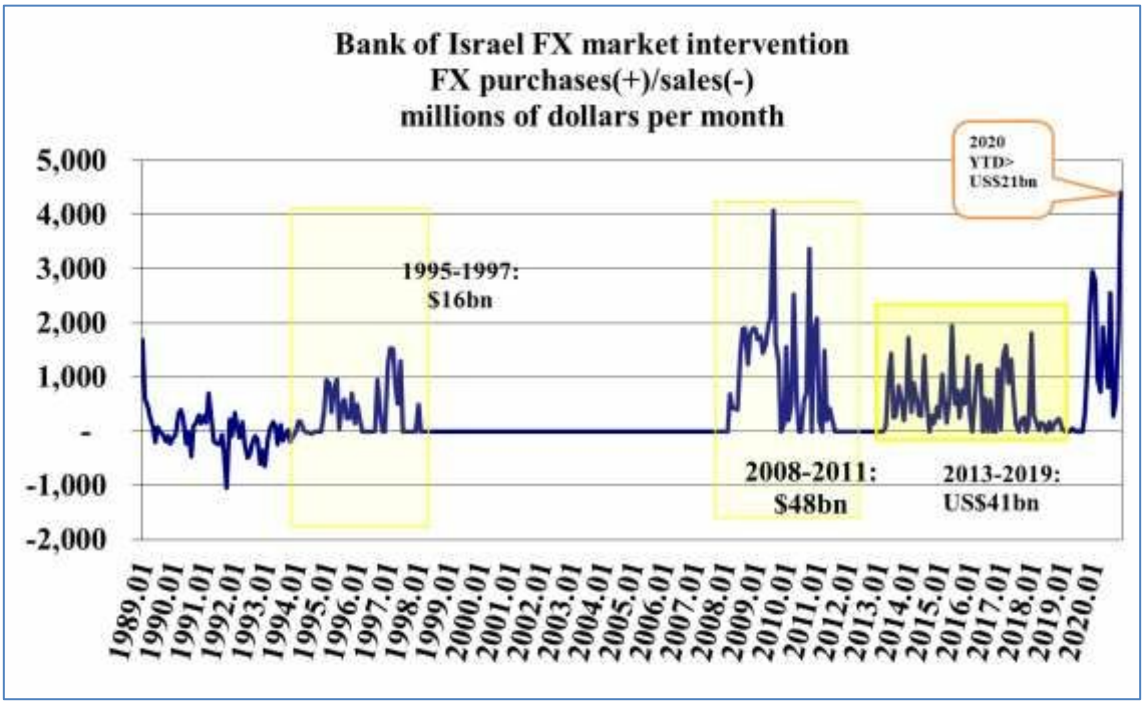
Leumi Economic Weekly

January 20, 2021

Statement from the Bank of Israel regarding the framework of its foreign currency purchasing plan for 2021

On January 14, the Bank of Israel (BoI) announced it will purchase US$30bn in the foreign currency market in 2021. According to the BoI, the advance notification on the volume of purchases is intended to provide the market a greater degree of certainty regarding the central bank's commitment to deal with the sharp strengthening of the shekel that has occurred since November, and even more so in the first half of January 2021.

In order to moderate the strengthening of the shekel, the BoI had already heightened its intervention in the foreign exchange market in 2020, purchasing an overall sum of US$21bn. Despite this, the shekel strengthened vis-à-vis the currency basket, and even more so over the last two months. On top of this must also be added the effects of the weakening US dollar around the world, with all this resulting in a substantial strengthening of the shekel vis-à-vis the dollar. Hence, the BoI's intervention activity in the foreign exchange market over the past dozen years has succeeded only to moderate the rate at which the shekel has strengthened.



The BoI explains the strengthening of the shekel with the intensification of foreign currency inflows into the Israeli economy, against the backdrop of the increase in the current account surplus (approximately US$20bn in 2020). Also contributing to the shekel's strength have been direct investments, net financial investment inflows, and recently, foreign currency sales (hedging activity) in high volumes by institutional investors against their investment gains in overseas equity markets.

