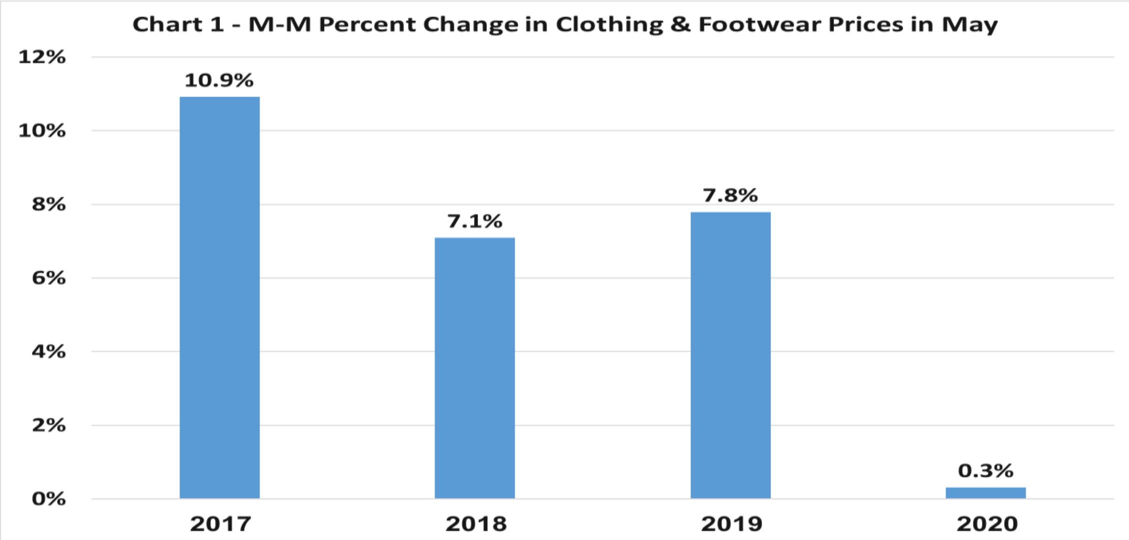
Leumi Economic Weekly

June 17, 2020

The May CPI was below expectations, primarily due to a notable slowdown in clothing and footwear prices

The consumer price index (CPI) declined 0.3% in May, coming in substantially below most of the initial forecasts in the economy (the consensus forecast called for an increase of 0.1%). This is the first time a decline in CPI has been registered in the month of May since 2003.



The decline in the May CPI stems, to a large part, from the clothing and footwear component, which registered a minimal increase (+0.3%), substantially below the seasonality that generally characterizes this component in May each year (an increase of 7% and higher, see Chart 1). Routinely, the clothing and footwear component registers a sharp rise each May, in light of a special measurement carried out in this component referred to as a "bridge", by which the prices of summer items are compared with their prices the year before and the prices of year round items (marketed through the whole year) are compared with their prices approximately six months earlier.

This year, the "bridge" measurement in May yielded, as mentioned above, only a minimal increase, since the summer season items started off this year with relatively low prices. This is apparently from the desire of clothing and footwear stores, following their renewed opening with the end of government shutdown orders, to increase sales volumes, and to thus compensate, even if only partially, the losses incurred during the period in which all stores were closed.

Data on credit card purchases published by the Bank of Israel (BoI) indicate that this policy met with some success. According to the data, during May there was a substantial

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increase in the volume of purchases of clothing goods, which even increased above the volume of purchases registered in the beginning of the year, prior to the coronavirus crisis. However, it is worthwhile to remember that these data are unadjusted for seasonality, and this possibly also affected the level of purchases.

In addition to the clothing and footwear component, a decline in gasoline prices (-2.3%) also pushed the May CPI downwards. There was also a substantial drop in the food component (-0.9%). This decline stems from both lower prices of some food products (particularly dairy products) towards the Shavuot holiday, which occurred at the end of May, and also from a downward correction after the sharp increases that were registered in some food products in March and April, first and foremost meat, chicken, and fish products.

The housing component declined 0.3%, as a result of a 0.5% drop in the owned dwellings services sub-component (which reflects housing rental prices in new and renewed contracts that started in April-May 2020). This is a sharper drop than the seasonality that generally characterizes this sub-component in May each year, and thus serves as an initial indicator of a slowdown in housing rental prices resulting from the coronavirus crisis. Due to the low index, the annual rate of increase in housing rental prices slowed from 2.3% to 2.0%. In our opinion, the rate of increase of rental prices is likely to continue to moderate in the coming months, due to the coronavirus crisis, although this trend apparently will not continue over time.

