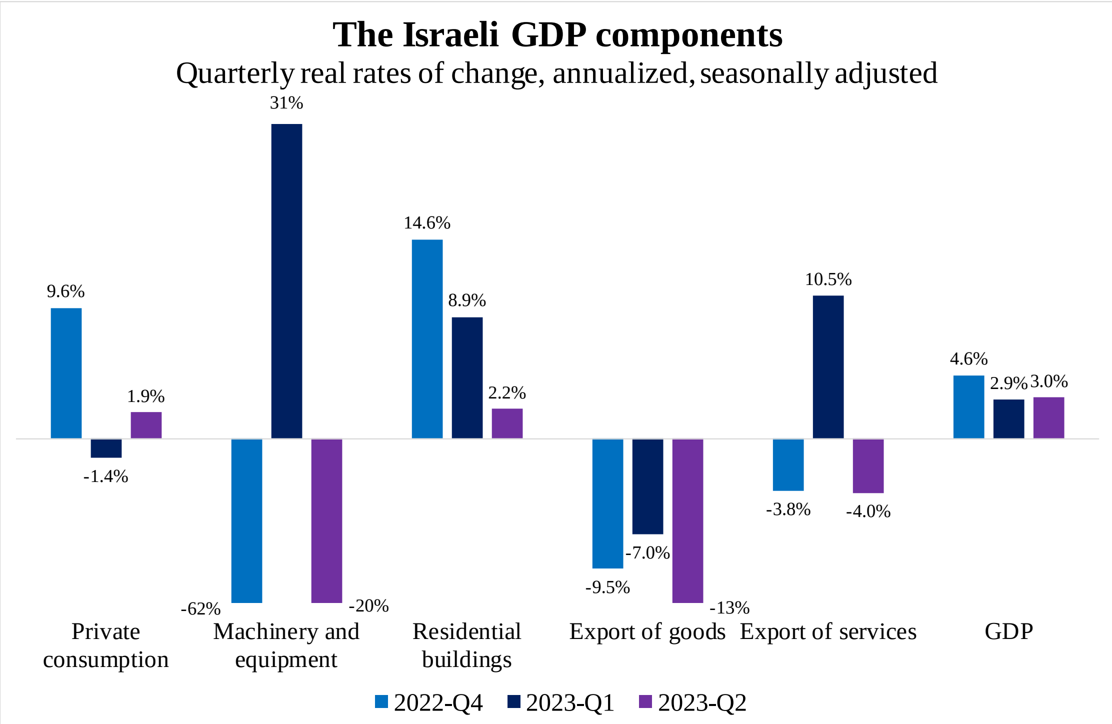
Leumi Economic Weekly

August 16, 2023

Israeli GDP grew in the second quarter of the year by an annualized 3.0%

According to estimates from the Central Bureau of Statistics (CBS), local economic activity continued to expand in the second quarter of this year, by a rate similar to that in the first quarter. Israel's GDP grew 3.0% in the second quarter (in real terms, annualized; excluding seasonality), after having grown 2.9% in the first quarter of the year (annualized; revised downward from 3.2%).



The local economy indeed grew in the second quarter of this year by a rate within a close range of most of the growth forecasts for the current year. However, analysis of the growth rates broken down by the components of GDP indicates relative weakness of the economy's main growth engines (see accompanying chart). Growth in this quarter was supported mainly by an increase in public consumption, coupled with a sharp drop in imports. Private consumption indeed increased 1.9% (annualized), after having declined in the first quarter of the year, mainly due to a sharp drop in automobile purchases. However, the latest figure reflects a standstill in private consumption per capita, compared to an average growth rate of 2% per capita over the years.