Since there really is not any restriction on the level of foreign currency reserves that may be held by the BoI, the move taken is only "declaratory", and as was the case in the past, during the tenure of previous central bank governors, the BoI eventually found itself acquiring much more foreign currency than what it had initially declared, beyond levels stipulated in foreign currency reserves target levels. Therefore, in practice, there is nothing to prevent the BoI from purchasing more than US$30bn in foreign currency throughout the year.

Continuing with the above, it seems this activity is intended to prevent "over-appreciation" of the shekel, which would go beyond what is derived from underlying fundamentals. The US$30bn framework for purchases exceeds the expected surplus in the current account of the balance of payments in 2021, and is intended to deal with additional forces that are fueling the strength of the shekel, primarily the influence of financial factors.

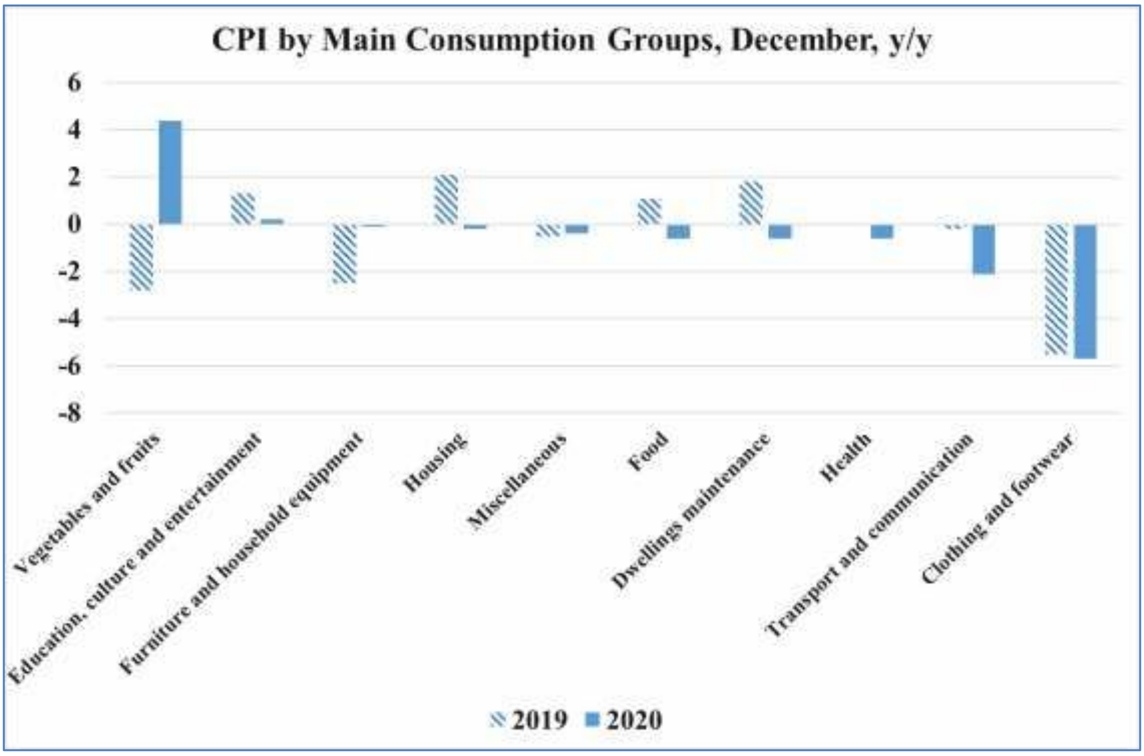
The BoI notes that the foreign currency purchases, which are in fact not limited to "only" US$30bn, will continue *"so long as they do not lead to a depreciation at an extent that is not consistent with the achievement of the Bank's price stability and financial stability objectives."* It is worthwhile to note, as can be seen in the accompanying chart, that the declared sum of purchases for this year is higher than that seen in any year in the past, and this reflects the strength of the factors behind the shekel appreciation and its implications for the economy in a time of deep economic crisis.

