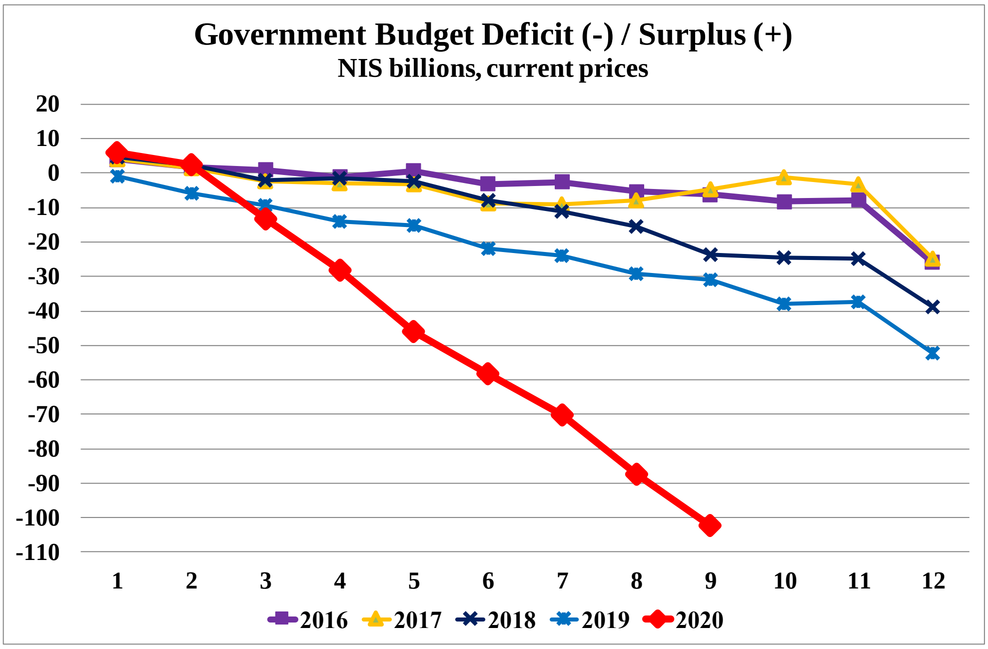
Leumi Economic Weekly

October 14, 2020

The sharp increase in the government deficit continued in September; the deficit is expected to continue to increase also in the coming months

Government activity in September this year amounted to a NIS 14.9bn deficit, compared to a deficit of only NIS 1.9bn in September last year. Furthermore, the cumulative deficit in January-September this year amounted to NIS 102bn, which is substantially higher than the deficit registered in the parallel period of 2019 (NIS 31bn) and in previous years. This comes against the backdrop of the rise in government expenditures and the drop in revenues resulting from the coronavirus crisis (starting in March this year). Thus, in the first nine months of 2020 government revenues declined 10%, while at the same time government expenditures increased 16% (nominal rates of change).



The budget deficit over the trailing 12-month period (October 2019-September 2020) increased to 9.1% of GDP, compared to 8.1% of GDP last month, and this figure is expected to continue to climb also in the coming months.

In light of the above, we forecast the deficit will continue to increase in the coming months, such that 2020 will conclude with a deficit equal to 12% of GDP, while in 2021 we expect a high, single-digit deficit. This development is expected to lead to a sharp increase in Israel's debt/GDP ratio, to a level of 72% of GDP in 2020 and approximately 80% of GDP in 2021, compared to less than 60% of GDP in 2019, prior to the coronavirus crisis. The figures represent an increase of more than NIS 280bn in government debt.

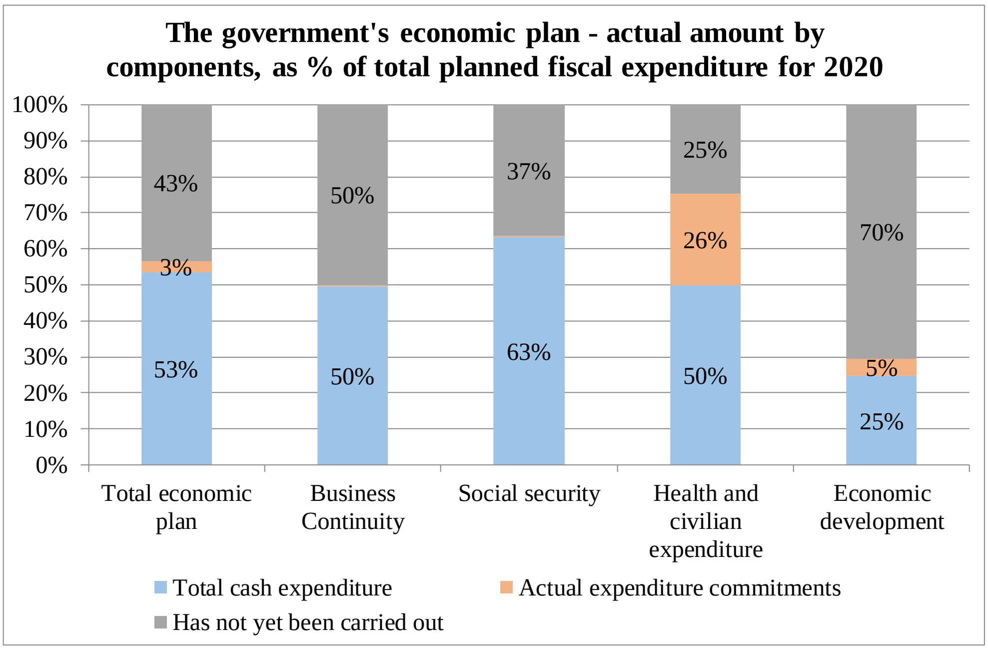
BANK LEUMI LE-ISRAEL, THE CAPITAL MARKETS DIVISION
The Economics Sector, P.O.Box 2, Tel Aviv 61000
Ph: 972-76-885-8737, Fax: 972-77-895-8737, e-mail: Gilbu@bll.co.il
http://english.leumi.co.il/Home/

