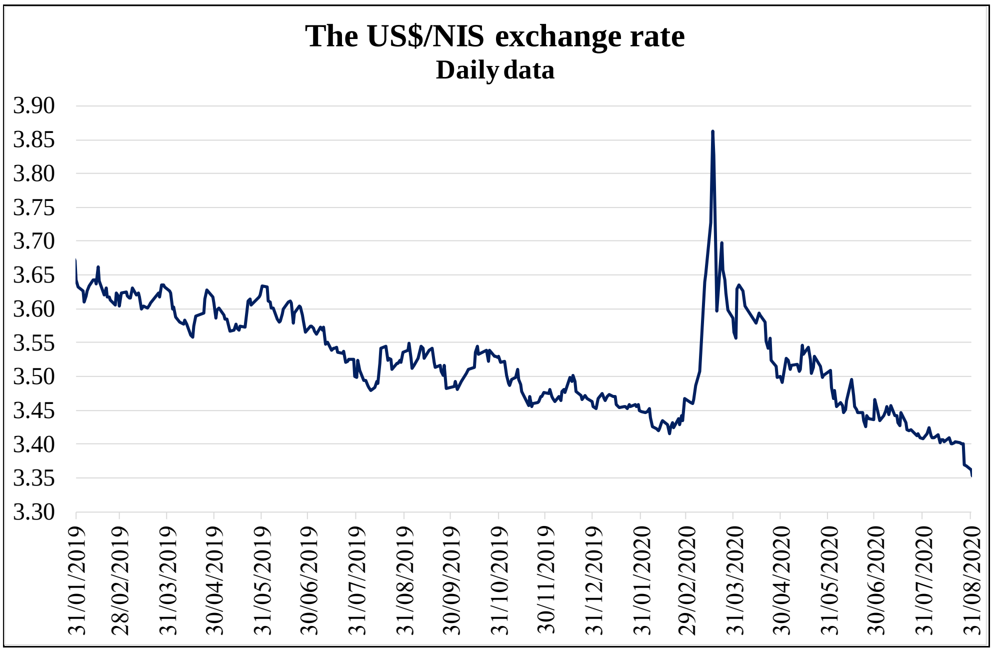
Leumi Economic Weekly

September 9, 2020

The shekel continues to strengthen, despite the coronavirus crisis and foreign currency purchases by the Bank of Israel

The shekel is continuing to strengthen, despite the deep economic crisis in which the economy finds itself during this time. In August the shekel strengthened 1.1% vis-à-vis the currency basket, while in the first eight months of the year (January – August) the shekel appreciated 2.7%, this in continuation of the 8.1% appreciation in 2019.



The shekel's strength vis-à-vis the currency basket comes against the backdrop of the currency's appreciation vis-à-vis the US dollar. During August the shekel appreciated 1.3% vis-à-vis the dollar, while year-to-date the shekel has appreciated 2.7%. The current level of the shekel/dollar exchange rate stands at below NIS 3.4, which is the lowest level registered since 2008. This has led the Bank of Israel (BoI) to start intervening in the foreign exchange market through the purchase of foreign currencies with the goal of weakening the shekel, and thus helping exporters. Through these actions the central bank also intends to assist in maintaining inflation within the price stability target range (1-3%).

The continuing strength of the shekel has led the BoI to purchase large amounts of foreign currency. Thus, in August the BoI purchased US$2.56bn in foreign currency, and since the beginning of the year the volume of foreign currency purchases stands at US$14.15bn.

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Consequently, the BoI's foreign currency reserves have increased to a total of US$161.7bn, which is equivalent to 40.6% of GDP.

