# Leumi Economic Weekly

**July 08, 2020**

***The Bank of Israel kept its interest rate unchanged at 0.1%, and at the same time declared additional monetary measures***

The Monetary Committee of the Bank of Israel (BoI) decided at its meeting on July 6, 2020 to keep its interest rate unchanged at 0.1%. In light of the strength at which the coronavirus has damaged economic activity, the Monetary Committee emphasized the need to broaden the degree of monetary policy expansion and to ensure the continued orderly functioning of the financial markets. At this time, the BoI chose not to make an additional cut to the central bank rate; however, it was decided to broaden the use of existing quantitative measures and to implement three additional policy instruments, which will deepen the degree of expansion and support the monetary pass through mechanism, and in doing so will assist in providing an answer to the credit needs of the economy.

The BoI is operating primarily via the credit channel in the economy, by enabling the government, households, and businesses to borrow at interest rates as low as possible, and this without defining a long-term interest rate target. All the measures support this goal: intervention in the corporate bond market by buying the market index in order to narrow the premium and to ease capital raising by large businesses, operations vis-à-vis the banks in order that they will provide cheap loans to small businesses, and of course all prior programs that assist in financing the fiscal deficit at a low price. The possibility for an interest rate cut remains on the table, and is dependent on the assessment of the situation regarding economic developments.

Within the framework of the additional monetary measures declared this week, the BoI will start to purchase corporate bonds in the secondary market. In a special announcement it was stated that the goal of this plan is to ensure the continued orderly functioning of the corporate bond market – even though it was not stated if inappropriate activity is happening, as occurs from time to time in the foreign exchange market and leads to BoI intervention – and to strengthen the pass through from monetary policy to the credit market, by reducing the interest rate at which companies issue credit in the capital market, and making additional sources of credit available for all industries.

This is a measure that has been implemented by other central banks around the world. In the case of Israel, the actions of the central bank are only in the secondary market at this time, and not in the primary market, as initiated recently by the US Fed. Through these means, the BoI will carry some of the risk in the corporate bond market and the hope is that through this process, and its impact on the market, it will be clearly utilized in order to stabilize the Israeli business sector in this challenging period.

The BoI will purchase corporate bonds at a scope of NIS 15bn (equivalent to 1% of GDP) on the basis of a broad benchmark of securities. The benchmark includes only companies rated A- or higher, and does not include foreign companies' bonds, bonds with an equity component, or bonds that are not indexed to the shekel and are not fixed rate. We note that the market value of the Israeli corporate bond market is approximately NIS 341bn, and the benchmark covers 75% of the market. This is an initial process implemented with a limited scope, this in order to pave the way so that larger sums may be processed through this mechanism in the event the conditions will require it.

In addition to the introduction of the corporate bond purchasing mechanism, the BoI is renewing the plan under which it will provide the banking system with fixed-rate loans at a 0.1% interest rate, for a term of three years, with the goal of increasing the supply of bank credit to small and micro businesses, and to assist them in getting through the coronavirus crisis. This is the renewal of a plan originally implemented following an April 6, 2020 decision by the Monetary Committee, through which the BoI provided banks with loans at a 0.1% interest rate, for a term of three years, contingent on their providing credit to small businesses. The plan was in operation until the end of May, and through it, banks were provided with loans at a scope of NIS 4.6bn against credit extended by the banks to those businesses.

In order to ensure the continued flow of credit and particularly in the scenario of an additional increase in the severity of the economic situation, the BoI will establish an operational and legal infrastructure that will enable banks to put up mortgage portfolios as collateral against credit, through the framework of a special plan (in addition to highly liquid assets such as government bonds). This infrastructure will enable banks to extend credit under the scheme at a lower cost while maintaining high liquidity.

At the same time, we note that in June the BoI purchased NIS 4.2bn worth of government bonds, and cumulatively since the start of the plan (March 23, 2020) the central bank purchased NIS 23.4bn worth of government bonds, out of a planned sum of NIS 50bn. The governor of the BoI referred to the plan within the framework of the interest rate decision, and noted that the scope of bond purchases is likely to increase if there will be a need. Furthermore, the BoI is continuing to intervene in the foreign currency market, when it purchased US$1.4bn in June, and close to US$11.5bn since the beginning of 2020, this with the goal of moderating the appreciation of the shekel. As a result, the BoI's foreign currency reserves reached a peak of US$147bn, which is equivalent to 36.7% of GDP.