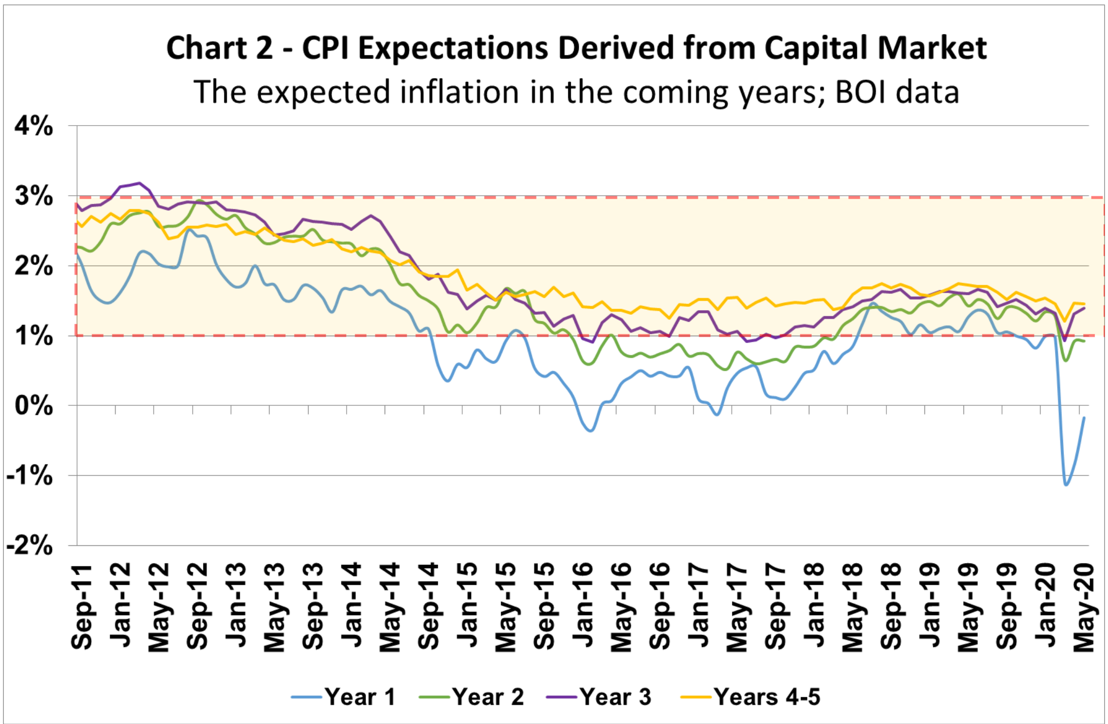
In parallel, the annual rate of increase in the house price index (according to the monthly housing survey of the Central Bureau of Statistics, which is not included in the CPI calculation) has been in a gradual slowdown since the beginning of 2020, reaching 3.5% in March – April, compared to a 4.2% annual rate in December 2019 - January 2020. In our opinion, the slowdown in the rate of increase of housing prices is likely to continue also in the coming months, in light of the notable decline registered in the number of home purchases in the economy because of the coronavirus crisis, and because of the low willingness of households to carry out large purchases during the current period (as derived from the consumer confidence index released by the Central Bureau of Statistics).

The "inflation environment" is very far from the price stability target

Inflation over the trailing 12-month period (May 2020 compared to May 2019) declined to minus 1.6%, representing the lowest inflation rate in 16 years. Also the annual rate of increase of the different core indices (the CPI excluding housing, the CPI excluding energy, etc.) are all deep into negative territory. Looking ahead, annual inflation (that is to say, each month relative to the parallel month in the preceding year) is expected to increase gradually throughout the coming year, this on the assumption that economies in Israel and around the world will continue to recover and there will not be a renewed burden involving shutdown measures. Under these assumptions, in our opinion the inflation rate for all of 2020 is expected to still be negative (around minus 0.5% to minus 1.0%); however, looking over the coming year (June 2020 – May 2021) inflation is likely to return to positive territory, to a very moderate positive order of magnitude of 0.5% - 1.0%.

The expected increase in inflation in the coming year is supported by a number of factors, such as: the exit of very low past CPI figures (June-July 2019) from the annual window of calculation; the impact of the recovery in global energy and commodities prices over recent weeks; a continued increase in the housing component, even though it is likely to be moderate; and the expectations for an increase in prices in some of the services sectors (overseas flights, restaurants, etc.), in an attempt to compensate for the damage to profitability resulting from the implementation of social-distancing measures.

