Leumi Economic Weekly

October 28, 2020

The Bank of Israel is deepening monetary expansion through credit instruments and not by an interest rate cut

The Monetary Committee of the Bank of Israel (BoI) decided in its October 22nd meeting to leave the central bank interest rate unchanged at 0.1%, in-line with the *Bank Leumi* forecast. Yet, the BoI launched a "targeted credit" plan that it will offer to the banks in order to channel credit at a low interest rate (not exceeding Prime + 1.3%) to small and micro businesses, while requiring low margins. It should be noted that the BoI chose not to fully adopt the program established by the European Central Bank (ECB), the Targeted Longer-Term Refinancing Operations (TLTROs), which enables accessibility to subsidized resources only to banks that increase their credit balances beyond certain threshold levels. We estimate that the potential efficiency of this program is impaired by the fact that the BoI implements the local "targeted credit" program not according to the ECB's parameters, but according to a different approach.

Over recent months the BoI has been emphasizing the "credit channel" as the path through which it acts in order to support the economy and employment. This development is reflected in the range of credit and liquidity measures the BoI offers to markets and the financial system, as well as in accompanying measures, such as reducing certain components of the banks' liquidity obligations in recent months and reducing interest rates on "targeted credit" in the latest decision.

In the words of the central bank, *"In view of the magnitude of the crisis's adverse impact on economic activity, the Committee continues to utilize a range of tools in order to increase the extent of the monetary policy accommodation and to ensure the continued orderly functioning of the financial markets. The Committee will expand the use of the existing tools, including the interest rate tool, and will operate additional ones, to the extent that it assesses that the crisis is lengthening and that it is necessary in order to achieve the monetary policy goals and to moderate the negative economic impact created as a result of the crisis."* This statement leaves the "door open" for further measures later on, including an interest rate cut, yet with an emphasis on credit and liquidity measures.

Accordingly, the BoI, which launched a couple of months ago a NIS 50bn government bond purchasing program in the secondary market with the goal of easing credit terms in the economy and supporting economic activity as well as financial stability, decided to increase the purchase program by an additional NIS 35bn.

The research division of the BoI published an update to its macro-economic forecasts. The forecasts includes two baseline scenarios – a scenario characterized by full control over the development of coronavirus morbidity, together with a scenario characterized by minimal control over the development of morbidity. In the scenario involving full control

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over morbidity, the GDP is expected to contract 5.0% in 2020 (see accompanying table). It is important to note that the current forecast of the BoI's research division is very close to the various components of our forecasts at *Bank Leumi*. In this scenario, no further extensive shutdowns or substantial downtime in economic activity are expected.

Accordingly, in the scenario in which control over morbidity is achieved, growth in 2021 is expected to be relatively high, at 6.5%. In this scenario, the "broad" unemployment rate is expected to reach 16.7% of the workforce in the final quarter of 2020, and to decline gradually to 7.8% by the end of next year. The government deficit is expected to equal 13% of GDP this year, and to fall to 8% of GDP in 2021. Hence, the debt/GDP ratio will increase to 73% by the end of this year, climbing further to 76% next year. These forecasts are similar to the forecasts *Bank Leumi* has held since mid-August.

