Leumi Economic Weekly

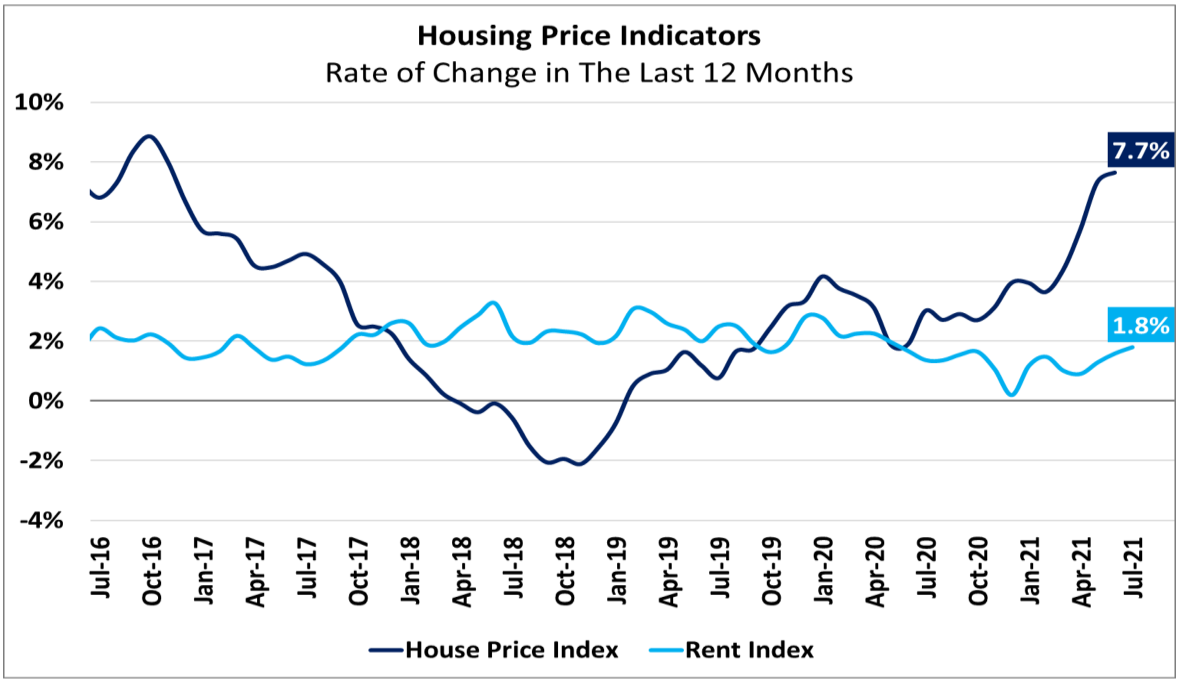
August 18, 2021

The consumer price index surprised on the upside, thereby raising annual inflation to a peak of almost eight years

The consumer price index (CPI) for July surprised on the upside, increasing 0.4% compared to the consensus forecast that called for an increase of 0.3%. Price increases were registered within various product categories (such as gasoline, food, furniture and household equipment). This is due to the rise in energy and commodities prices around the world over recent months, and also in light of the increase in global freight costs.

The services sectors showed a mixed trend. On one hand, notable increases occurred in the prices of recreation, holidays and trips in Israel and abroad (also due to reasons involving seasonality). On the other hand, relatively low indices were registered compared to the recent months in the prices of meals away from home and also prices of parties and events. That is to say, it appears prices of services are still affected to a large degree from an accelerated rise in demand with the return of the economy to regular and full operations, yet this impact may be starting to diminish.

The housing component increased 0.4% in July, resulting from an increase totaling 0.5% in the owned dwellings services sub-component (reflecting housing rental prices in new and renewed contracts), a greater monthly rate of increase than that registered in the sub-component in July 2020. Consequently, the annual rate of increase of prices of owned dwellings services continued to climb, reaching 1.8%.



