Leumi Economic Weekly

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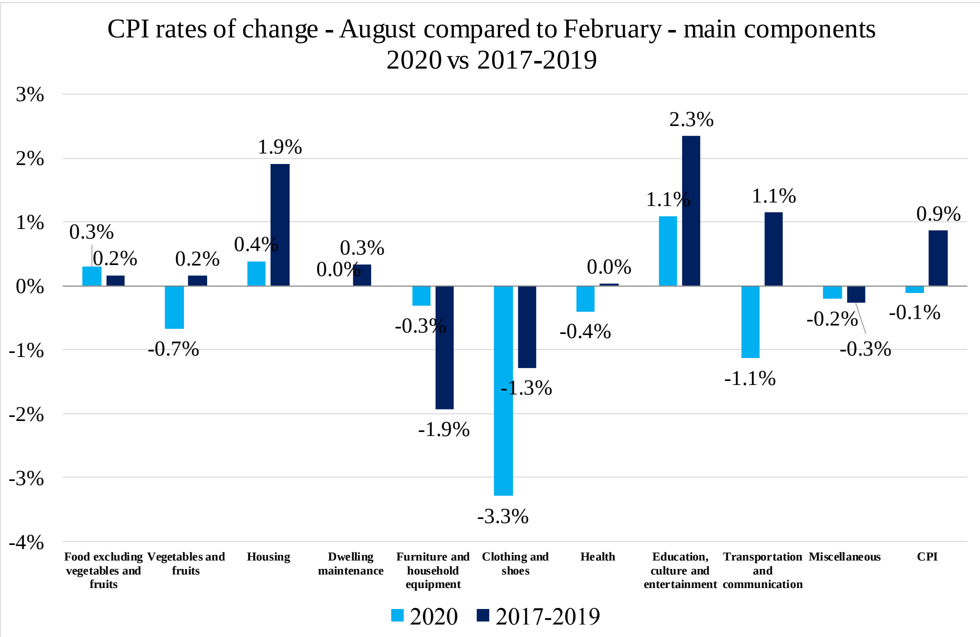
The CPI components most affected by the coronavirus crisis until now are: housing; transportation and communication; clothing and shoes; and education, culture and entertainment

The consumer price index (CPI) remained unchanged in August, this when the consensus forecast called for a 0.2% increase. Price increases were registered in the culture and entertainment component, as well as in fresh vegetables. In contrast, price declines were registered in the clothing and shoes, fresh fruits, and communication components. In addition, we note that convalescence and recreation prices increased in-line with the seasonality that characterizes these activities in August each year, yet not more than this, despite that these prices are at substantially lower levels compared to previous years and despite the rise in demand on the part of Israelis in August compared to June-July.



Another sub-component worth mentioning is that of "other housing expenditures", which falls under the housing component. Usually this sub-component is not characterized by substantial changes, such that due to its low weighting in the CPI it does not impact on inflation in normal times. However, in August this sub-component dropped sharply, in light of the cut in purchase tax on the acquisition of a second or greater housing unit (cancellation of the tax hike initiated by the previous minister of finance, Moshe Kahlon) – a development that contributed to a decline of almost 0.1% in the August CPI.

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/

The accompanying chart presents a summary of the impact of the coronavirus crisis until now on the CPI. This is by means of analysis of the August 2020 CPI (the most recent CPI) compared to the February 2020 CPI (the last CPI unaffected by the coronavirus) in a breakdown of the main components, and this compared to changes in these components in the same period in preceding years (2017-2019). As can be seen in the chart, the notable components in which negative trends were registered compared to the past in the analyzed period include: housing; transportation and communication; clothing and shoes; and education, culture, and entertainment. It should be noted that the weightings of the first two components listed are relatively high, and from this their impact on the general index is in accordance with the high weighting.

The weakness in the housing component apparently stems from the decline in the confidence level of tenants, and also from the fall in inflation expectations in the economy since the beginning of the crisis. The transportation and communication component was weighed down by the decline in the price of oil and its effect on gasoline prices; and this component was also negatively affected by the inability to directly measure the sub-component involving expenditures on overseas travel, as these prices usually contribute to an increase in the CPI during this period. Prices of clothing and shoes fell more than in previous years in light of the shutdown that affected sales volumes of the fashion companies and led them to offer aggressive sales. Meanwhile, culture and entertainment prices were pressured downward as convalescence and recreation prices eroded, against the backdrop of, among other things, a ban on the entry of tourists from abroad.