Most of the main CPI components fell in 2020: housing, as well as transportation and communication, stood out for their contribution to the decline in inflation

The consumer price index (CPI) declined 0.7% in 2020 (end of period), this compared to an increase of 0.6% in 2019. This is the first year that has ended with negative inflation since 2016, and the seventh consecutive year that ended with inflation below the price stability target range of the BoI (1% - 3%).

A look at the main CPI components shows the decline in the CPI in 2020 was broad, with eight of the main components, out of ten overall, falling in 2020 (see accompanying chart). Some of the components declined primarily due to the consequences of the coronavirus pandemic. As is known, the effects of the pandemic on prices can be broken down to two aspects that act in opposing directions. On one hand, there is a decline in demand that acts to lower prices, in light of the increase in uncertainty, the damage to the income of some households, social distancing restrictions, and the fears of being infected with the virus. On the other hand, disruptions to the production and supply chains of goods and services due to the economic shutdowns and the restrictions on activity lead to a reduction in supply, a development that supports a rise in prices.

In light of the sharp drop in the rate of change of the CPI, it can be estimated that the demand impact has been until now greater than the effects relating to supply. The impact of the pandemic is notable primarily in the main CPI components that have a high weighting in the index, including housing (approximately 25% of the CPI), as well as transportation and communication (approximately 20%), such that their impact on the change in the CPI has been high as well. The contribution of these components to the change in the inflation rate in 2020 relative to 2019, which amounted to a decline of 1.3 percentage points, is estimated to equal a decline of 0.9 percentage points.



The increase during 2020 in the owned dwellings services sub-component (reflecting the change in prices in new and renewed housing rental contracts), which represents a main portion of the housing component, was close to zero. The moderate increase reflects substantial weakness on the demand side. The purchasing power of renters was substantially hurt, since the coronavirus crisis primarily hurt the employment of workers who earn relatively low wages. These employees, for the most part, tend to live in rental housing and do not own their homes, and this situation led to weakness in sentiment among renters.

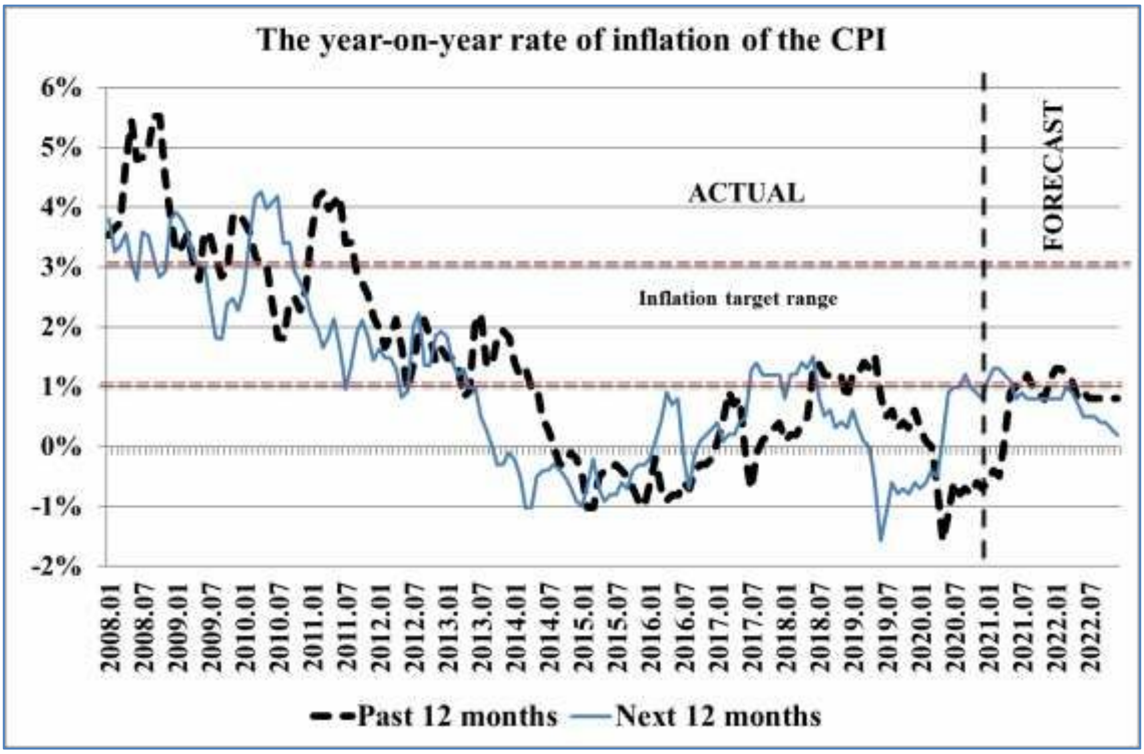
Furthermore, because of the crisis there was a decline in demand for rental accommodation among students and young people (some of whom returned temporarily to live with their parents), due to the loss of jobs and in light of the shifting of studies to distance learning. In addition, another factor affected the housing component, and this factor is not directly related to rental prices or to the coronavirus. This is referring to the cut in the purchase tax on housing.