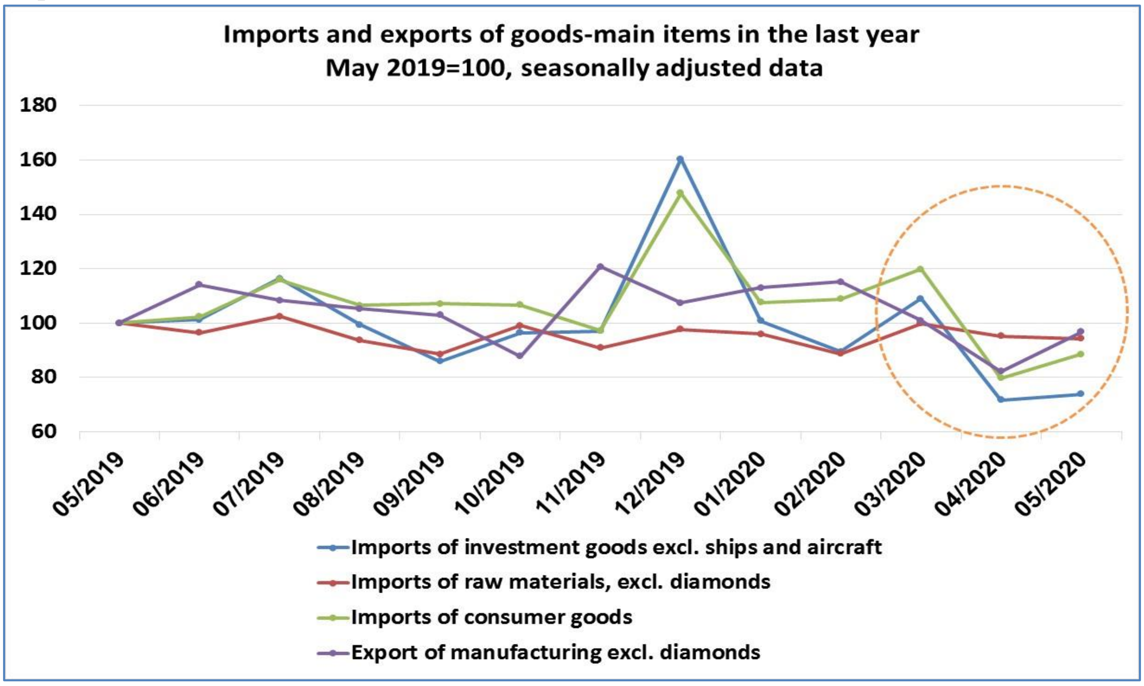
Looking at the coming years, under the assumption that the coronavirus will be brought fully under control, inflation is expected to cross over the lower boundary of the price stability target range (1%), and possibly slightly above this level. This also arises from forward expectations of the capital market for the coming years (see Chart 2). The main factors that are expected to support the rise in inflation include: tax hikes in Israel and around the world to finance rising government debt, with at least some of these tax hikes, it is reasonable to believe, causing consumer price increases (such as a VAT hike); the rise in commodities and energy prices in light of the expected gradual recovery of the global economy, and also likely resulting from an acceleration in de-globalization processes that will increase disruptions and changes in global supply chains; higher market concentration, against the backdrop of bankruptcies of many companies and also mergers and acquisitions as a result of the coronavirus crisis; and the inflationary impact of the substantial monetary expansion implemented currently in Israel and around the world following the crisis.



In addition, it is important to note that the housing component in the CPI is likely as well to accelerate in the medium-term, because of the expected shortage in housing in the economy, as a result of the slowdown in housing construction starts and also in construction completions during 2020 due to the different effects of the coronavirus on this activity. This development is coupled with a decline in the ability of households to purchase housing due to the deterioration in the labor market. The upward path of housing prices and housing services (rent) is likely to be affected as well from a possible acceleration in the increase in the number of households, due to a slight expansion in the number of new immigrant arrivals to Israel.

Bank Leumi's 2020 growth forecast for Israel has been revised downward, to minus 4.6%

Israel's trade deficit (the difference between goods imports and exports) amounted to US$7.8bn in the first five months of the year, approximately US$1.0bn less than the deficit in the parallel period of 2019. However, the "core" deficit (the overall deficit excluding especially volatile components such as ships, aircraft, diamonds, and energy products) during January-May of this year was similar to that in the same period of last year. When analyzing the development of Israel's foreign trade over recent months, during the period of the coronavirus crisis, it can be seen that following a substantial drop in April, in imports of consumption and investment goods, and industrial exports (see accompanying graph), it turns out that in May there was a slight recovery, even though the data still reflect activity substantially below that from the pre-crisis period. In contrast, imports of raw materials have remained stable in recent months, likely indicating a degree of relative optimism regarding a recovery in manufacturing and industrial exports.



Analysis of foreign trade activity (exports and imports of goods) together with estimates regarding activity in the realm of services exports and imports, are reflected in our estimates regarding the expected decline this year in both imports and exports of goods and services. This comes primarily against the backdrop of the expected sharp drop in global demand of Israel's main trade partners, which until now have mostly been hurt more by events than Israel. In addition, the sharp decline in the import of investment goods hints at the expectation also in the realm of investments in the industrial sectors that are expected to be substantially hurt, against the backdrop of the high degree of uncertainty that is leading to heightened risk. This is despite the low level of the interest rate in the economy (the real interest rate is negative, both in the short- and the long-terms) that is supposed to encourage and to increase investments.

Against the backdrop of these and other data, and also in light of the assessment of the renewed situation involving the rise in the number of those infected by the coronavirus in Israel and in other countries around the world, we revised our 2020 Israel growth forecast downward, compared to the preceding forecast. Currently, we estimate that a negative growth rate of 4.6% is expected this year, while in the business sector the negative growth is likely to be of an order of magnitude equal to minus 7%. The heightened number of virus infections in recent weeks is likely to delay the recovery of some of the sectors of the economy; and therefore, this is expressed in our estimate on the situation of the business sector.

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