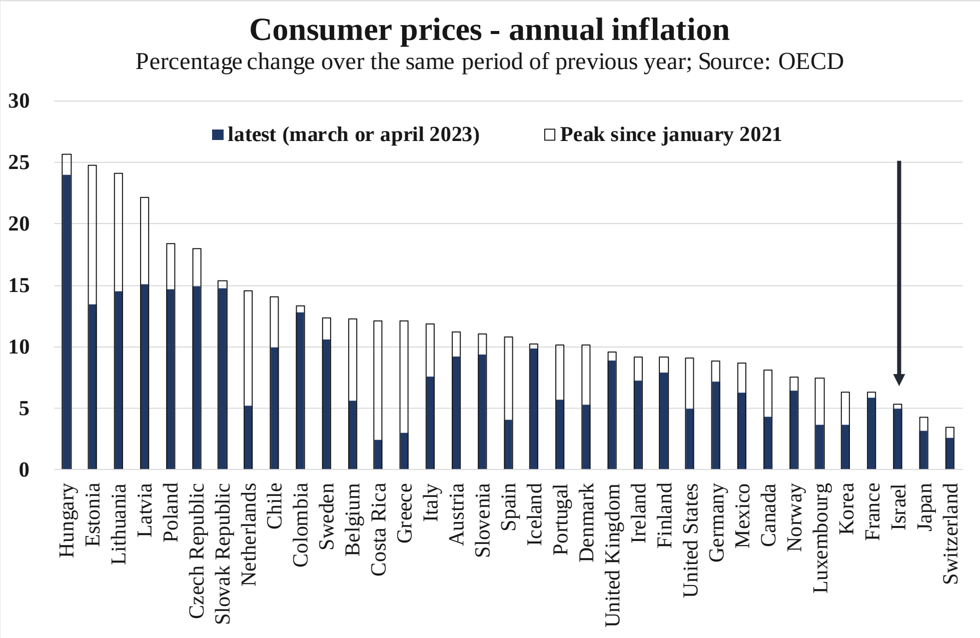
# Leumi Economic Weekly

**May 17, 2023**

***April's CPI surprised substantially on the upside compared to the preliminary forecasts; the inflation rate in Israel fell only slightly in an international comparison***

According to data from the Central Bureau of Statistics (CBS), the consumer price index (CPI) increased 0.8% in April this year, twice the rate of preliminary expectations (according to the consensus forecast). Against this backdrop, the rate of increase in prices over the trailing 12-month period remains unchanged at a level of 5.0%.




Notable price increases were registered in the following components: food, housing, fruits and vegetable, clothing and footwear, as well as recreation, holidays and trips. The sub-component involving expenditures on overseas travel also jumped sharply (8.8%), and was extraordinarily high from an historic perspective (the average monthly increase in the month of April during the years 2014-2019 was 3.4%). This development likely explains to some degree the upward surprise in April's CPI compared to the initial forecasts.

On the other hand, the cancellation of the tax on sweetened drinks and a reduction in electricity tariffs contributed to declines in relevant CPI components. Similar to the case involving the cut in the tax on disposable kitchenware, the decline in beverage prices (-2.1%) was substantially below the rate of increase registered back in the month in which the tax on sweetened drinks was first introduced (+6.9%, January 2022).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The April CPI surprise supports a continued cycle of rate hikes by the Monetary Committee of the Bank of Israel (BoI), which is expected to convene next week (May 22, 2023), in the upcoming interest rate decision. Until now, actual inflation in Israel has fallen only moderately, as it has remained above 5% since October 2022, reaching a peak of 5.4% in January 2023. On this regard, it is interesting to see that the development of inflation in Israel stands out in an international comparison with the developed countries of the world.

As can be seen in the accompanying chart, which presents the current inflation rate within OECD countries compared to the peak inflation rate registered in each country since the beginning of 2021 (the year during which inflation around the world started to spike), the drop in inflation in Israel since its peak is low compared to the other countries (the median decline of all the other countries stands at 2.6 percentage points), and is almost the lowest (only in Iceland the current inflation rate is below the peak level by less than that in Israel). However, it is important to emphasize that inflation in Israel from the beginning was lower compared to that in the other OECD countries (see in the chart the column that presents the peak in each country), a situation that has characterized Israel for a decade.