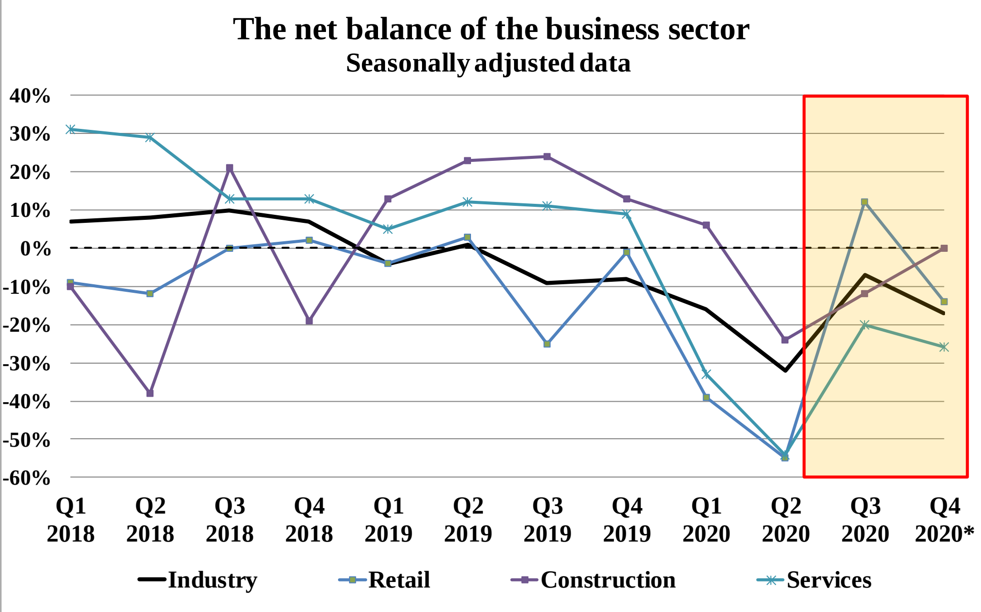
Forecasts of the BoI research division – scenario involving full control over morbidity				
	2020		2021	
	Previous (Aug. 2020)	Current (Oct. 2020)	Previous (Aug. 2020)	Current (Oct. 2020)
GDP	-4.5%	-5.0%	6.0%	6.5%
Private consumption	-7.5%	-8.9%	9.0%	9.9%
Investment in fixed capital goods (excl. ships and aircraft)	-7.5%	-7.7%	4.5%	3.9%
Exports (excl. diamonds and start-up companies)	-4.0%	-3.6%	4.0%	3.9%
Broad unemployment rate (persons aged 15+, annual average)	13.9%	15.7%	9.5%	10.0%

In the scenario involving minimal control over morbidity, GDP is expected to contract 6.5% in 2020, while next year growth will amount to only 1.0%. The "broad" unemployment rate is expected to reach 20.2% during the final quarter of 2020 (a period of economic shutdown), falling to as low as 13.9% only towards the end of next year. The government deficit is expected to equal 13% of GDP in 2020, dropping to 11% of GDP in 2021, such that the debt/GDP ratio will rise to 75% by the end of this year, and climbing further to 83% next year.

In each of the two scenarios, the BoI expects its central bank interest rate will range between 0% - 1.0% in a year from now. However, in the event of deterioration of the situation, and particularly if the scenario involving only minimal control over morbidity will be realized, then the BoI will implement a variety of measures, including the possibility for, as mentioned above, an additional cut in the interest rate, in accordance with developments.

Recovery in the activity of most sectors in the third quarter of the year; however, a slight deterioration is expected in the fourth quarter

The Companies Survey of the BoI, which is based on qualitative, and not quantitative, reports of companies from chosen sectors within the overall business sector, indicates continuing contraction in business sector activity in the third quarter of the year, but by a more moderate rate compared to the second quarter of the year, which represented a low from an historical perspective (since at least 2000). The net balance, which is the percentage of companies reporting an increase in activity minus the percentage of companies reporting a decline in activity, of the overall business sector increased relatively sharply, yet remains within negative territory (minus 17% compared to minus 47%).



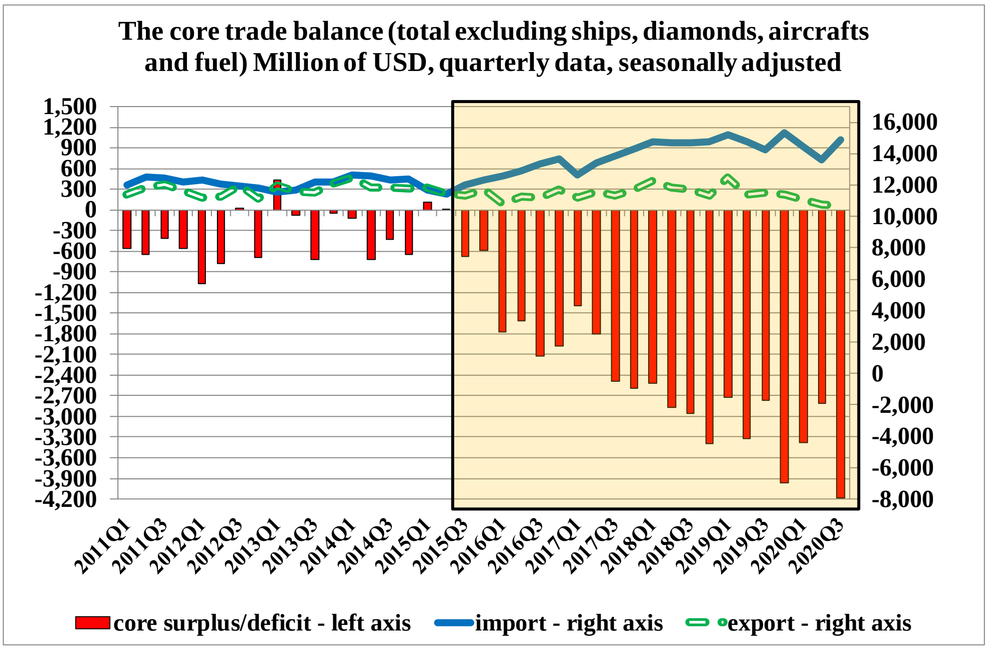
* Expectation for the activity in Q4/20. original data. the industry figure refers to the local sales.