BANK LEUMI LE-ISRAEL, THE CAPITAL MARKETS DIVISION
The Economics Sector, P.O.Box 2, Tel Aviv 61000
Ph: 972-76-885-8737, Fax: 972-77-895-8737, e-mail: Gilbu@bll.co.il
http://english.leumi.co.il/Home/

We note that near-zero growth was registered in the current consumption of services (flights, hotels, and more), alongside a continued decline in consumption of durable goods (automobiles, furniture, and electronic equipment) as well as semi-durable goods (clothing and footwear, and more). This development occurred against the backdrop of an erosion in the purchasing power of households, attributed to the relatively high inflation and interest rate environments, and is expected to weigh on private consumption also in the coming quarters.

In addition, investment in capital goods declined, after having grown rapidly in the first quarter of the year. This comes against the backdrop of a decline in investment in machinery and equipment, coupled with continued moderation in the rate of expansion in investment in residential construction, due to the decline in construction starts over recent quarters. A notable weakness stands out in the export data of goods and services from Israel (in real shekel terms, adjusted for seasonality), against the backdrop of declines in all the main export components (goods and services), including: industrial exports, other services (mainly high-tech), and tourism services.

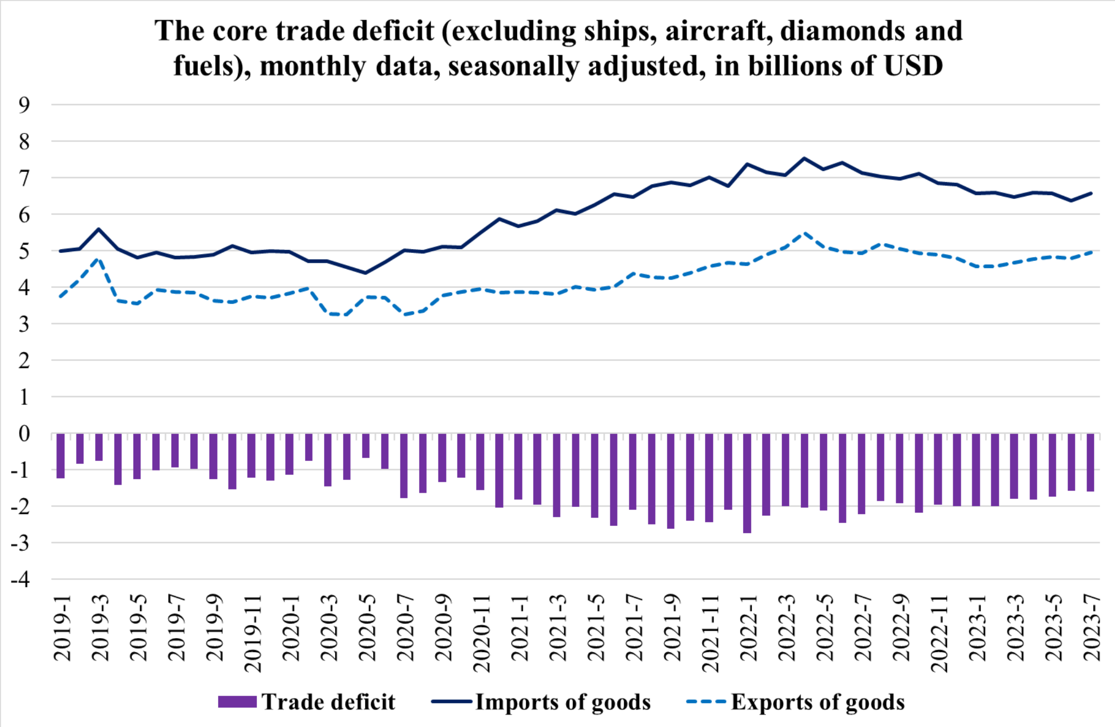
On the other hand, we note that the current, original data that are not adjusted for the effects of, among other things, changes in prices and exchange rates, indicate an increase in the second quarter. This development is in-line with the monthly foreign trade data, which are denominated in current US dollar terms (see details in the next section). At the same time, the sharp drop in the import of goods and services contributed to growth; however, this indicates the potential for moderation in the rate of expansion in domestic activity later on. Looking ahead, we estimate in our baseline scenario that GDP growth in 2023 is expected to range around 3% (annual average).