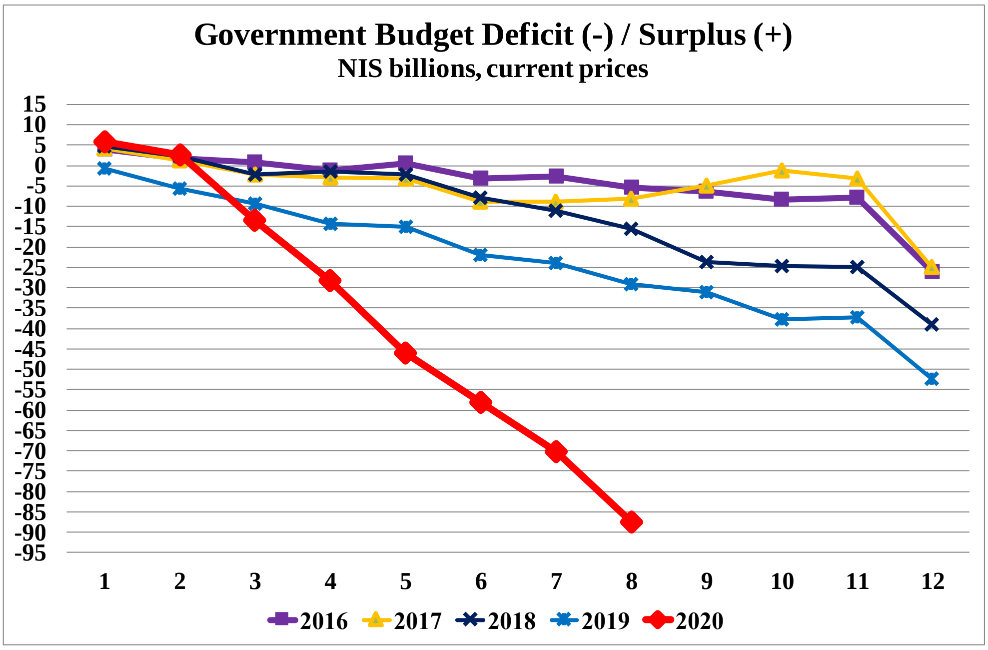
In the meeting protocols from the last interest rate decision on August 24, 2020 it states *"The exchange rate and its impact on exports, employment, and economic activity, and the return of the inflation rate to the target remain a focus of the Committee's discussion and policy decisions."* On this regard, we note that in an interview with Bloomberg news service the deputy governor of the BoI, Mr. Andrew Abir, stated that the central bank *"We certainly would not like to see a major appreciation in the shekel from these levels (less than NIS 3.40 per US$1), that will make it more difficult for the export sector."* In light of what was said, we cannot rule out the possibility of the use of additional monetary instruments in the coming months, in the event the shekel will continue to strengthen. However, an interest rate cut to a negative level remains very unlikely in our opinion.

The shekel is expected to maintain its strong level, supported by the continuing surplus in the current account of Israel's balance of payments, against the backdrop of the surplus in the country's services account. The shekel is also supported by capital inflows into the economy, with an emphasis on foreign direct investment (FDI). Furthermore, Israel's entrance into the World Government Bond Index (WGBI) also supports demand for the shekel due to the purchases of Israeli government bonds in the local market by foreign institutions.

The increase in the government deficit continued also in August; this increase is expected to continue also in the coming months

In August, government activity amounted to a deficit of NIS 17.3bn, compared to a deficit of NIS 5.2bn in the parallel period last year. It is noteworthy that the August deficit was affected by, among other things, a grant payment to each citizen, amounting to an actual cumulative cost of NIS 6.4bn. Against the backdrop of the rise in expenditures and the decline in revenues resulting from the coronavirus crisis (starting from March), the government deficit since the beginning of the year is substantially higher than the deficit registered in the parallel periods of preceding years (see Chart). Furthermore, it is important to note that the fiscal deficit over the trailing 12-month period (September 2019-August 2020) increased to 8.1% of GDP, compared to 7.2% of GDP last month, and this is expected to continue to climb also in the coming months.

The government is continuing to function within the framework of a continuing budget, since an official budget has still not been confirmed. This means the government operates with a monthly budget equivalent to 1/12 of the full year budget from 2019, with an addition linked to the consumer price index (CPI). This arrangement acts as a restraining factor on government expenditure and also limits the ability to realize changes in socio-economic policies. The Ministry of Finance (MoF) notes that due to a revision in the law, the government will be permitted to spend an additional NIS 11bn through the end of this year, or until a budget will be approved for 2020 (only 0.8% of GDP). We note that this sum does not include NIS 81.1bn in direct fiscal expenditures allocated for a specific government economic plan to assist in dealing with the coronavirus crisis. Through the end of August a total of only NIS 35.5bn of the funds from this government plan have been spent.