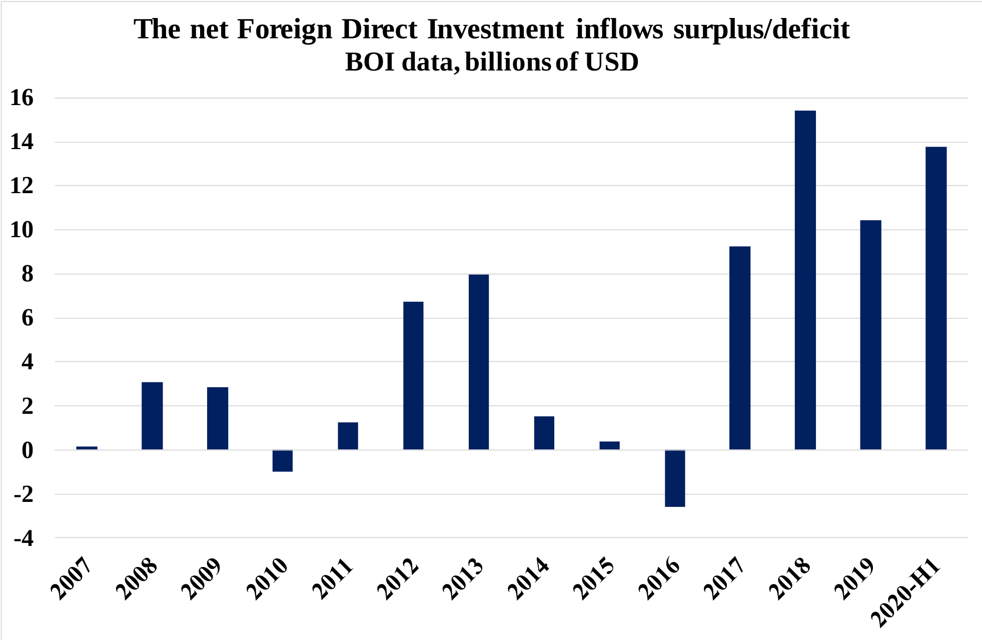
In summary, annual inflation in Israel remains low. Over the trailing 12-month period (August 2020 compared to August 2019) the CPI declined 0.8%, while the CPI excluding housing declined 1.3%. Looking ahead, in our opinion the rate of change in the CPI in 2020 is expected to be minus 0.4%-0.7%, while in the coming 12 months the CPI is expected to increase 0.7%-1.2%.

In the first half of 2020 the surplus in (net) capital inflows into the economy were maintained, and even increased compared to 2019

Recently published data from the Bank of Israel (BoI) show that direct investment inflows into Israel stood at US$10.8bn in the second quarter of 2020, which is double the amount registered in the first quarter of the year. In total, in the first half of 2020 foreign direct investment (FDI) amounted to US$15.9bn, compared to US$19.0bn in all of 2019.

The BoI notes this increase occurred partially as a result of the acquisition of an Israeli company operating in the semiconductor industry. However, it is important to note that this investment was offset for the most part by the realization of financial investments in stocks by non-residents, most of which were held by foreign investors. Thus, the BoI notes that this investment did not impact the local market.

On the other hand, the flow of direct investments overseas by Israelis equaled US$1.0bn in each of the first two quarters of the year. In total, the surplus in direct investment inflows (capital inflows minus outflows) amounted in the first half of the year to US$13.8bn, which is greater than the surplus in 2019, yet lower than that in 2018 (see accompanying chart).

