Leumi Economic Weekly

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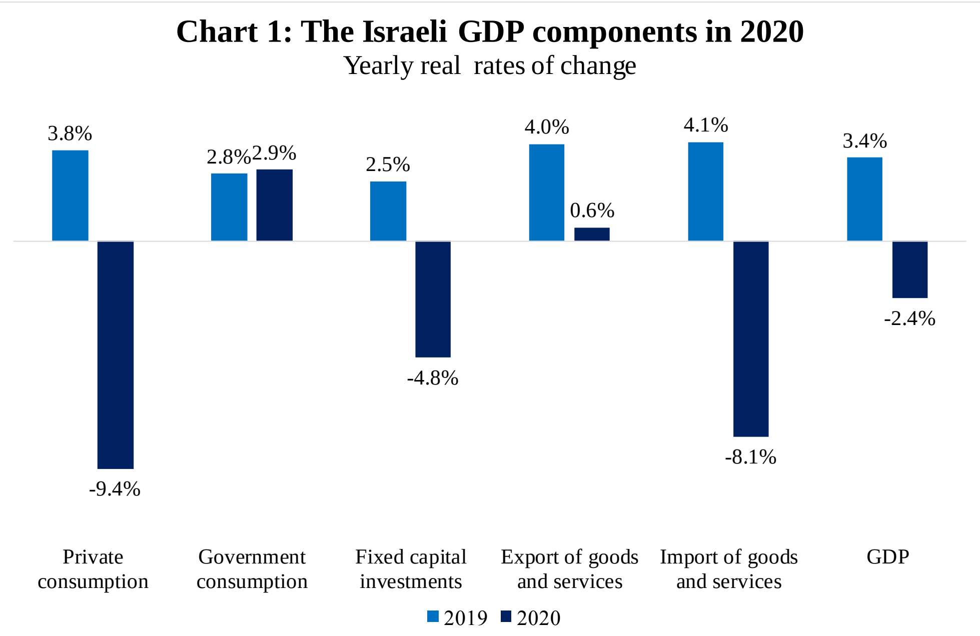
Israel's GDP contracted 2.4% in 2020, thus surprising with a less negative result compared to the initial estimates

Data from the Central Bureau of Statistics (CBS) show that Israel's GDP contracted by a real rate of 2.4% in 2020, attributed to the negative effects of the coronavirus crisis. This is a more moderate rate of decline compared to the preliminary estimates, which forecast a decline ranging between 3%-5%, or even more. This less negative surprise in the annual growth rate is the result of an increase in the fourth quarter of 2020 GDP that was sharper than expected, and this despite the fact that the economy was operating under relatively substantial restrictions during the quarter. This increase was supported by increases in all the main GDP components, except for the export of goods and services. The GDP components that stood out positively include: transport vehicles purchase (for both consumption and investment), against the backdrop of advanced transactions ahead of a revision in the green tax calculation starting in the beginning of 2021, which led to a rise in automobile prices; investment in machinery and equipment; and public consumption.



The private consumption component registered the sharpest rate of decline among all the components in 2020, contracting by 9.4% (see Chart 1). The contraction was broad and encompassed each of the main consumption components, while the following components registered the steepest declines: current consumption of services (education, health, real estate agents, restaurants, and more), the component most negatively affected by the social distancing rules and restrictions on activity; and overseas consumption by