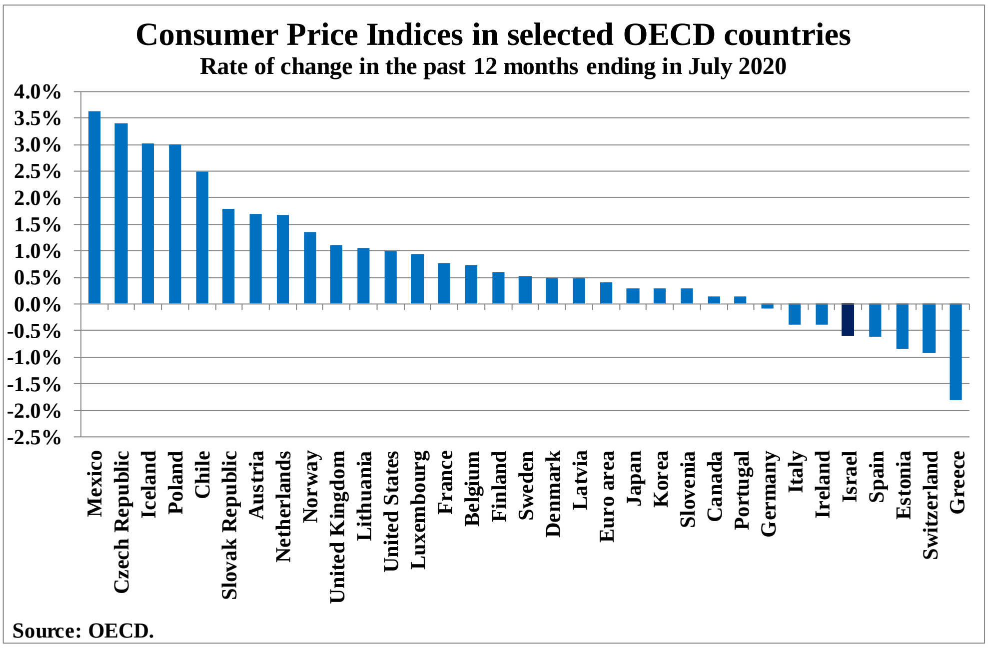
In light of the above, the deficit is continuing to swell, and in our opinion the deficit is expected to reach 12% of GDP by the conclusion of 2020, or slightly below the 13% of GDP deficit forecast of the BoI. On this regard, we note that within the framework of discussions held by the Economics Committee of the Knesset (parliament), the general-manager of the Ministry of Finance (MoF) expressed concerns that the deficit could climb to 14.5% of GDP in a pessimistic scenario, which involves an additional period of economic lockdown and a further deterioration in the country's economic situation. This compares to a forecast 13.3% of GDP deficit in the baseline scenario. In our opinion, the increase in the deficit is expected to lead to a substantial rise in the debt/GDP ratio, to a level of 75% of GDP in 2020, and to 80% of GDP in 2021, compared to a level of 60.4% of GDP in 2019, prior to the breakout of the coronavirus crisis. This translates into a NIS 280bn increase in government debt.

With respect to financing the debt, we note that from BoI data it can be seen that in recent months there has been a rise in government bond holdings by non-residents, apparently against the backdrop of Israel's entrance into the World Government Bond Index (WGBI). There has also been an increase in bond holdings by the banks, as well as by the BoI, this within the framework of the plan the central bank is implementing to guarantee the regular functioning of the markets and to support economic activity and financial stability of the economy. In August, the BoI purchased NIS 6bn worth of government bonds, which led to a rise in the cumulative value of government bond purchases to NIS 29.9bn out of total planned purchases in the amount of NIS 50bn.

In the minutes to the last interest rate decision meeting (August 24, 2020) it states, *"The Committee discussed a number of alternatives regarding monetary steps that can be implemented at this time in view of the situation in the economy. It was noted that the tools that the Committee is utilizing at this time are providing a response to the needs of the economy."* That is to say, it is expected that these plans will continue in the coming months and may even be expanded (an increase in bond purchases) as long as the deficit financing needs of the government will grow, and the BoI will want to maintain low bond yields.

Inflation in Israel is among the lowest in the OECD countries

Actual inflation in the local economy stands at minus 0.6% (July 2020 compared to July 2019). Even though it has increased compared to preceding months (from a low of minus 1.6% in May), inflation in Israel remains among the lowest in OECD countries, similar to the trend over recent years (see accompanying chart), and it is substantially below inflation in the US and Britain, and is also below the euro bloc average.



The breakout of the coronavirus and the imposition of restrictions on economic activity led to a relatively sharp drop in inflation in Israel as well as in other developed countries, against the backdrop of, among other things, the sharp fall in energy prices and the weakness in demand. Afterwards, in parallel with the gradual lifting of the restrictions on economic activity and supported by expansionary policy measures (monetary and fiscal), coupled with a recovery in oil prices, inflation started to climb, but remains below its pre-coronavirus levels.

Inflation in the developed countries is likely to continue to increase with the continuing process of the return to full activity. In the medium-term, inflation is likely to increase above the inflation targets of the leading central banks, due to the unprecedented injection of money during the time of the coronavirus crisis and the sharp increase in government debt. On this regard, we note that the US Federal Reserve Bank (the Fed) announced it was adopting a certain degree of flexibility with respect to its inflation target, in a manner that will permit the central bank to allow inflation to rise above the 2% target level for a certain period of time. This will involve taking a multi-year look at average inflation, such that periods of inflation below the target will be offset by periods in which inflation will be above the target. That is to say, there will be an inflation target that is implemented on the basis of a multi-year average, instead of looking at inflation at each point in time.

Regarding Israel, the inflation target itself is already currently more flexible – involving a range (1%-3%) and not a specific target – and it is noteworthy that inflation has been below the target for a number of years, such that it appears a step similar to that taken by the Fed is less relevant for Israel in the near term. Looking ahead, it appears that a strong shekel is expected to continue to support low inflation in Israel compared to other developed countries. In our opinion, annual inflation is expected to increase gradually during the coming year, this under the assumption that no substantial shutdown measures will be taken on the economy down the road.

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