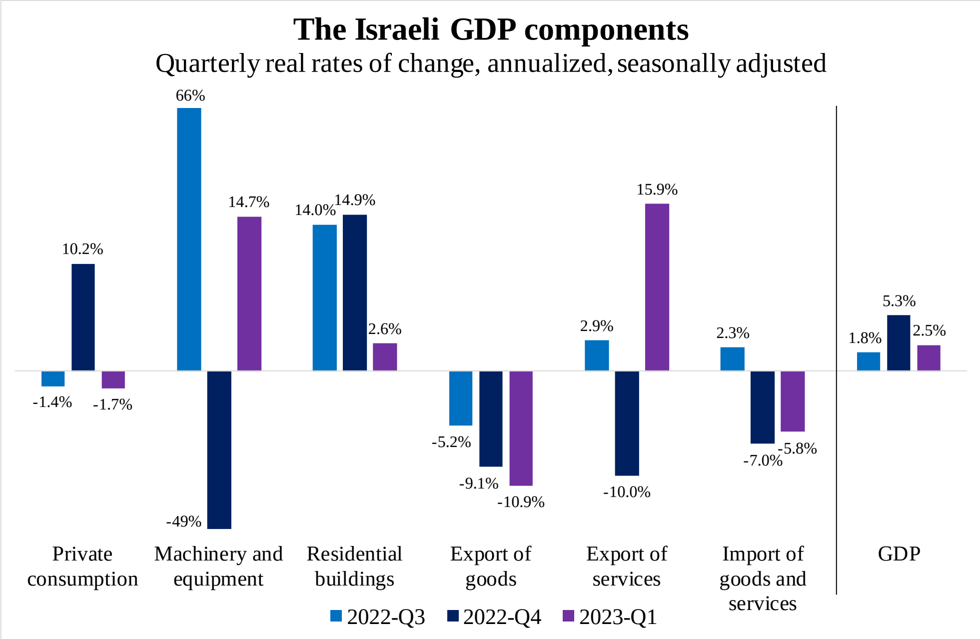
In summary, inflation in Israel is "sticky" and high, and it is notable that the level by which inflation in Israel has been reined in is low compared to what has occurred in the other developed countries of the world. Thus, and against the backdrop of other factors, such as Israel's tight labor market, high inflation expectations, and continued expansion in local economic activity (see details in the next section), we estimate that a 25bps interest rate hike is expected, which will bring the BoI interest rate to 4.75%, with an additional rate hike above this level possible later in the year.

***GDP increased in the first quarter of the year by a rate of 2.5%, in annualized terms***

According to CBS estimates, local economic activity continued to expand also in the beginning of the year, albeit with a slowdown in the pace. Israeli GDP grew 2.5% in the first quarter of 2023 (in real terms, adjusted for seasonality, annualized), following more rapid growth of 5.3% (in annualized terms) in the fourth quarter of 2022.

Analysis of the growth rates according to GDP components shows there are large differences in the development of the main components (see accompanying chart). Private consumption declined 1.7% (in annualized terms), mainly against the backdrop of a sharp drop in automobile purchases, after such purchases peaked in the preceding quarter due to advanced purchases prior to a revision in the "green" tax formula that came into effect in the beginning of 2023 and led to price increases on a large number of car models. However, it is important to note that also when excluding this component, private consumption growth slowed considerably. This is due to the erosion in the purchasing power of households, resulting from the substantial rise in the inflation and interest rate environments, which is expected to weigh on private consumption in the coming quarters.

In addition, against the backdrop of the moderation in the growth rate of global economic activity, with an emphasis on Israel's main trade partners (the US and the euro bloc), there was a decline in the export of goods and services from the economy, a development that is likely to continue also in the coming quarters. This is the result of a decline in goods exports, which have been trending downward for four consecutive quarters, by a growing rate. On the other hand, services exports registered an increase, with an emphasis on the tourism and other services components (mainly high-tech), after having fallen sharply in the preceding quarter.

