Leumi Economic Weekly

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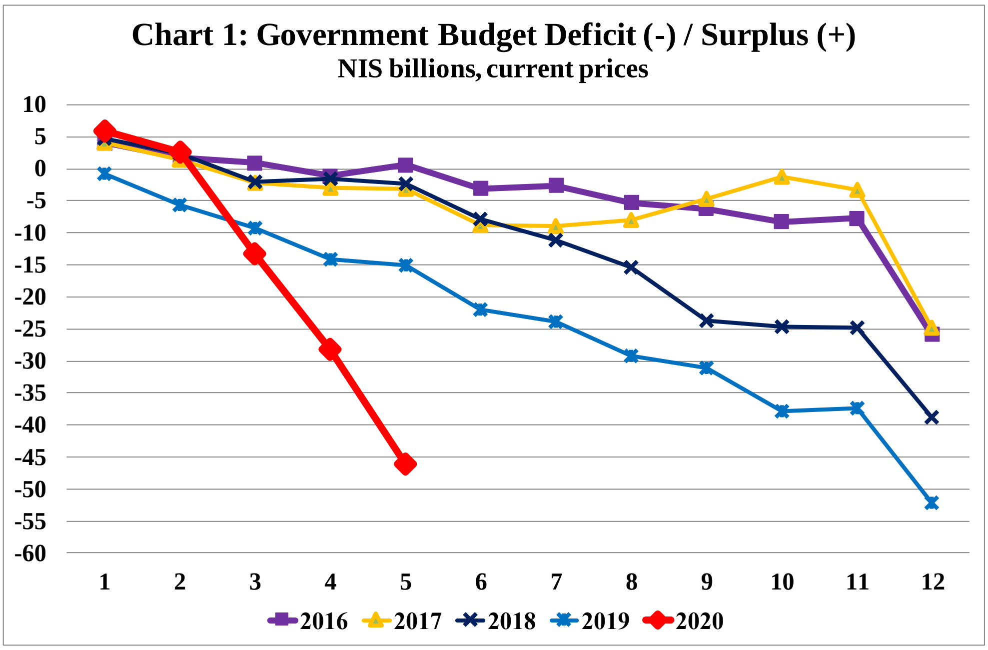
The fall in government revenues is continuing in the shadow of the coronavirus crisis, alongside a relatively low implementation of government support programs. However, the deficit increase is likely to be more moderate than the Ministry of Finance forecast

Government activity amounted to a NIS 17.9bn deficit in May this year, compared to a NIS 1.0bn deficit in May 2019. The cumulative deficit over the first five months of the year (January – May) stands at NIS 46.2bn – unusually high compared to parallel periods in preceding years (see Chart 1). In addition, the budget deficit over the trailing 12-month period (June 2019 – May 2020) increased to 6.0% of GDP, compared to 4.8% of GDP in the preceding month, and this figure is expected to continue to climb throughout the remainder of the year.



As was noted in the Ministry of Finance (MoF) announcement, the effects of the spread of the coronavirus in Israel on economic activity and on the government budget began to be evident starting in March. This comes against the backdrop of the government's and the economy's response in dealing with the coronavirus crisis, both on the medical front, and also on the economic front. The coronavirus crisis led, as mentioned, to a sharp increase in the budget deficit. This increase occurred against the backdrop of a sharp (cumulative) decline of 27% in state revenues (nominal rates of change, compared to the parallel period in the preceding year) in March – May, as a result of the loss of activity resulting from the government initiated shutdown of the economy and the effects of "automatic stabilizers", and also due to a 14% increase in government expenditures during these months, against the backdrop of the government support in the economy at this time.

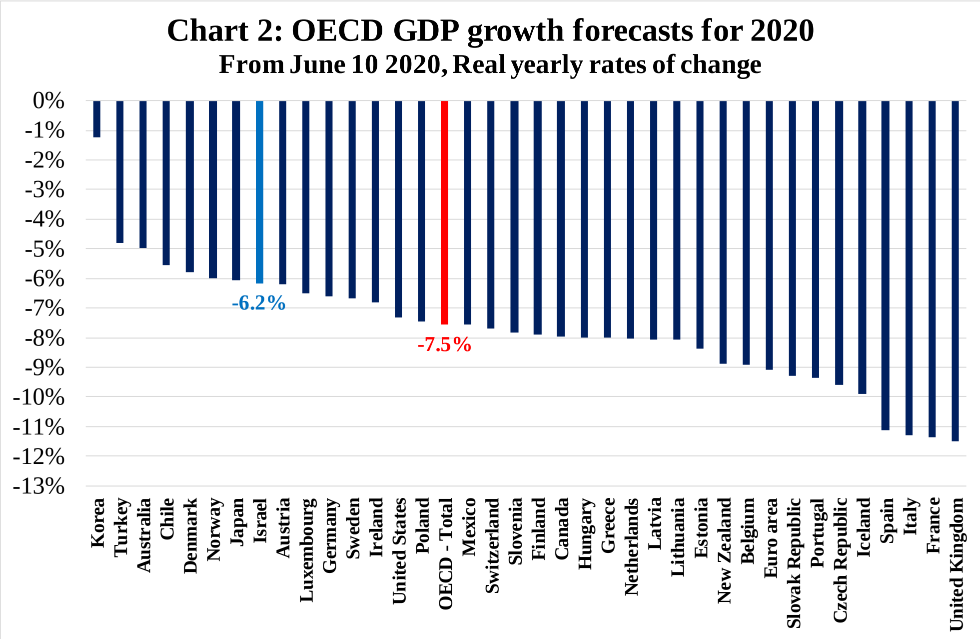
Regarding the revenue side, we note that in light of the fact that the average salary of the employees who stopped working during this period (approximately 1.5m employees as of April, according to the workforce surveys of the Central Bureau of Statistics) is substantially below the average salary in the economy, this according to the survey from the chief economist of the MoF, the fall in government revenues from direct taxes (income tax) from the beginning of the year, approximately 3% (in real terms, compared to the parallel period last year), was less than the decline in revenues from indirect taxes (for example, VAT), approximately 10% (in real terms). In light of the fact that most of the employees who stopped working pay less tax, the damage to state revenues was lessened.