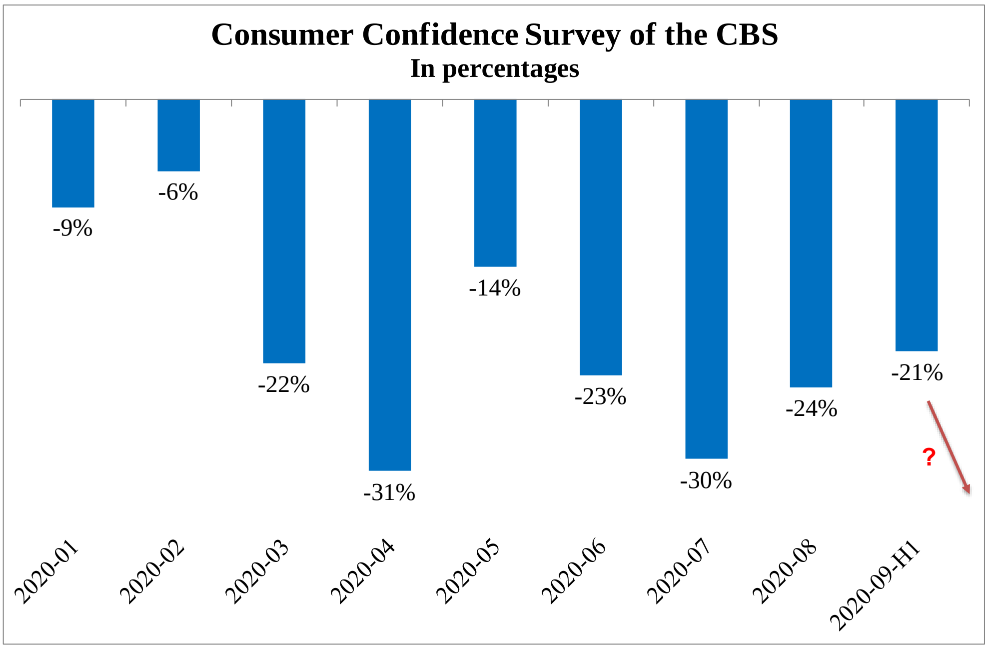


The flow of financial investments in Israel by non-residents stood at US$6.4bn in the second quarter of the year, compared to US$3.4bn in the first quarter. This increase occurred against the backdrop of a flow of financial investments in government bonds (US$12.5bn), primarily as the result of a bond issue of the Israeli government (in foreign currency) overseas. In the opposite direction, the flow of financial investments overseas by Israelis amounted in the second quarter of the year to US$11.7bn, compared to a net realization of US$1.7bn in the first quarter of the year. This comes against the backdrop of net investments in foreign bonds, and also by a more moderate degree in stocks. The bulk of investments were carried out by institutional investors and the banks. In total, a moderate deficit of US$0.2bn was registered in financial investment inflows in the first half of 2020.

In summary, the total surplus in capital inflows into the economy (direct and financial investments) in the first half of 2020 amounted to US$13.5bn, following a surplus of US$3.8bn in 2019. As long as the scope of investments will continue at the current pace, it appears that 2020 will conclude with a substantial surplus in capital inflows (see accompanying chart). The figures reflect confidence in the Israeli economy, despite the crisis. This development, together with additional factors, such as the continuing surplus in the current account of the balance of payments and Israel's entrance into the World Government Bond Index (WGBI), represent factors that support the strength of the shekel also in the remainder of the year.

Expectations for an increase in the degree of pessimism among households in the near term, against the backdrop of the economic lockdown during the Jewish holiday season, a process that is expected to hurt primarily lower income households

According to data from the Central Bureau of Statistics (CBS), consumer confidence in the first half of September improved slightly compared to August. The current level is indeed higher than that in July, at the time of the start of a second wave of coronavirus infections in the country, yet still low compared to the pre-coronavirus crisis levels.



It is nonetheless important to note that the index measuring large purchases by households deteriorated slightly compared to the second half of August, and continues to express the damage caused by the coronavirus crisis to household income, which negatively affects the readiness of households to consume.

On this regard, we note that the Director of the research department of the BoI, Prof. Michel Strawczynski, referred to the damage to household income caused by the coronavirus crisis. In an analysis he presented it is claimed that the period of the second economic shutdown, which the country is currently experiencing, is expected to lead to damage to economic activity that will apparently lead to an additional wave of workers released to unpaid vacation and to layoffs.

On the other hand, he noted a number of points that are likely to mitigate the damage to activity during the period of the current economic shutdown, including: the fact that the economy is better prepared during the current period for working from home, the fact that there are many places of work that usually are closed down anyways during the Jewish holiday period, and the assistance from expanding and extending government support to both businesses as well as workers.

The Director of the research department notes that more severe damage to the income of households will occur with differences among the different strata of households. In his words, the damage will continue to be concentrated primarily among households in the lower economic deciles (1-4), and in households in which at least one income earner is independent. Although in May-June there was a decline in the severity of the damage to the different categories of households, the damage worsened slightly in July and is expected to worsen even more so in September-October against the backdrop of the economic closure during the current Jewish holiday period. This will be with an emphasis on households whose income earners are employed in the sectors most severely hurt by the coronavirus crisis. These sectors are characterized by below average salaries and include: hospitality and food services; art, entertainment, and leisure; as well as trade and other services. Therefore, this situation is expected to primarily hurt the households at the lower economic deciles.

In summary, the current crisis is characterized by inconsistencies in the severity of damage to the economy and to the Israeli public. For the most part, this situation will cause especially heavy damage to sections of the population and to sectors that were weak to begin with, and in which for the most part low wages are paid out. Sectors that will experience substantial damage include the leisure and entertainment, tourism, food services, and other sectors. The current economic shutdown is expected to intensify the damage to these groups.

Authors: Dr. Gil Michael Bufman, Yaniv Bar, and Gili Ben-Avraham