Indeed, against the backdrop of the low interest rates currently in the economy, the service of this debt will not greatly increase government expenditures in the coming years; however, difficulty is likely to arise primarily when it comes time to repay the capital, due to its extreme scale.

Regarding the financing of the deficit, we note that since June 2020 the proportion of financing the debt from the local market has been increasing. In order to assist in this finance burden, which is growing rapidly, in September the Bank of Israel (BoI) continued to purchase government bonds in an amount totaling NIS 3.7bn, which has led to an increase in the cumulative volume of government bond purchases to NIS 33.6bn, out of NIS 50bn in total planned purchases. As long as the financing needs of the deficit will grow, in parallel with the desire of the BoI to continue to maintain relatively low yields-to-maturity on Israeli government bonds, while at the same time guaranteeing a relatively high degree of liquidity in this market, the central bank's bond purchasing plans are likely to continue in the coming months, and may even increase above the original NIS 50bn framework.

The lack of long-term plans to return to fiscal balance is likely to lead to criticism, and even a negative response, by international credit rating agencies

The pace of performance of the government's economic plan to help overcome the coronavirus crisis remains low. It is important to note that the gap between what has been planned and what has actually been carried out, in a monthly breakdown, is in a widening trend. Out of a total cumulative ceiling expenditure (according to law) of NIS 58bn, only a total of NIS 43bn has been spent through the end of September. Including future liabilities, an actual sum of NIS 48bn has been spent from the state budget, out of a total planned sum of NIS 85bn. The amount spent until now represents fiscal support equal to 3.5% - 4.0% of GDP, which is low compared to the government support provided in most of the developed countries of the world. Furthermore, analysis of the rate of actual performance of the government plans as a percentage of the total planned for 2020 shows that 43% of the total economic plan has not yet been carried out (see accompanying chart).



Excluding the government plan for dealing with the coronavirus crisis, the government is continuing to operate this year under a continuing budget, since a budget law has still not been confirmed. A continuing budget permits a monthly budget equal to 1/12 of the full year budget from the preceding year, with an addition linked to the consumer price index (CPI). As we noted in previous weekly surveys, this development represents a restraining factor on government expenditure, which also limits the ability to plan and to realize important changes in socio-economic policies.

In Israel, the budget approval process for 2020-2021 remains unclear (historically, it has been customary for the government budget approval process for each year to take place in the summer months in the preceding year), and furthermore, an orderly plan looking several years ahead to deal with the on-going budgetary imbalance left by the coronavirus crisis has not yet been released. Yet, there are countries around the world that have already started planning for their budgetary convergence in the longer term.