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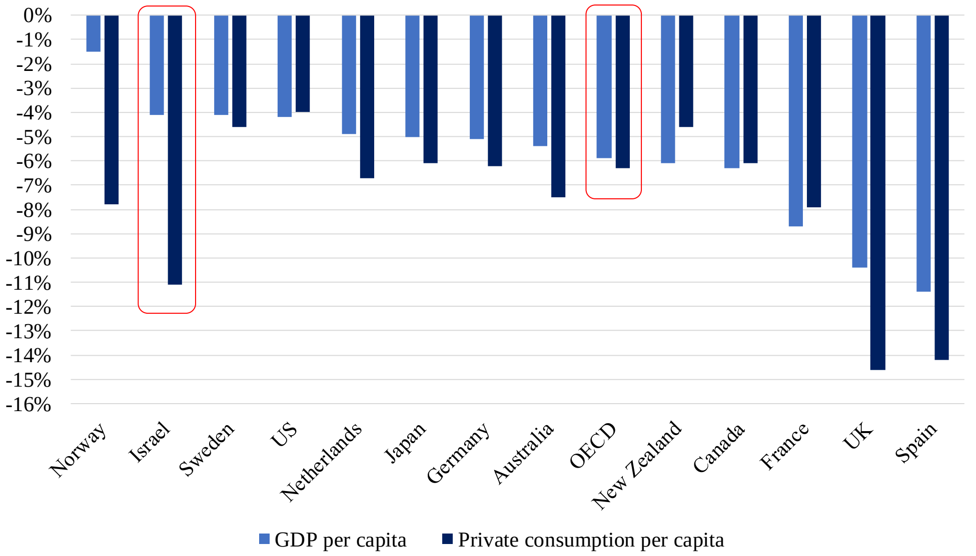
Israelis, which declined almost completely due to the near complete shutdown of international travel. More moderate declines were registered in the other consumption components, such as: gasoline, electricity and water, clothing and shoes, furniture, and more. On the other hand, the food and beverage, electronic equipment, and manufactured goods for current consumption components, all of which were defined as essential and consequently continued last year also during periods of shutdown, registered increases.

Investment in fixed capital assets declined 4.8%, due to declines in investments in residential construction and also in the industrial sector (machinery and equipment, transport vehicles, and more), against the backdrop of the high degree of uncertainty that characterized activity under the shadow of the crisis. The declines in consumption and in investments, some of which originate from imported sources and not from domestic manufacturing, led to a sharp decline of 8.1% in the import of goods and services into Israel. In parallel, the rate of export growth of goods and services moderated substantially last year, yet remained positive, this despite a sharp drop in global trade volumes in 2020, which is estimated by the International Monetary Fund (IMF) to have declined 9.6%.

We note that goods exports increased 4.8% last year, and the exports of other services (mostly high-tech services) increased by a sharp rate of 11.3%. On the other hand, the export of tourist services contracted 74.5% due to the crisis and thus pulled downward the overall export component. The rise in net exports (exports minus imports) contributed substantially toward partially offsetting the declines in other components, and this had a substantial contribution to the current account of the balance of payments.

Chart 2: GDP and Private consuption per capita in 2020 - selected OECD countries; Yearly real rates of change; OECD data