***The research department of the BoI revised downward its 2020 growth forecast***

The research department of the BoI revised downward its macro-economic forecast for 2020. On this regard, we note the words of the central bank governor, which emphasize the difficulty of formulating macro-economic forecasts at the current moment that is characterized by a high degree of uncertainty, *"It is important to emphasize that although we are presenting the figures as they derive from our calculation, it would not be correct to focus on the precise figures, as the forecast is compiled under conditions of tremendous uncertainty and it is difficult to assess the impact of the crisis on economic activity."*

The 2020 growth forecast of the research department was revised downward, and currently GDP is expected to contract 6% this year, this in light of the deterioration in the morbidity data recently, which increases uncertainty and delays the return of economic activity to "normal", and it is possible there will be an increase in the percentage closure of the economy, after approximately 12% of the economy was shut down in June, compared to 36% on April 19. The downward revision comes also in light of similar developments in some countries around the world, primarily the US and emerging market countries, such as Brazil, India, and Russia. It is important to note that the current forecast is below both the previous forecast from May (-4.5%) and also the forecast from the beginning of April (-5.3%). The downward revision in the BoI forecasts comes following a similar move by the International Monetary Fund (IMF) and the OECD regarding most of the large economies of the world.

| Forecasts of the BoI Research Department | | | | |
|---|---|---|---|---|
| | 2020 | | 2021 | |
| | Previous (May 2020) | Current (July 2020) | Previous (May 2020) | Current (July 2020) |
| GDP | -4.5% | -6.0% | 7.0% | 7.5% |
| Private consumption | -4.5% | -6.5% | 7.5% | 8.5% |
| Capital investments (excl. ships & aircraft) | -12.5% | -13.5% | 7.0% | 5.5% |
| Exports (excl. diamonds & start-ups) | -11.0% | -13.0% | 7.0% | 7.5% |
| Unemployment rate (ages 25-64; annual avg.) | 6.4% | 6.2% | 6.8% | 7.4% |
| Inflation (CPI avg. in 4Q compared with 4Q in preceding year) | -0.4% | -1.1% | -- | 0.7% |

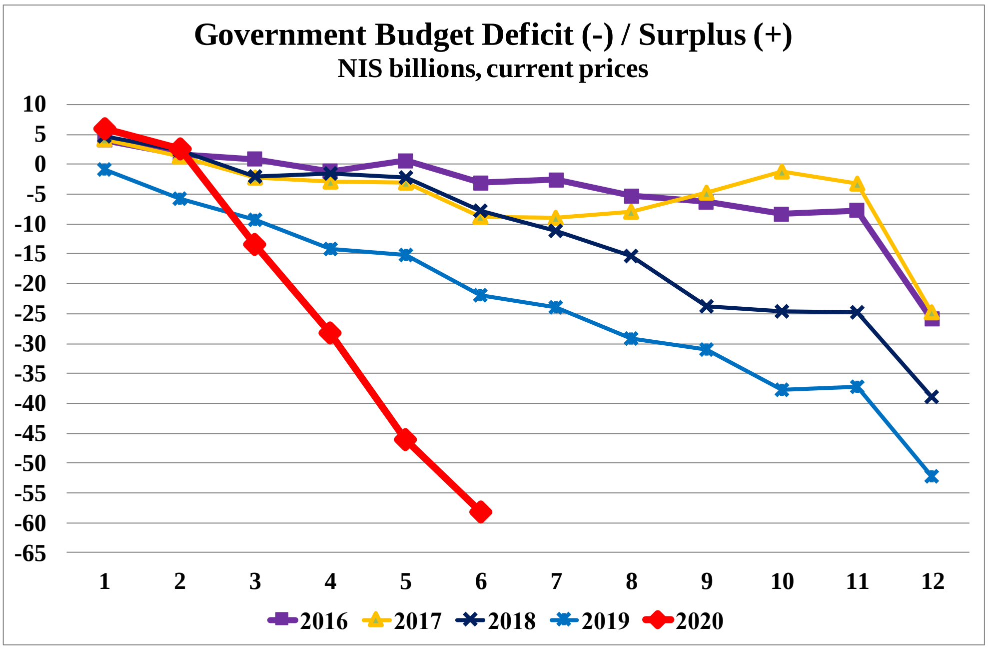
According to the BoI forecast, as a technical correction to the 2020 growth forecast, the forecast for 2021 has been revised upward by 0.5 percentage points, to 7.5% (see accompanying table). The growth components include first and foremost private consumption, which is expected to decline 6.5% in 2020. The annual decline in private consumption is extremely unusual from an historical perspective. Again, based on a technical assessment, by 2021 private consumption is expected to recover. Real investments are expected to decline 13.5% in 2020 as a result of the increase in uncertainty and the expected decline in investment activity in the economy and residential construction, and to increase 5.5% in 2021. Exports are expected to decline 13% in 2020, against the backdrop of global weakness in demand, despite positive data in the first quarter of the year. In line with the expected recovery in world trade in 2021, the BoI estimates exports will grow 7.5% in 2021.