In July, at the start of the third quarter of 2023, the export of goods from Israel increased, while imports registered an increase as well

CBS data show that the export of goods from Israel (seasonally adjusted data; excluding ships, aircraft, and diamonds) amounted to US$5.0bn in July 2023, at the start of the third quarter of the year. This figure reflects a 3.3% increase (in nominal US dollar terms) compared to the preceding month, and a 0.7% increase compared to the parallel month last year.

The following industries registered substantial increases in their exports compared to the preceding month: the manufacture of fabricated metal products, machinery and equipment; and the manufacture of chemicals and chemical products. It appears these increases occurred against the backdrop of rising demand for these industrial goods from Israel’s trade partners. In addition, it is possible the rise in the export prices of these goods contributed to the increase in goods exports, in nominal US dollar terms. This is in contrast to the decline in the export of goods and services from Israel in the second quarter of the year in real shekel terms. An additional possible explanation is the depreciation that occurred in the shekel exchange rate vis-à-vis the euro and the dollar, which increased the competitiveness of Israeli exporters relative to the exporters of other countries.

Goods imports (seasonally adjusted data; excluding ships, aircraft, diamonds, and fuels) equaled US$6.6bn in July 2023. This sum reflects a 3.1% increase (in nominal US dollar terms) compared to the preceding month, yet indicates a decline of 8.0% compared to the parallel month last year, a period in which exports from Israel were at a peak. The increase compared to the preceding month was broad and characterized all the categories of goods (raw materials, consumption goods, and investment goods). The more rapid increase in exports compared to imports, in the event this will continue also in August-September, will support the decline in Israel's core trade account deficit (excluding ships, aircraft, diamonds, and fuels) in the third quarter of this year.