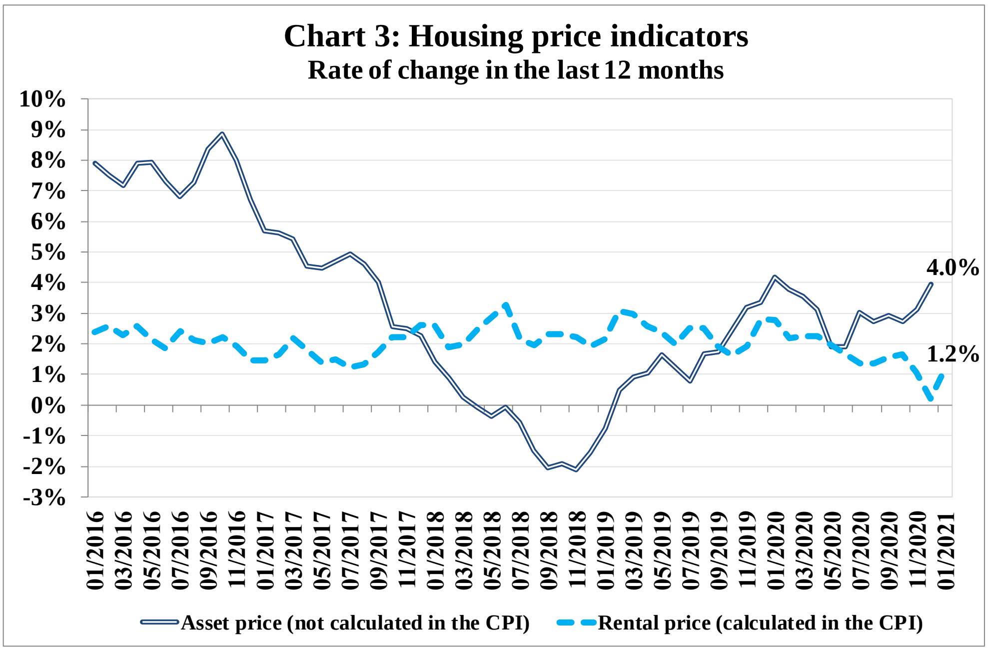


The rate of decline in Israel's GDP in 2020 is among the lowest of the OECD countries, even though the number of days of closure in Israel was high compared to some of the other countries. A similar picture also arises from an analysis of GDP per capita. However, As can be seen in accompanying Chart 2, while the rate of decline in Israel's GDP <u>per capita</u> stand out positively, the rate of contraction in private consumption per capita is high compared to the OECD average, and is secondary only behind the economies that were sharply hurt by the crisis, for example Britain and Spain. That is to say, the positive performance of Israel's export of goods and services relative to the rest of the world improved the country's relative condition on this matter.

Looking ahead, we expect that in the baseline scenario, which assumes continuing inoculation of the population in a manner that will permit a broad opening of the economy no later than toward the beginning of the second half of 2021, a process of recovery will be spread across 2021-2022, during which time the rate of economic growth is expected to substantially accelerate. Regarding 2021, we forecast 5% GDP growth.

The January CPI surprised by being less negative than forecast, with an increase in the housing component; an increase in prices is apparent for all of 2021

The consumer price index (CPI) surprised by being less negative than forecast, as it declined 0.1% in January compared to the consensus forecast that called for a 0.3% decline. It is important to note that in January 2021 the CPI was calculated for the first time according to its revised composition, according to a new system of weightings, yet the change in the basket had a negligible impact on the general index. Among the components that surprised on the upside in the January CPI can be noted the following: food, housing maintenance, furniture and home equipment, and the automobile sub-component. On the other hand, the components that surprised on the downside and thus partially offset the rise include: fruits and vegetables, as well as clothing and shoes (seasonal decline).



The housing component increased 0.3%, resulting from a 0.4% uptick in the owned dwellings services sub-component (which reflects housing rental prices in new and renewed contracts). This is an extraordinary increase, since this sub-component fell in the month of January over the last several years by 0.5%-0.8%. In light of the above, the annual rate of increase of the owned dwellings services sub-component, the weighting of which in the CPI stands at 17.4% – the largest sub-component in the CPI – increased to 1.2% (see Chart 3).

At the same time, housing prices (according to the monthly housing survey of the CBS, which is not included in the CPI calculation) registered a relatively sharp increase of 0.9% (November-December 2020 compared to October-November 2020). Consequently, the annual rate of increase in housing prices rose to 4.0% – the highest rate since January 2020, prior to the outbreak of the coronavirus crisis. The increase in housing prices, against the backdrop of a shortage in supply and the expected recovery in demand later in the year, as long as the pandemic will be brought under control, may lead to a gradual increase in the housing component of the CPI, a development that is expected to support inflation in light of the large weighting of the housing component in the general index.

In summary, over the trailing 12-month period (January 2021 compared to January 2020) the CPI declined 0.4%, the CPI excluding housing declined 0.7% and the CPI excluding fruits and vegetables declined 0.3%. On the other hand, the CPI excluding energy increased 0.1%. It is quite possible that the rise in the number of components that increased in the January 2021 CPI, and the nature of the upside surprises, indicates a more sustained process of price increases that is formulating, this is in contrast to what characterized most of 2020 that mostly experienced price declines. In 2021, the CPI is expected to reflect supply side effects, such as a rise in global commodities prices – agricultural commodities, energy, and more; an increase in international freight prices; and more.