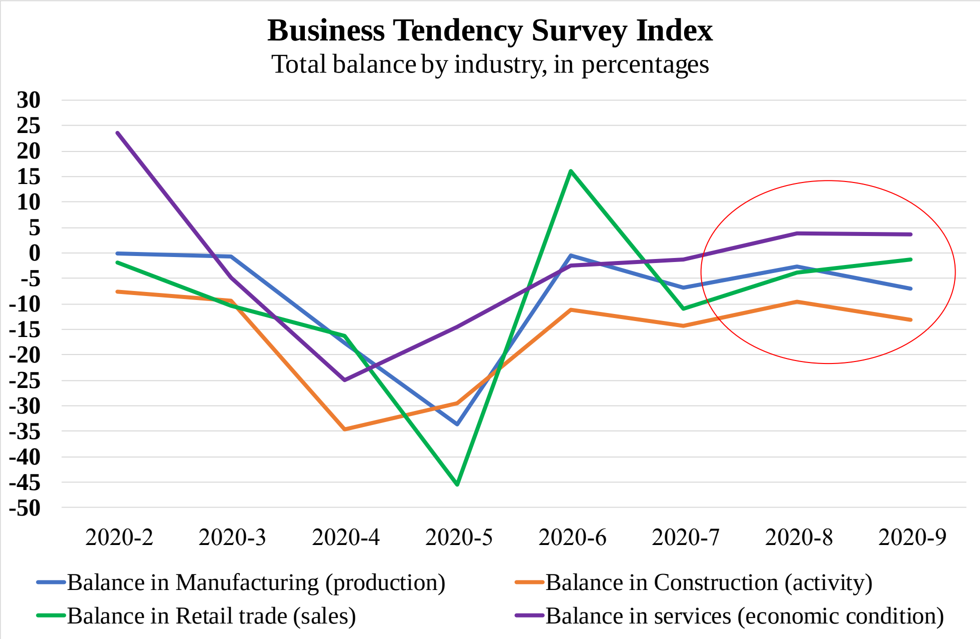
For example, South Korea, an economy with a similar credit rating to that of Israel (rated 'AA' by S&P) and one of Israel's peer countries in an international comparison, according to both the Ministry of Finance (MoF) and the BoI, has already started to plan fiscal rules (that have not yet received parliamentary approval) stipulating that the country's debt/GDP ratio will not breach a 60% of GDP ceiling, and the government deficit will not rise above 3% of GDP. These measures will be implemented starting in 2025, by which time it is expected the need for fiscal support as a result of the coronavirus crisis will substantially diminish. It is important to note that the credit rating agencies reacted positively to South Korea's plans. The contrast between South Korea's pro-active approach and the current situation in Israel is stark.

Looking ahead, in light of the deterioration in Israel's fiscal profile, parallel to the delay in approving a budget and the lack of any forward planning in the medium-term, in contrast to what can be seen occurring in other countries, there is a concern that credit rating agencies will reconsider taking action with respect to the credit rating outlook on the Israeli economy. It is important to note that a downgrade on the part of the rating agencies is likely to weigh in the future on the government's fund raising costs, which is especially important at the current moment involving an expanding government deficit, and there is increasing need to finance this deficit by, among other ways, external debt in order to slightly ease the pressures in the domestic bond market. This is all in order to keep the yields-to-maturity of domestic bonds at a low level in such a way that it will indirectly support local economic activity.

The possibility for an increase in fundraising costs for the government is expected to increase the debt servicing payments on government debt. This development is likely to weigh on the state budget in the coming years, in a manner that will come at the expense of civilian expenditures and other pro-growth endeavors, and will also make it difficult for a renewed convergence to a downward path in the debt/GDP ratio.

An increase in the degree of pessimism within the business sector regarding economic activity

As can be seen in the accompanying chart, the Business Tendency Survey of the Central Bureau of Statistics (CBS) indicates slight declines in the net balances (the weighted difference between the percentage of company managers reporting an improvement in their situation and the percentage of company managers reporting a deterioration in their situation) in the leading indices of most of the sectors in September. This is in contrast to the improvement registered in these indices in August.



The CBS notes in its accompanying announcement that the results of the survey were methodologically adjusted for the many changes that occurred during the month, including the economic shutdown imposed on September 18, which affected the survey findings. It seems the current level of indices does not reflect the severity of the shutdown in economic activity, a development that is likely to be reflected in the October survey, in light of the deterioration in expectations in most of the indices on economic activity.

Analysis of data on credit card purchases through mid-October, data that is published by the BoI, shows that the sum of purchases is substantially below the levels from the early part of 2020. The decline in purchases, which started in parallel to the announcement of the economic shutdown, was broad and evident in all the sectors of activity. However, it seems that in recent days there has been a slight recovery in the purchases of electronic goods, clothing and furniture, as well as in gasoline and transportation, but as mentioned, all in all, the level of activity remains low.

The negative impact of the shutdown on economic activity is expected to be expressed in a sharp decline in GDP in 2020. On this regard, we note that the International Monetary Fund (IMF) published on October 13 its updated macro-economic forecasts. Within the framework of the update, the growth forecast for Israel in 2020 was revised to be slightly less negative, from minus 6.3% (in April) to minus 5.9%, and it is currently close to our forecast at *Bank Leumi*.

However, it is important to note that the current IMF forecast reflects slightly more substantial damage deriving from the coronavirus crisis on the Israeli economy in 2020, compared to the average in the developed countries (an average of minus 5.8%). This is in contrast to the revision from April, at which time the average forecast growth rate of the developed countries stood at minus 8.1%, or 1.8 percentage points below Israel's forecast growth rate. That is to say, the revised estimate of the IMF reflects a deterioration in the forecast on Israel compared to the other developed countries (on average), even if the absolute forecast has been revised to a slightly less negative figure. This deterioration becomes starker when taking into consideration per capita growth, since the rate of population growth in Israel is considerably higher than in most other developed countries. Looking to 2021, the IMF expects faster growth in Israel (4.9%) compared to the other developed countries (3.9%).

Author: Yaniv Bar