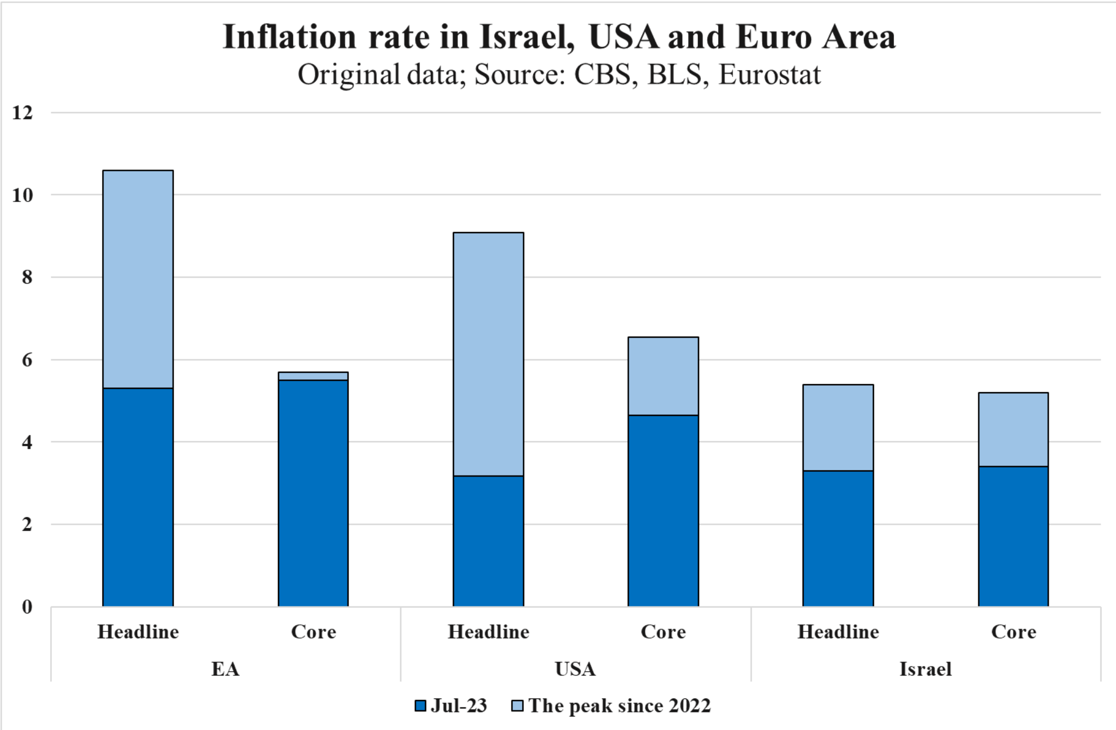


Annual inflation fell sharply in July, but is expected to climb sharply next month

According to CBS data, Israel's consumer price index (CPI) increased 0.3% in July 2023. This rate of change is slightly below what were the initial forecasts in the market, for the third consecutive month (the median inflation forecast stood at 0.4%, while our forecast at *Leumi* stood at 0.5%). The rate of increase in prices over the trailing 12-month period fell sharply from 4.2% to 3.3%, this mainly against the backdrop of the exit of the July 2022 data point from the window of calculation, as last year's figure was extraordinarily high (increased by a rate of 1.1%). However, it appears that after the publication of August's CPI, the rate of increase in prices over the trailing 12-month period will rise, to approximately 4%, for the opposite reason, since the August 2022 CPI figure, which was substantially below that from recent years, will drop from the window of calculation.

Notable price increases were registered in the following components: fruits and vegetables, housing, and expenditures on overseas travel. On the other hand, substantial price declines occurred in the following components: furniture and home equipment, which has fallen in each of the last six months; and clothing and footwear, which has declined sharply since the beginning of the year, by 6.1% (July vis-à-vis December), compared to 5.2% on average in the same period in the years 2017-2019.

Inflation in Israel, and within Israel's main trade partners, the US and the euro area, has been moderating over the recent period (see accompanying chart). Thus, since the peak registered back in January 2023, the inflation rate in Israel has fallen 2.1 percentage points, and in the US and the euro area inflation has fallen by more substantial sums compared to their peaks, by 5.9 percentage points (since June 2022) and by 5.3 percentage points (since October 2022), respectively. The sharper declines in the US and the euro bloc are explained mainly by the notable increases that were registered in energy prices in these economies, due to the consequences of Russia's invasion of Ukraine, whereas in Israel the rise in energy prices was more restrained.



In contrast, core inflation (excluding food and energy prices – according to the accepted definition around the world), which has also been moderating, fell by a lesser degree compared to general inflation (although in Israel the differential between the declines in headline and core inflation is relatively moderate). This is because core inflation is more dependent on domestic factors, such as: the timing and intensity of monetary restraint, the rate of increase in the average salary in the economy, and more. Thus, core inflation is less affected by global commodities prices, and therefore moderates more slowly compared to headline inflation.

Looking ahead, according to our *Leumi* forecast, after the rise in inflation over the trailing 12-month period in August, as mentioned above, the inflation rate is expected to decline gradually, and toward the second quarter of 2024, it is even expected to decline to within the price stability target range (1% - 3%). However, it is important to emphasize that the changes in policy of the Ministry of Finance (MoF), with respect to the duration and/or the scope of reduction in the excise tax on gasoline, may have a substantial impact on the inflation rate. It is quite possible that in the near term the MoF may decide to cancel the reduction in the gasoline excise tax, for a number of possible reasons, including: to increase state revenues against the backdrop of the increase in the fiscal deficit in terms of GDP; or a decline in inflation in Israel, which will create a more "convenient" environment for the implementation of such a step. A complete cancellation of the reduction to the gasoline excise tax (at its current level) is expected to lead on its own to a cumulative 0.4% increase in the CPI.

In addition, we note that the overall picture, as has been described, does not support any change to the current interest rate level of the Bank of Israel (BoI) in the coming months. In our baseline scenario, we estimate an initial interest rate cut is expected only during the first half of 2024.

Authors: **Gili Ben Avraham and Yaniv Bar**