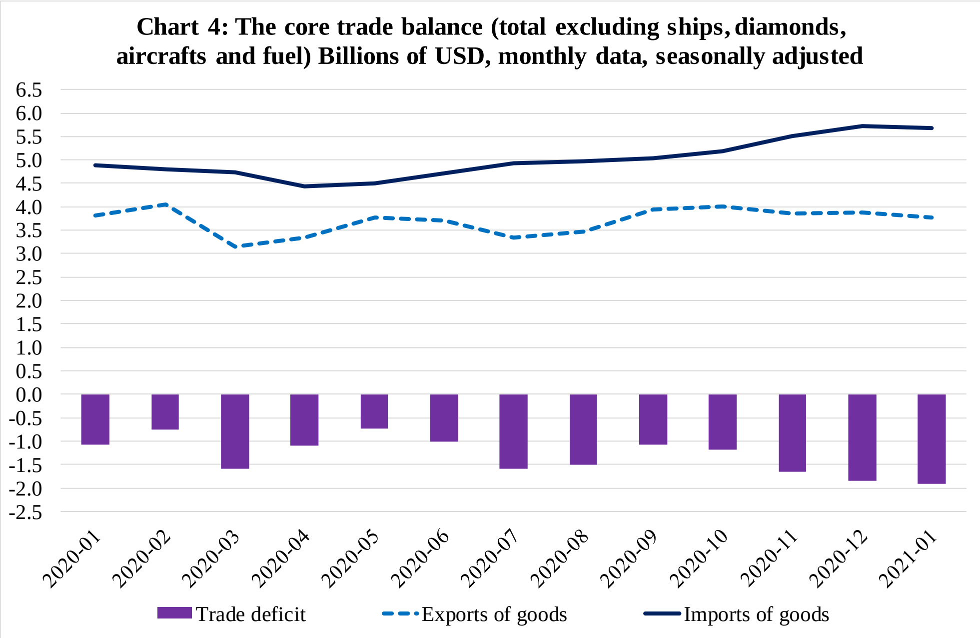
In addition, as long as the process of inoculating the Israeli population continues and successfully progresses, while achieving vaccination and natural immunity of a large portion of the population, the possibility for continuing to open different activities in the economy increases. Simultaneously, this development will create a situation involving a relatively rapid return of demand to the market as a result of an expected improvement in the condition of households, together with an increase in the quantity of money held by the public. On the other hand, there are specific sectors of the economy in which the supply has suffered on-going damage due to the difficulties of the past year.

This situation, involving a temporary mismatch between increasing demand and limited supply, may lead to a sustained rise in prices. This year is expected to conclude with relatively high inflation that will lead to a higher price level in the economy, which is expected to be maintained throughout 2022-2023. Looking ahead, the annual rate of inflation, over a trailing 12-month basis, is expected to climb to above 1%, this with the exit of the negative CPI figures that characterized the first half of 2020. We expect that inflation over the next 12-month period will reach 1.4%.

The rise in imports, parallel to the fall in exports, led to an expansion in the deficit in the core trade account in January 2021

In January, the export of goods from Israel (excluding ships, aircraft, and diamonds) amounted to US$3.76bn (seasonally adjusted data). This represents a 3.9% decline (in nominal US dollar terms) compared to the average monthly level in the fourth quarter of 2020, and a 1.2% decline compared to January 2020. The main industrial export sectors that led the declines include: electronic components, chemicals (after a relatively sharp increase in activity in the fourth quarter of 2020), transport vehicles, and rubber and plastic. In contrast, an increase was registered in the export of pharmaceuticals, this in continuation of the trend from the preceding month.

Goods imports (excluding ships, aircraft, diamonds, and energy products) amounted to US$5.67bn in January. This figure reflects an increase of 3.7% compared to the average monthly sum of imports in the fourth quarter of 2020, and a sharp 16.4% increase compared to January 2020. We note that in each category of goods (consumption, investment, and raw materials) increases were registered compared to the monthly average in the fourth quarter of 2020 and also compared to January 2020. The increase in imports, parallel to the decline in exports, led to an expansion in the core trade deficit (excluding ships, aircraft, diamonds, and energy products) in January to US$1.9bn, this in continuation of the trend from recent months (see Chart 4).



Looking ahead, as long as the process of inoculating the population in Israel progresses and will lead to achieving a critical mass of vaccinated persons in a manner that will permit a broad opening of the economy, then an accelerated recovery can be expected in the demand for goods and services, which is expected to be expressed in a rise in imports into Israel during 2021. A faster increase in imports compared to exports, against the backdrop of the slower recovery occurring within Israel's main export destination countries, is expected to lead to a continued expansion in the trade deficit during the year, a development that is likely to moderate the strength of GDP growth. Such a development will also act to narrow the relatively large surplus in the current account of the balance of payments.

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