Also according to the forecast of the research department of the BoI, in 2020 the government fiscal deficit is expected to equal 12% of GDP, this the result of the loss of NIS 55bn in revenues (3.7% of GDP) due to the slowdown in activity, and a NIS 60bn increase in expenditures (4.0% of GDP) for the purpose of financing unemployment claims and assistance measures declared by the government – this on the assumption of full performance of these expenditures (see details below). Government debt as a percentage of GDP is expected to climb to 75% in 2020, and in 2021 this ratio is expected to reach 77%.

The BoI estimates the inflation rate in the coming four quarters will equal only -0.1%, and at year-end 2021 it will equal 0.7%. The inflation forecast for the next four quarters was lowered primarily as a result of the May CPI figure, which came in below the initial forecasts, and as a result of the downward revision in the forecasts for the coming months. The expected recovery in the inflation rate in 2021 is explained by the expectations for an increase in demand, coupled with a recovery in private consumption and an expansion in public consumption, starting from the third quarter of 2020. The inflation forecast of the BoI for the coming year is substantially below that of other forecasters in the market, and slightly below the expectations of the capital market. According to the forecast, the interest rate of the BoI will stand at between 0.0-0.1% in one year from now.

***The government deficit continued to grow also in June, in parallel with relatively low performance of the government support programs***

Government activity amounted to a NIS 12.2bn deficit in June this year, compared to a NIS 6.9bn deficit in June 2019. The cumulative deficit in the first half of this year (January – June) stands at NIS 58.2bn, an extraordinarily large figure compared to parallel periods in preceding years (see accompanying chart). In addition, we note that the fiscal deficit over the last 12 months (July 2019 – June 2020) increased to 6.4% of GDP, and it is expected to continue to increase in the coming months. The impact of the coronavirus crisis on the increase in the deficit in the first half of the year is reflected in a 12.7% decline in state revenues (compared to the parallel period last year), and a 7.4% increase in government expenditures, with an emphasis on the second quarter in which government expenditures increased 18.8%.




It is important to note that 2020 has been administered until now, prior to the approval of a state budget, by a continuing budget, which is equivalent to a monthly budget of 1/12 the full year budget from 2019, with an addition with respect to CPI linkage. In addition, total surplus expenditures for dealing with the coronavirus crisis during 2020 equals NIS 50bn (not including the return of debt to the national insurance institute). Analysis of the actual budget performance vis-à-vis the ceiling set in law for the monthly expenditure shows that until now the rate of performance of the budget portion of the government assistance program is low.

Actual expenditures, through June, stood at NIS 16.4bn compared with a permitted ceiling of NIS 31bn. Furthermore, total cumulative payments to furloughed workers in the economy through the end of June, which is carried out via the National Insurance Institute, stood at NIS 5.8bn out of a total allotment of NIS 13.9bn. This is to say, it appears there are fiscal resources for supporting workers released on furlough also in the coming months.

Looking ahead, in our opinion, the 2020 fiscal deficit will equal 10% of GDP. As long as the current morbidity rate will climb and thus delay the return of the economy to full operational capacity, the government deficit will likely increase further.

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