Leumi Economic Weekly

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The revised macroeconomic forecast of the Bank of Israel Research Department reflects a more optimistic outlook for 2021-2022

As expected, the Monetary Committee of the Bank of Israel (BoI) decided at its January 4, 2021 meeting to keep the central bank interest rate unchanged at 0.1%. In addition, no additional policy measures were announced. Similar to what was stated at previous meetings, the BoI continued to note it will implement additional channels, as required, in order to achieve the monetary policy targets and to moderate the economic damage created as a result of the crisis.

The BoI noted in its announcement the rapid pace at which the Israeli public is being inoculated against the coronavirus. This process is increasing optimism with respect to a rapid return of the economy to a path of growth in the coming year. The BoI announcement emphasized that at this time the likelihood for realizing the scenario involving a rapid inoculation of the population is substantially greater than the likelihood of the slower scenario occurring.

The announcement notes that since the previous interest rate announcement, the shekel has strengthened 1.5% in terms of the effective exchange rate, by 2.8% vis-à-vis the US dollar and by 0.6% vis-à-vis the euro. The BoI warns that even though exports have grown despite this appreciation, at a certain stage the exchange rate is likely to have a negative, non-linear effect on exports. Furthermore, the continued appreciation of the shekel represents a factor that contributes to an additional slowdown in inflation.

In the BoI announcement, the central bank noted that in light of the dissolution of the Knesset (parliament) without an approved budget for 2021, and in order to prevent broad cuts in government activities, the government increased the budget framework for 2020, such that the continuing budget in 2021 will be less contractionary then what was expected before this change. Against this backdrop, the total government deficit in 2020 is estimated to be 12% of GDP, and the forecast for 2021 is for a deficit within a range of 8-11% of GDP.

The more substantial portion of the BoI announcement involved the revised macroeconomic forecast of the BoI Research Department. This forecast estimates the rate of decline in the GDP in 2020 will equal minus 3.7% (*Bank Leumi* forecast – minus 3.9%). For the coming years, 2021-2022, the BoI presents two scenarios, which are differentiated by the pace at which the Israeli population is inoculated: "*a scenario that includes a process of rapid inoculation of the population that lasts until May 2021 (hereinafter the rapid inoculation scenario), and a scenario that includes a more prolonged inoculation process lasting until June 2022 (the slow inoculation scenario). Following the date of full inoculation in either of the scenarios, there would be no*

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

government restrictions with significant impact on economic activity. <u>As of now, in view of the rapid pace of inoculations over the past two weeks, it seems that the rapid scenario is significantly more likely than the slow scenario.</u>"

The range of growth forecasts for 2021 of the BoI is 3.5% in the slow inoculation scenario and 6.3% in the rapid inoculation scenario (see accompanying table). The average of this range equals 4.9%, just like the baseline scenario of *Bank Leumi*. It should be noted that the BoI chose not to include in its published quantitative forecasts also the pessimistic scenario, within the framework of which a serious disruption to the inoculation process is taken into consideration. However, the central bank did refer to such a possibility in a general statement, noting that additional possible scenarios exist (more pessimistic or more optimistic) that may come to fruition.

To illustrate, the forecast did not address the possibility of a tightening in the economic shutdown, which could continue, and which the BoI now estimates will cost NIS 3.0bn – NIS 3.5bn per week, similar to the cost at the time of the second shutdown (October). Further to this, the BoI's forecast range for 2022 is narrower – 6.0% growth in the slow inoculation scenario and 5.8% growth in the rapid inoculation scenario, that is to say, without a clear difference between the scenarios, and this is despite a large variety of risks/prospects that may be realized until 2022 and throughout the year.

Forecasts of the BoI Research Department					
	2020	2021		2022	
		Rapid Inoculation	Slow Inoculation	Rapid Inoculation	Slow Inoculation
GDP	-3.7%	6.3%	3.5%	5.8%	6.0%
Private consumption	-11.0%	12.5%	7.5%	8.0%	10.5%
Investment in capital assets (excl. ships & aircraft)	-7.5%	3.5%	-1.5%	8.5%	7.5%
Exports (excl. diamonds and start-ups)	1.5%	3.0%	2.0%	4.5%	4.5%
"Broad" unemployment rate (ages 15 and above, annual avg.)	15.8%	9.6%	12.5%	6.2%	8.5%
Govt. deficit (% of GDP)	12.0%	8.0%	11.0%	3.6%-4.0%	6.0%

The bulk of the economic recovery in the 2021 forecast is expected to be in private consumption and investment in capital assets – the components that have suffered the most substantially from the crisis. However, the BoI forecast on exports in 2021 is moderate and does not reflect the consensus forecast for a substantial expansion in global trade in the event of broad global success in the matter of inoculation against the coronavirus and beating the pandemic. The process of recovery of the local economy from the coronavirus crisis is expected, according to the BoI and also in our opinion, to be spread out across the years 2021-2022.