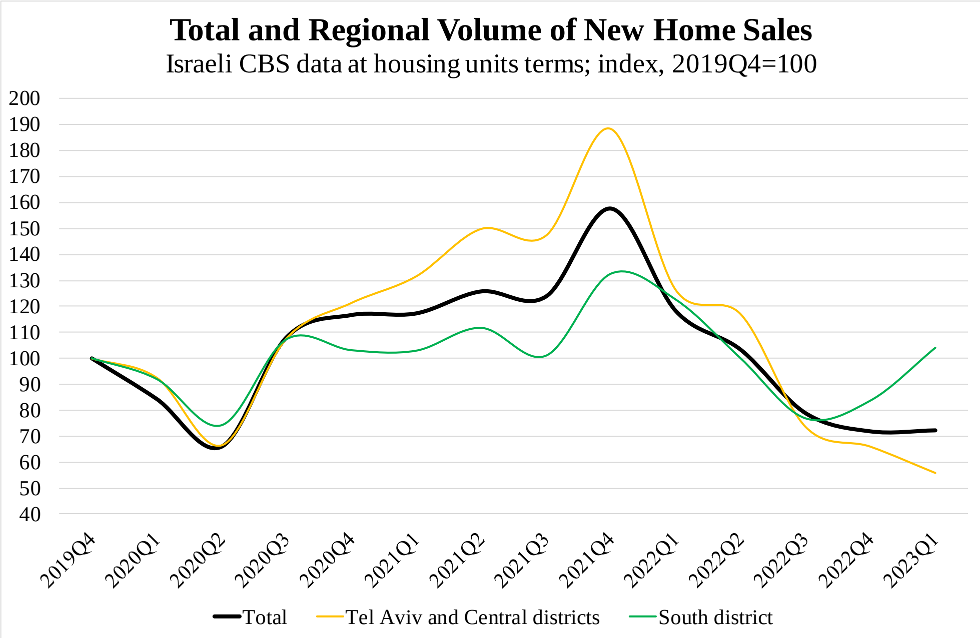



The component that contributed the most substantially to growth in the first quarter of the year was investment in fixed assets, this despite a drop in investments in transport vehicles. The increase occurred mainly against the backdrop of a substantial uptick in investment in machinery and equipment, and continued growth of investment in residential construction, this despite a drop in construction starts in the recent period, with a substantial moderation in the pace. A drop in imports also contributed to growth in the first quarter; however, this may indicate the possibility for a moderation in the rate of expansion in activity later on.

In summary, the national accounts data for the first quarter of the year present a mixed picture. On one hand, the current level of GDP matches the economy's potential, in continuation of the situation over recent quarters. However, on the other hand, some of the components of GDP are displaying relative weakness, especially in private consumption. In our baseline scenario, we estimate 2023 is expected to conclude with a 2.6% GDP growth rate (annual average), which is low compared to the two preceding years (2021-2022).

***A standstill in home prices and new home sales in the economy, although with substantial geographic differences***

The house price index of the CBS (which is not included in the CPI calculation) remained unchanged in the February-March 2023 period compared to January-February 2023. This comes in continuation of the stable trend that has characterized this index for a number of months already, against the backdrop of the hike in interest rates and rising inflation, and also in light of the heightened economic uncertainty in the country. However, due to the rapid rise in the house price index up until a couple of months ago, it still remains approximately 11% above its level from a year ago (February-March 2022).




The recent stability seen in the house price index, which includes transactions of new as well as second-hand homes, "hides" the differences in the price trends between these two market segments. According to additional data released by the CBS, prices of new homes in the open market continue to decline, this for a number of months already, and from this it can be deduced that prices of second-hand homes are continuing to climb moderately and are preventing the house prices index from falling. It appears the fall in new home prices in the open market is helping to some degree to stabilize the number of transactions in this market segment. In the first quarter of 2023 the number of new homes sold in the economy equaled 7,743 units (CBS data, seasonally adjusted), representing a moderate 1.7% increase compared to the last quarter of 2022, which came after four consecutive quarters of declines in new home sales (each quarter vis-à-vis the preceding quarter). However, the current level of activity is still low compared to recent years, that is to say, the number of transactions in the economy is stabilizing at a low level.

Furthermore, despite the stability in the number of transactions in new homes, there are substantial variances in the data among the various regions of the country. In high-demand areas, including the Tel Aviv and Central districts, the volume of transactions continued to drop also in the first quarter of 2023 and reached levels even below those registered in the second quarter of 2020, at the beginning of the coronavirus crisis (see accompanying chart). This is apparently because the rise in interest rates in the economy adversely affects the ability to purchase homes especially in these regions, which are characterized by very high home prices.

In contrast, in the Southern district over recent months there has been a tangible recovery in the volume of transactions, supported by a substantial supply of new homes in the region. This comes against the backdrop of a construction boom that occurred in the district over recent years. In addition, contractors have been offering special deals to potential buyers, as reported recently by the Chief Economist Department of the Ministry of Finance (MoF), with this being reflected in a decline in the home price index in the Southern district over recent months.

Looking ahead, we estimate the number of home purchases in the economy will continue to be relatively moderate in the coming period, and may even take an additional step downward. This comes against the backdrop of expectations for a continued rise in the BoI interest rate in the coming months, and is also in light of the high economic uncertainty that currently exists in the economy. Under these circumstances, the inventory of unsold homes which increased 22% over the past year, is expected to continue to increase and to support a single-digit downward trend in the home price index throughout the coming year. This will occur while the downward trend in prices expands also to the second-hand homes segment.

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