It is important to note that 2020 has been administered until now, prior to the establishment of the government and the approval of a state budget, under the framework of a continuation budget, which involves a monthly budget equivalent to 1/12 of the 2019 full year budget, with an addition according to the CPI. It is important to note that according to reports in the press, it is likely the continuation budget is expected to continue until October. In the beginning of April, an additional expenditure was approved for the government, under a temporary framework, to assist the economy to overcome the coronavirus crisis during 2020. This additional expenditure was set at NIS 50bn (including the return of debt to the National Insurance Institute), which is equal to slightly less than 4% of GDP.

An examination of the actual performance of expenditures against the quota stipulated in the monthly deployment law, indicates that so far the rate of implementation of the active part of the government plan, as well as the rate of expenditure under the continuing budget, has been moving relatively slowly. Thus, the actual total expenditures that are not for the purpose of responding to coronavirus matters equaled NIS 160.5bn in January-May this year, compared to a permitted quota of NIS 167.0bn; and the actual total sum of expenditures carried out for the purpose of responding to coronavirus related matters equaled NIS 12.3bn, compared with a permitted quota of NIS 17.6bn.

Looking ahead, in our opinion, the 2020 budget deficit will equal 8%-9% of GDP, which is below the estimate of the MoF and the Bank of Israel (BoI), according to which 2020 is expected to conclude with a budget deficit of more than 10% of GDP. It is important to note that the total expected deficit reflects a more substantial impact from passive fiscal policy factors, such as automatic stabilizers and a decline in revenues from indirect taxes. This compares to a relatively moderate impact on the deficit deriving from active measures, from within the budget, with the implementation of fiscal policy. In light of the fact that the gradual return of the economy to activity is occurring somewhat quicker than what was expected by the BoI, it appears that the economic damage will be more moderate, and as a result there is also less pressure to increase the deficit.

Regarding the growth forecasts for 2020, we note that in the last update of the research department of the BoI (May 2020), the growth forecast was revised to be slightly less negative (from minus 5.3% to minus 4.5%), and in this manner moved in the direction of the minus 2.7% forecast of *Bank Leumi* from the end of March. In addition, from the June 10 revised forecasts of the OECD, it can be seen that in the scenario that does not assume a second wave of virus infections in the summer of 2020, Israel is one of the countries that is hurt to a lesser degree by the coronavirus crisis in 2020 (see Chart 2). In terms of growth per capita, Israel stands out even more positively.



Thus, relative to OECD countries, the damage to the Israeli economy is expected to be more moderate. In light of this, and due to the findings of the analysis of the BoI regarding the better containment of the virus in Israel compared to the OECD, it appears it will be possible to return to a renewed opening of economic activity more quickly. This is of course under the assumption that the current rise in virus infections does not indicate an expected occurrence of a new wave of morbidity that will require a renewed shutdown of the economy.

Indicators on May activity show a continued contraction in the US economy, albeit more moderate than April's contraction

May data show some moderation in the intensity of the impact of the coronavirus crisis on the US economy. The rise in the consumer confidence index, coupled with the decline in May's unemployment rate to 13.3%, shows the positive contribution of the US government's fiscal efforts, suggesting the economy may gradually recover as the spread of the coronavirus in the US is halted. The rise in the consumer confidence index is consistent with the assessment that most households are still not facing substantial economic pressure. For example, the number of home renters who did not pay rent in April was only 3% higher than last year. Also, the moderation in the number of new unemployment claims during May indicates that the intensity of the crisis has moderated; nonetheless, the number of continuing unemployment claims remains very large compared to the period before the spread of the coronavirus. Preventing any deterioration in the status of US households is expected to require the local and the federal governments to make substantial transfer payments.

In May, 2.5m new employees were added to the economy and the unemployment rate fell from 17.4% in the beginning of the month to 13.3% by the end of the month. The drop in unemployment was faster than expected, with "technical" aspects that may very well reflect considerable problems with respect to measuring the data. Thus, the decline in the unemployment rate comes as a result of an increase in the workforce participation rate, which increased in May from 60.2% to 60.8%; however, this level is substantially below the 63.4% workforce participation rate in February. This means there are a large number of unemployed people who are not actively looking for work and are not included in the official unemployment rate. Also, part of the increase in the number of employees likely stems from the government's Paycheck Protection Program (PPP), which incentivizes small business owners to continue to employ workers by providing a federal government subsidy. In the hospitality and leisure sector, the most severely affected industry in the current crisis, with employment plummeting 45% in April, an additional 1.24m employees were added. In the construction sector, approximately 500,000 employees were added, and in the health and education sectors 400,000 employees were added.

The initial indicators for May show continued economic contraction, but by a more moderate rate than in April. The May PMI remained also this month below 50 points, indicating continued contraction of the American economy, both in the manufacturing and the service sectors. However, the services sector is likely to contract slightly more than the manufacturing sector. The composite PMI increased in May from 27.0 to 36.4, while the PMI of the manufacturing sector increased from 36.1 to 39.8 and the PMI of the services sector increased from 26.7 to 36.9. Looking ahead, we forecast a 5.4% contraction in US GDP in all of 2020 – a more moderate rate than that included in the revised forecast of the OECD. With the halt in the spread of the coronavirus and the return to economic activity, the unemployment rate is expected to return to a single digit number.

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