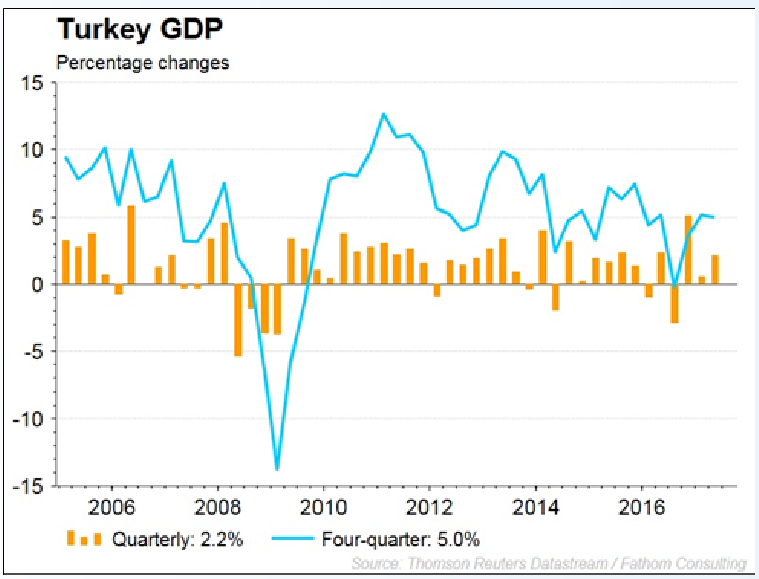
However, in 2016 a number of incidents occurred that led to a slowdown in the growth rate, which dropped to 2.9% – the lowest since 2009, and it is expected to be even lower at the conclusion of the year. The main incidents that occurred included the crisis in relations with Russia following the downing of a Russian airplane in November 2015, which led to a list of economic sanctions between the countries, including the cancellation of Russian tourist vacations to Turkey. It is important to note that the relations completely recovered during 2017. There was also a wave of on-going terror in the country that increased throughout 2016, primarily in the larger cities and particularly in Istanbul. Until now this wave of terror is responsible for the deaths of more than 400 individuals. This has had a negative impact on tourism and on investment activity (domestic and foreign) in the country. Furthermore, the country suffered from political instability, primarily against the backdrop of the military coup attempt in July 2016, which led to a wave of firings and arrests of soldiers, judges, academics, and journalists who were suspected of being against the regime, and also the closing of television stations, radio stations, newspapers, and more. Finally, Turkey has intervened in the fighting in neighboring countries, and particularly in Syria and the fight against the ISIS terror organization.

Against the backdrop of the above-mentioned developments, the credit rating agencies, Moody's and S&P, lowered their rating outlooks on Turkey from "stable" to "negative" in the beginning of 2017, and in parallel Fitch lowered its rating on the country. According to the rating agencies, the main risks in Turkey are: the political developments in the country that have weakened the power of the institutions responsible for the checks and balances in the country, together with the strengthening of the power of the president, Recep Tayyip Erdogan; continuing high geo-political risk; and continuing weakness in the external accounts of Turkey. On this regard, we note that the relatively low domestic savings in Turkey (the balance of savings minus investments, both in the private and the public sectors, is negative as a percentage of GDP) in combination with relatively large current account deficits over the years, have forced Turkey to rely on foreign financial capital flows in order to finance economic activity.

These developments have left Turkey's economy vulnerable and exposed to changes in investor confidence. Economic growth in Turkey is heavily dependent on short-term foreign cash flows, while the FDI rate in the economy remains low (2.3% of GDP in 2015, below the global average and below the rate of investment in the years 2006-2007, 3.5% of GDP), this in light of the political developments, the rise in geo-political risks, and the social tensions in Turkey in recent years. In addition, net overseas liabilities (NIIP) and the country's external debt as a percentage of GDP have increased in recent years and these parameters are at a high level compared to other emerging market countries (see accompanying chart).

At the same time foreign currency reserves have declined due to the fears of investors and businesses regarding a continued depreciation in the lira and risks in the Turkish economy in general. These developments do not reflect positively on the financial resilience of Turkey. It should be emphasized that the relatively low level of foreign incoming investments in recent years, alongside the weakness in the external accounts with a deficit in the current account (equaling 4.5% of GDP), create stability risk and expose the Turkish economy to the risk of depreciation in the exchange rate of the Turkish lira.

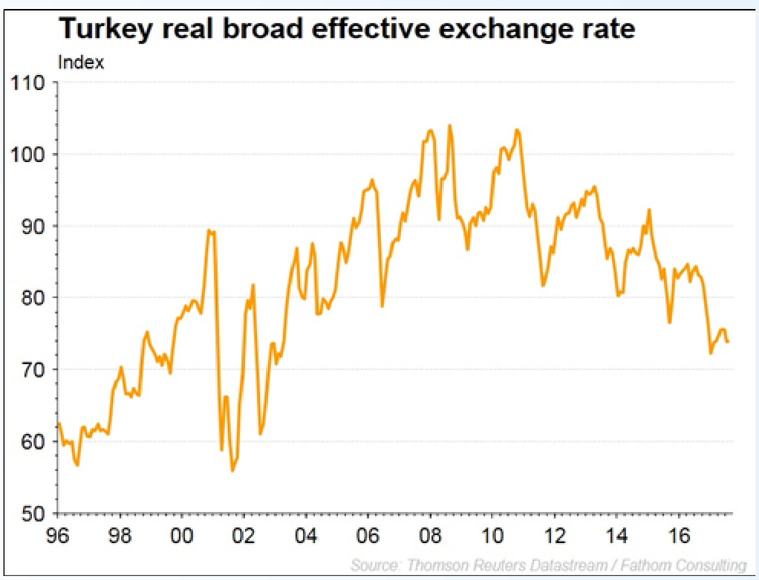
The sharp climb in terror attacks in the country (with an emphasis on central tourist areas) in combination with the political instability have deeply hurt the tourism sector in Turkey, which previously had been in an accelerated growth trend. Incoming tourism to Turkey dropped 30% in 2016, primarily from European countries and Russia. It is important to note that incoming tourism to Turkey is of crucial importance to economic activity, since the tourism sector accounts for 5% of GDP and is directly responsible for 600,000 jobs, which is equivalent to 2.3% of total employed persons in the Turkish labor market, and indirectly responsible for another approximately 1m additional jobs in food service and recreation. The IMF estimates that a 10% decline in incoming tourism to Turkey ultimately translates into a drop of between 0.3% - 0.5% in GDP. Also sectors such as transportation, communication, trade, and textiles are negatively affected by a decline in incoming tourism. Looking forward, the process of recovery that started recently is expected to continue gradually and slowly, and apparently will require a lot of time until things return to the way they were before 2016.



