Leumi Economic Weekly

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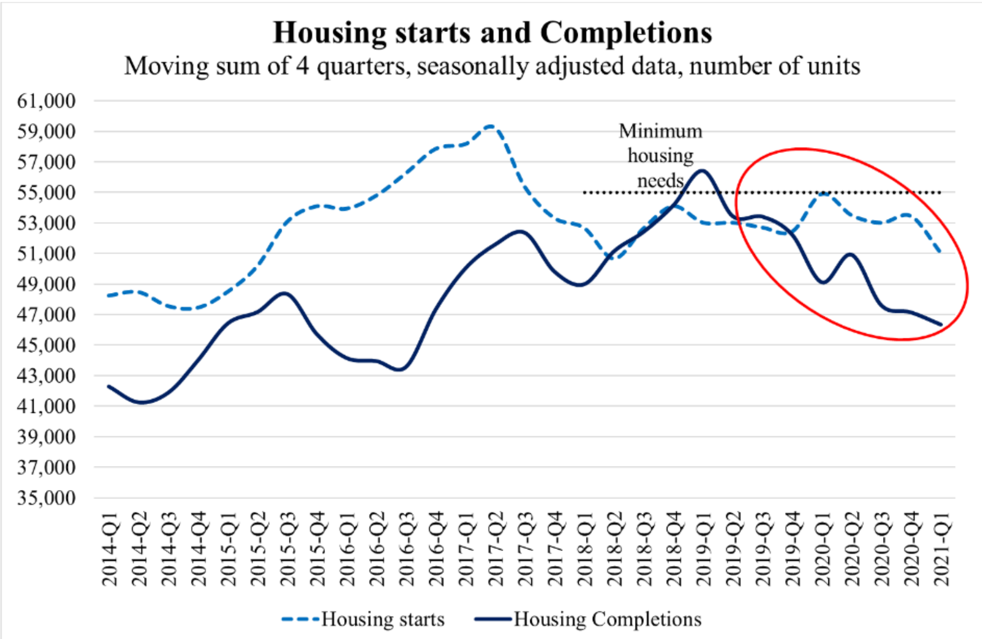
The pace of housing construction in the economy continues to stand still amid the effects of the coronavirus, to a degree that is likely to intensify demand pressures in the market

Data from the Central Bureau of Statistics (CBS) indicate that housing starts in the first quarter of 2021 amounted to about 12,000 units, while over the last four quarters about 51,000 housing starts were registered (seasonally adjusted data). Even though the pace of construction starts over the past year is about 7% below the level from the preceding year, it is important to take into consideration that the initial housing starts data tend to be revised upward at a later stage. In light of this, <u>it appears the current pace of housing starts is only somewhat below, if at all, the pre-coronavirus level.</u> Nonetheless, the level of construction is still below the minimum requirements of the economy, which we estimate to equal 55,000 units per year.



<u>Housing completions, on the other hand, continue to be distinctly below their pre-coronavirus crisis levels</u>, and also below the required level for the needs of the economy. The number of completions in the first quarter of 2021 reached only about 11,000 units, and over the past year the number reached about 46,000 units, the lowest annual level in the last 4½ years (see accompanying chart). Against the backdrop of the fall in completions, the number of units under active construction increased, reaching a record number of 129,000 units in the end of the first quarter of 2021.

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/

The decline in housing completions is consistent with additional indications of the construction sector's difficulties in recovering from the effects of the coronavirus, such as the level of investment in residential construction, which remained relatively low in the first quarter of 2021. A major barrier hampering the construction sector's return to its pre-crisis pace of construction is a shortage of manpower, amid the difficulty experienced in recruiting workers furloughed during the coronavirus crisis (a difficulty that is likely to fade away if and when the government payouts to furloughed employees in the economy will halt for many workers, starting from July 2021 and onwards). Also hampering the level of manpower has been the government restrictions on the entrance of professional construction workers from overseas into Israel. The severe shortage in workers within the construction sector is expressed in a relatively high rate of job vacancies in the sector (6.5% as of May, 2021, compared to 5.6% in 2019 prior to the coronavirus crisis, and higher than the average for the overall economy).

In summary, <u>the data show the pace of residential construction is struggling to return to its pre-coronavirus crisis level, in such a manner that adversely affects especially the pace of housing completions, and the delivery of available inventory to the residential market, and to a lesser degree housing starts.</u>

What is expected in the housing market in the near-term?

The relatively weak pace of housing construction in the economy, which means a level of supply that does not increase at a desirable rate, is occurring in parallel to the release of substantial "pent-up" demand, especially in the new home segment, and therefore has the potential to increase excess demand in the housing market. Against the backdrop of these processes, home prices have been experiencing a substantial acceleration over recent months – over the past half-year home prices increased by an annual rate of 9.4%, the highest rate in the last five years.