The Research Department of the BoI believes that in the two main scenarios, the improvement in economic activity, together with a diminishing effect of the shekel appreciation that has been felt until now, will lead to a moderate rise in inflation throughout the forecast period, such that at the end of 2022 inflation is expected to be near the lower border of the price stability target range (1%-3%). In the rapid inoculation scenario, inflation during the next four quarters (ending in the fourth quarter of 2021) will amount to 0.6%, and will equal 0.9% during 2022. In the slow inoculation scenario, inflation during the coming four quarters is expected to amount to 0.1%, and to equal 0.8% during 2022. In both these scenarios, the Research Department estimates that in another year the interest rate of the BoI will fall within a range of 0.0%-0.1%, a situation that is consistent with the expectation for a continued substantial deviation of inflation from the price stability target in the stated period.

The "broad" unemployment rate declined to 12.7% in the first half of December; the income of salaried employees is supported by the government assistance program

The Central Bureau of Statistics (CBS) published the data from its workforce survey for the first half of December 2020. As we have noted in our previous weekly surveys, the CBS data include reference to the unemployment rate according to the standard definition (the "regular" rate) and also according to the more inclusive definition (the "broad" rate). Currently, under the influence of the coronavirus crisis, the "broad" unemployment rate provides a more comprehensive picture of the scope of non-employment in the economy, in contrast to the "regular" unemployment rate, due to reasons with respect to definitions and inclusions.

Consequently, the analysis in this section will concentrate on the unemployment data within the broad definition (data unadjusted for seasonality). The "broad" unemployment data include unemployed persons, furloughed employees, workers who have been dismissed due to the coronavirus crisis, as well as persons not participating in the workforce (those not dismissed from jobs due to the crisis or have not worked at all in the past) who are interested in working, but did not seek work over the past month due to the crisis.

In the first half of December 2020, the "broad" unemployment rate declined to a level only slightly higher than the unemployment rate in the period between the first economic shutdown (March-April 2020) and the second shutdown (September-October 2020). As can be seen in Chart 1, the "broad" unemployment rate stood at 12.7%, which equates to 517,000 unemployed persons. This is close to the number of unemployed in the period between the two shutdowns, but still substantially higher than the pre-crisis levels (an unemployment rate of less than 4%, which equates to 150,000 unemployed persons).

Looking ahead, it appears that an increase in unemployment is expected, which is likely to be expressed already in the data from the second half of December 2020. This is due to the third economic shutdown, starting on December 27, and also against the backdrop of the upcoming substantial tightening in restrictions that will include a drastic reduction in the scope of economic activity and the closure of most of the education system, which will come into effect January 8, 2021. The "tight shutdown" is expected to lead to an increase in overall unemployment during January 2021, likely to a level similar to that registered during the second shutdown (that is to say, more than 20%).

The rapid progress in the inoculation process in Israel is expected to contribute to the economic recovery over time. As long as the current pace of inoculation, which is notably positive in an international comparison, will be maintained, it appears that a critical mass of inoculated persons (most of the population) will be achieved in Israel already towards the end of April 2021. This is a more rapid expected timetable compared to the developed world, in which inoculation is expected to show its signs only towards the end of the second half of 2021. Against this backdrop, and in light of the government support for the unemployed that is likely to continue beyond the first half of 2021, it appears that in the baseline scenario, the "broad" unemployment rate is expected to remain at a relatively high level throughout the first half of 2021.

The government assistance programs offered during the coronavirus crisis have supported the economic condition of households (on an aggregate level), and in this manner contributed toward reducing the damage to local demand for private consumption. Accompanying Chart 2 shows the development of the total income of all salaried employees in the economy (accounting for 85% of total employed persons in the economy), which is calculated as the sum of total monthly salaries (according to CBS data, unadjusted data in current prices) and the total government assistance provided in the coronavirus crisis to private individuals (according to the Ministry of Finance, not including assistance provided to freelancers).

From the graph it can be seen that without the government assistance (that is to say, the total sum of monthly salaries only) the total income of salaried employees fell 3.9% in the first ten months of 2020 (compared to the parallel period in 2019), due to the impact of the coronavirus crisis. However, the government support led the total income to rise in the same period by 2% (at the aggregate level). This means that on average, i.e. without taking into consideration the different effects on the various income deciles, the income of households headed by salaried employees was not harmed.

This situation has permitted households to continue to consume in accordance with the restrictions on activity. That is to say, consumption increased relatively sharply whenever restrictions have been eased, and fell sharply whenever restrictions have been tightened. In other words, the main harm to private consumption stems primarily from the impact of the restrictions on supply and less so from a decline in the demand of households to consume. This development is expected to help in the recovery of private consumption during 2021, at the time when it will be possible to reduce the severity of the restrictions and to set loose the pent-up demand.

Authors: Dr. Gil Michael Bufman and Yaniv Bar

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