The findings of the survey, which was conducted from mid-September through the third week of October (that is to say, during the period of the second shutdown of the economy since the coronavirus outbreak), indeed indicate recovery in most of the sectors within the overall business sector in the third quarter of the year, which was characterized for the most part by a less substantial degree of severity in restrictions on economic activity compared to the second quarter. However, the net balances of the sectors (with the exception of retail trade) remained in negative territory, and continued to indicate contraction in activity, yet by a more moderate scale. Regarding the fourth quarter of the year, there are expectations for a deterioration in activity in most of the sectors (except for construction), apparently against the backdrop of the shutdown in the country during the recent Jewish holiday period that started on September 18 and continued for one month under a tight regime of restrictions (see Chart 1).

Overall, the survey data reflect the recovery in activity following the economy's exit from the first shutdown (that is to say, during most of the third quarter of the year), and the expectations for a deterioration in activity in the fourth quarter of the year, resulting from the tightening of restrictions on activity. However, it is important to emphasize that the scale of the decline is expected to be substantially more moderate compared to the first economic shutdown, during which time the restrictions on movement, economic activity, and social distancing were more severe. These findings are consistent with recent indicators on economic activity, such as credit card expenditures (according to BoI data), which increased during most of the third quarter in a majority of the sectors of activity, yet towards the conclusion of the quarter started to decline. As long as the process of exiting the shutdown continues, and the return to normal activity will carry on without substantial delays and without the need for the implementation of additional restrictions, it appears activity will continue to recover during the final quarter of 2020, and into 2021.

An increase in the core trade deficit in the third quarter of the year, resulting from a sharper increase in goods imports compared to exports

The export of goods from Israel amounted to US$10.7bn in the third quarter of the year (excluding ships, aircraft, and diamonds; seasonally adjusted data). This represents a moderate decline of 0.7% compared to the preceding quarter and a 6.9% decline compared to the third quarter of 2019 (in current dollar terms). Increases were registered in, among other things, exports of the electronics sectors (excluding electronic components), pharmaceuticals, rubber and plastic, and transportation and shipment. On the other hand, relatively sharp declines were registered in the exports of chemicals and metal products.



Goods imports (excluding ships, aircraft, diamonds, and energy products) amounted to US$14.9bn, reflecting an increase of 9.6% compared to the preceding quarter and an increase of 4.3% compared to the parallel quarter in 2019. Increases were registered in each of the import components; however, the increase in the imports of consumption goods and investment products was more substantial than the increase in the import of raw materials, which was relatively moderate. This development is consistent with the recovery in activity in the third quarter of the year.

As can be seen in the accompanying chart, in light of the more rapid increase in imports than in exports, the core trade deficit (excluding ships, aircraft, diamonds, and energy products) increased in the third quarter of the year, and reached a peak level of US$4bn. In total, the core trade deficit in the first three quarters of 2020 amounted to US$10.3bn, which is 15% higher compared to the parallel period last year (a deficit of US$8.8bn). As this development becomes reflected also in the country's national accounts data in the third quarter of the year, which is scheduled to be published next month, it is expected to moderate the GDP growth rate. Looking ahead, we estimate both the imports and exports of goods are expected to contract during 2020 in light of the negative effects of the coronavirus crisis, and in the baseline scenario, the year 2021 is expected to be a year of recovery, depending on developments surrounding the spread of the coronavirus.

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