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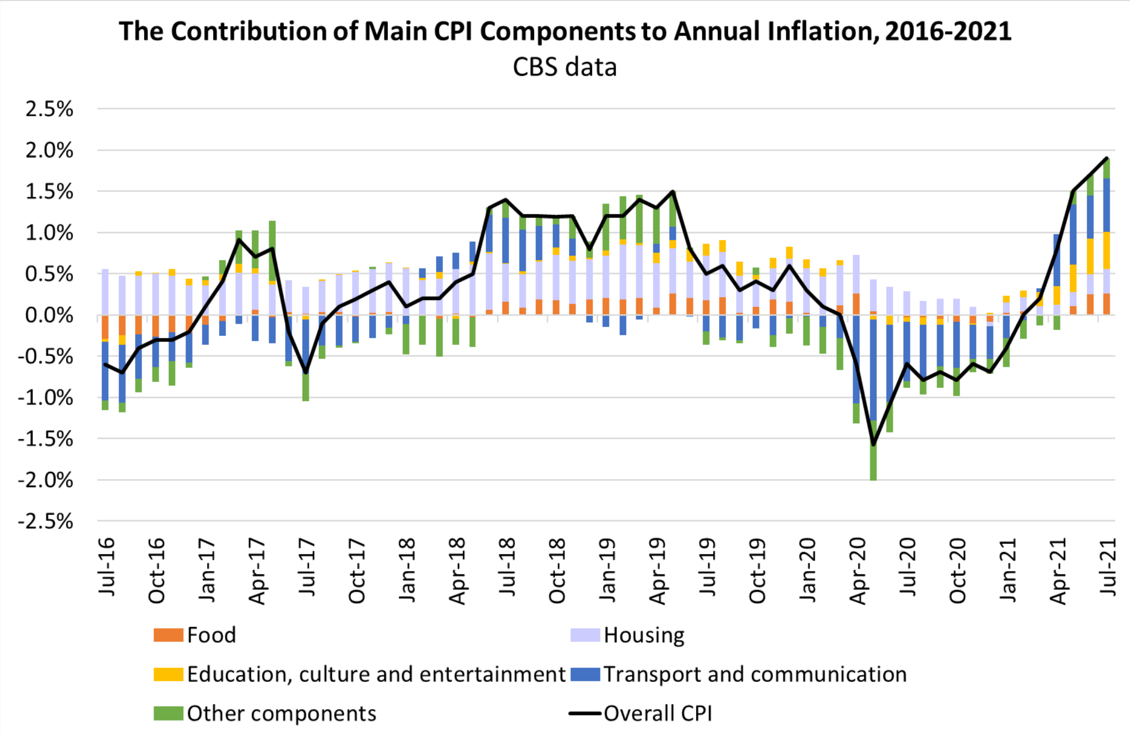
Home prices (according to the monthly housing survey conducted by the Central Bureau of Statistics, which is not included in the CPI) increased 0.6% in May-June 2021 compared to April-May 2021, and by 7.7% over the past year, the highest annual rate of increase since October-November 2016 (see accompanying diagram). In our estimation, the annual rate of increase in home prices is expected to remain similar to current levels, or slightly higher, in the coming months. This comes against the backdrop of an accelerated demand for home purchases in recent months, together with a level of supply that remains below the needs of the economy.

Over the trailing 12-month period (July 2020 – July 2021) the CPI <u>increased</u> 1.9%. This is to say, inflation is currently near the center of the price stability target range (1%-3%) of the Bank of Israel (BoI), and at its highest level since November 2013.

In an analysis of the contribution of the various CPI components to inflation (presented in the accompanying chart), it can be seen that the current rise in inflation stems from a broad rise in prices of various goods and services. Whereas in the past the housing component was the main component, and sometimes the sole component, that contributed to the rise in inflation, we see that its contribution to inflation over the past year has been relatively moderate.