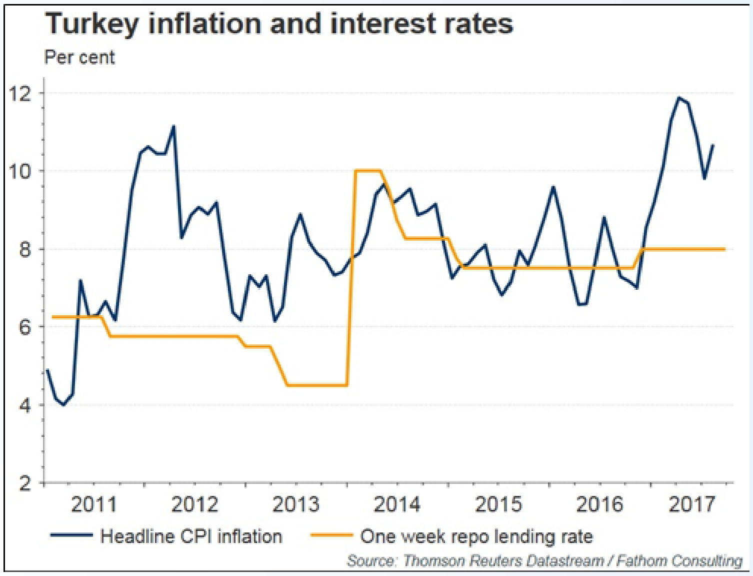
In the first half of 2017, there was relatively rapid growth of 5.0% (y/y). It is important to note that temporary factors and expansionary monetary policy have contributed substantially to growth; however, their effects are expected to weaken in the remainder of this year and also next year. Among these factors can be noted: a slight upward "correction" in the tourism sector, very expansionary monetary policy, and an increase in the supply of credit. On this regard we note that credit to the private sector increased sharply over recent months (although recently the rapid increase has ceased slightly), this through the support of the government, which set up a 250m lira credit guarantee fund (CGF) with the goal of accelerating economic growth in the country. It is important to note that private credit in Turkey increased over the past decade at the fastest pace among EM countries, with the exception of China (see accompanying chart). This represents a substantial potential for risk, since such a rapid increase in credit generally correlates with a decline in loan quality, which may ultimately lead to an increase in the rate of NPLs and to heightened risk to financial stability.

The economic growth rate is expected to moderate in the coming years, and there is a risk that growth will be revised downwards. There are a number of factors that are expected to weigh on economic activity in the short-term, including: a tense local political environment, high geo-political risk, uncertainty regarding Turkish – EU relations, a wave of terror incidences within Turkey, a high inflation environment (about 10%), and high unemployment (10%).

On the other hand, factors expected to support growth within the country and to moderate the negative factors include: continued fiscal expansion, an improvement in the degree of competitiveness of Turkish exporters due to the depreciation in the lira, the rise in wages, and the growth in population that is expected to support private consumption. The IMF expects Turkey's economy to increase 2.5% this year, and 3.8% in 2018. In general, the growth rate is expected to moderate in the coming years and to float around 3.5%, which is equivalent to 2.5% growth per capita.



There was an increase in the government deficit in 2016, which led to a rise in the debt/GDP ratio after six consecutive years of declines. This came against the backdrop of an increase in government expenditures in light of the above-mentioned economic developments. At the same time, it is important to note that the income tax base in Turkey is narrow due to broad tax evasion, and also in light of significant black market activity, estimated (by the OECD) to equal 25%-30% of GDP. However, it is important to note that the fiscal deficit and the government debt as a percentage of GDP are low compared to comparable countries with similar economic characteristics, and currently Turkey's fiscal risk is not so high, which enables fiscal flexibility and support for economic activity.



The Turkish lira has weakened in recent years due to weakness in the external accounts and the narrowing of interest rate differentials. Since the beginning of the 2008 financial crisis there has been a sharp depreciation in the effective exchange rate of the Turkish lira vis-à-vis the currency basket (70% in real terms, 40% nominal).

The trend of depreciation is indeed positive for exporters, but on the other hand it represents a central factor behind the high inflation in the country (10%), even though this has been in a gradual downward trend in recent months. Despite political pressures to lower the interest rate, the central bank raised the rate 0.5 percentage points to 8.00% at the end of 2016, this in order to deal with the high inflation and the weak currency. In light of this, and in combination with additional steps, it is likely that the potential for a continued trend of substantial depreciation is very limited, this in the absence of additional extraordinary events.

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