The sharp drop in energy prices, due to the fall in global demand, against the backdrop of social distancing restrictions and the economic shutdowns that were imposed around the world, is reflected in the CPI primarily through gasoline prices. This development showed its impact in the decline in the transportation and communication component.

The inflation environment is expected to increase, such that inflation in the coming year is likely to rise to around 1.0%

Looking ahead, on the assumption that the inoculation process in Israel and around the world will continue in a manner that will gradually permit the different sectors of the economy to return to full operations, then a substantial increase is expected in the inflation environment during the coming year. In our opinion, during the second quarter of 2021, with the exit of especially low CPI figures from the annual window of calculation (April-May 2020), inflation is expected to return to positive levels and by the end of the year it is likely to equal around 1.0% or slightly higher than this (see accompanying chart). It is important to note that also the capital market inflation expectations looking one year forward climbed substantially over recent weeks, similar to the trend around the world, although these expectations remain slightly below 1%.

There has been an accumulation of factors supporting the rise in inflation for the coming year. First, a notable increase was registered in recent months in global energy and commodities prices (agricultural commodities and metals prices are currently at higher levels than those registered before the coronavirus crisis). This increase is expected to trickle into inflation, with an emphasis on consumption goods included in the CPI. Part of this impact is immediate (expressed primarily in a rise in gasoline prices), although some of the effects are expected to start only with a slight lag, apparently near mid-2021 and beyond. On this regard, also sea shipping costs increased recently by a substantial degree, and this is an additional factor that is likely to support a rise in the prices of consumption goods in the coming months.



Second, on the assumption that the coronavirus pandemic will indeed be brought under control in Israel and around the world in the coming months, then an improvement is expected in economic activity and in the condition of households, in a manner that will support a recovery in local demand for goods and services. In particular, the housing component, the increase in which was totally stopped due to the coronavirus crisis, is expected to climb once again in the coming year, both as a result of the improvement in the purchasing power of renters, and also due to a shortage in supply, against the backdrop of the decline in residential housing completions over the past year.

Third, in some of the services sectors (such as hotels, restaurants, culture, and leisure), demand is likely to recover more quickly than the supply (against the backdrop of, among other things, the closure of many businesses during the crisis and the possibility for the continuation of partial restrictions on their activity). This situation is likely to lead to price increases in these sectors.

Fourth, if indeed the heightened intervention of the BoI will succeed to at least slow the appreciation of the exchange rate, following the accelerated appreciation of recent months, the "deadweight" represented by the exchange rate on the recovery of inflation will weaken. Such a development will have an additional contribution toward a renewal in price increases in the economy.

And finally, the substantial rise in the money stock in the economy (the amount of cash held by the public and current account balances) during recent months (against the backdrop of, among other things, the accumulation of savings due to the inability to consume some of the goods and services as usual), is likely to feed over time, at least partially, into a rise in prices, since in this situation more money in the economy "competes" in the short-term for a certain amount of goods and services. This situation can lead to a decline in the value of money and to price increases. This effect will possibly start to be felt toward the end of the coming year**.**

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