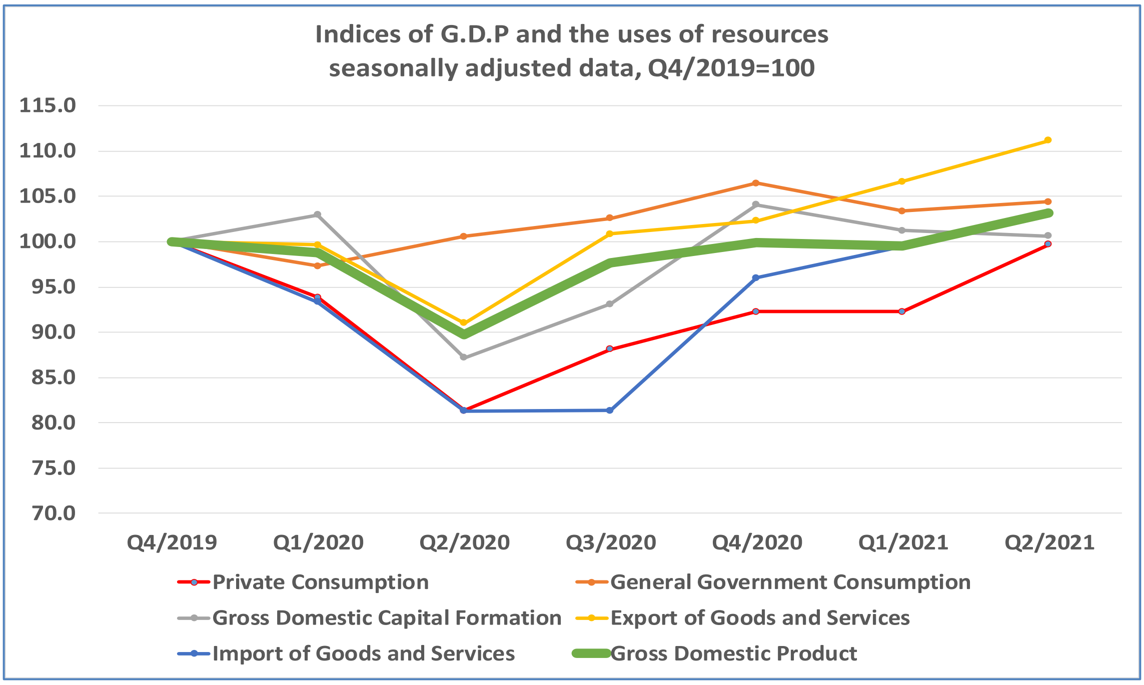
The main components that have contributed over the past year to the rise in inflation include the transportation and communication component (led by gasoline prices, which are included in this component), as well as the education, culture, and entertainment component (with an emphasis on prices of domestic recreation and holidays). In years gone by, these components had a more restricted contribution to inflation, or even a negative impact. We estimate that in the coming year the contribution of the housing component to inflation will increase, in light of, among other things, the expectation for a continued gradual recovery in rental prices. This is on the assumption that substantial restrictions will not be re-imposed on economic activity.

Looking ahead, the level of inflation is expected to stay in the coming months near the current level, such that by the end of 2021 inflation is expected to amount to 1.8% - 2.2% (December vis-à-vis December). During 2022 a slight slowdown in inflation is expected, due to, among other things, expectations for a stabilization in global energy prices, a recovery in supply in the services sectors, a continued process of appreciation of the shekel, and more.

Rapid growth in the second quarter of the year is likely to lead to greater-than-expected growth in full year 2021

Israeli GDP expanded by an annual rate of 15.4% in the second quarter of the year, compared to the first quarter of 2021, based on data in constant prices and adjusted for seasonality. This follows a fall in GDP, by an annual rate of 1.4%, in the first quarter of the year (this figure was revised substantially higher compared to the initial estimate of the Central Bureau of Statistics).

The main explanation for this rapid pace of growth in the second quarter of the year is the removal of most of the restrictions on economic activity, and also heightened purchases of private passenger cars, as the taxes on automobiles represent a portion of GDP. The purchase of private cars, as mentioned, contributed to the substantial 36.3% increase, in annualized terms, in second quarter private consumption. Furthermore, increased purchases of goods and services, which were curtailed prior to the removal of the restrictions on activity of many sectors of the economy, are expressed in the second quarter and also contributed to the impressive growth rate. In addition, an increase of 18.1% was registered in the exports of goods and services, which were positively affected by the increase in industrial exports and also by an increase in services exports (with an emphasis on high-tech services).



When analyzing the GDP of the second quarter of this year vis-à-vis the final quarter of 2019 (the quarter prior to the pandemic outbreak) it can be seen that the GDP level is more than 3% greater than that at the end of 2019 (see accompanying chart) and only 1.0-1.5% below the potential GDP level (the GDP that could have been expected if it were not for the outbreak of the crisis). What this means is that economic activity, as measured by GDP, increased to a level that preceded the crisis, while the output of the economy, as mentioned, was achieved with a labor market that did not include hundreds of thousands of workers who were not employed.

This situation may reflect, in the short-term, an increase in labor productivity (and perhaps also wage pressures, in certain sectors), alongside the potential of future growth in the economy, in particular if appropriate investment programs will be advanced for the benefit of workers who are not currently employed. This is so that the economy will be able to rapidly return to a state of full employment, expressed in a low unemployment rate, similar to the situation that prevailed before the crisis. Looking ahead, the growth data for the first half of this year, may lead to a rapid growth rate for all of 2021, perhaps even above the forecasts of most forecasting bodies. These forecasts have ranged until now between 5.0% - 5.5%. This is under the assumption that no substantial restrictions will be re-imposed anytime soon on economic activity, in light of the high morbidity.

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