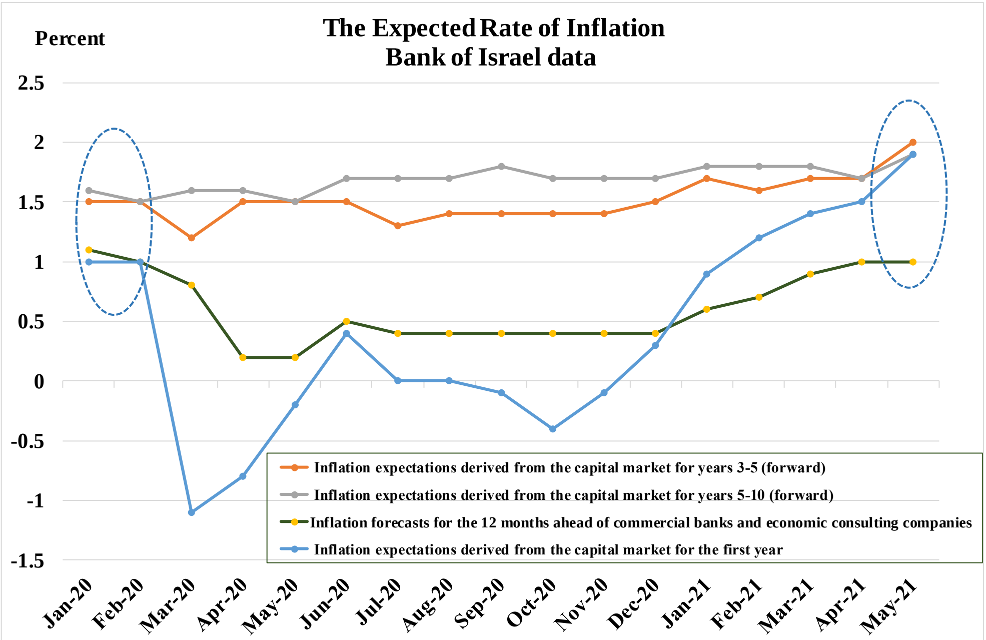
In our view, demand in the market will remain high in the coming months, yet the pace of construction is not expected to increase substantially, such that 2021 is expected to conclude with a high single-digit rate of increase in home prices. Later on, parallel to an easing in the shortage of workers in the sector, residential completions are expected to recover, yet in the medium-term a renewed drop in levels is expected, being the result of an intensification in "bottle-necks" in the "planning pipeline" over the last one-two years. This will be in such a manner that is likely to bring back, and to even intensify further, the shortage in new units in the economy, and to bring about a renewed acceleration in the rise in home prices in the medium-term.

Against this backdrop and over the long-term, the new Israeli government faces a substantial challenge of increasing the housing supply in the economy. In this context, a plan to accelerate economic growth recently released by the Bank of Israel (BoI) recommends increasing the supply of housing in areas of high demand through, among other ways, reducing barriers to urban renewal (adapting the planning process to urban renewal projects, formulating a uniform policy on home improvement levies, and more) and creating financial incentives for local authorities to meet targets for the issuance of building permits.

Inflation expectations are in an upward trend, yet do not deviate from the middle of the price stability target range

The inflation environment in the Israeli economy, as in most of the advanced countries, increased over recent months. In Israel, the consumer price index (CPI) increased 1.5% over the past year, while its rate of increase has accelerated compared to the past year (see analysis in our survey from June 16, 2021). However, in the coming months a more moderate rise is expected in the CPI, and also in the coming year.

The BoI recently published the inflation expectations derived from capital markets data, as well as from various financial institutions from which the central bank regularly collects forecasts regarding expected inflation in the coming year. As can be seen in the accompanying chart, the development of the capital market derived inflation expectations for the coming year over the course of time, shows an increase from a level of 1% in January-February 2020 (pre-crisis) to a level close to 2% in May 2021, that is to say, an increase of one percentage point. Data on the expectations for two years (not appearing in the chart) indicate a similar trend, whereas the one-year forecasts that are based on the forecasts of financial institutions in the economy (banks and consulting firms) do not indicate any substantial change (partial data for June attest to a slight uptick compared to the beginning of 2020).



Part of the explanation for the rise in the level of the expectations stems from an adaptive mechanism ("adaptive expectations"), which holds that "what has been is what will be", that is to say, expectations that inflation in the coming year will remain similar to the relatively high level relative to that registered in the past year. This is despite the fact that some of the current price increases represent a correction to the declines registered due to the impact of the crisis, such as a substantial effect resulting from increases in raw materials prices; transportation costs affected by the crisis; prices of electronic components, the supply of which has not met the growing demand for final products; and more. On this regard, it is worth noting that the Governor of the BoI recently presented an analysis at a conference of the Aaron Institute for Economic Policy at the Interdisciplinary Center in Herzliya, according to which, capital market expectations do not anticipate an inflationary outbreak in the foreseeable future, as most of the increase in inflation has stemmed from global effects of supply factors, as we have also presented here.

Together with the development of short-term expectations, we also analyzed the trends in capital-market derived expectations over longer durations: for 3-5 years and for the fifth through the tenth year. The data presented in the accompanying chart show an increase of one-half of one percentage point in the level of expectations since the beginning of 2020 until just recently. However, despite the increase in the level of expectations for the longer-terms, they are anchored near the middle of the price stability target range (1% - 3%), similar to their average level in the years 2016 – 2019.

In summary, in seems at this time that the recent rise in inflation expectations does not reflect a substantial permanent component, and is mainly a result of supply factors that are not expected to persist in the coming years. This is while the aggregate demand factors in Israel are not expected to expand at an accelerated pace (such as in the US economy, against the backdrop of substantial budgetary expansion), while in the background it is important to remember the weakness in the Israeli labor market, which is expected also to reflect the difficulty in returning some of the workers who were furloughed back into the labor force. Of course, these assessments are conditional on the continued recovery of the global and Israeli economies, assuming continued low morbidity in Israel, and improvement in the world situation.

Authors: Alon Kol Kreis and Eyal Raz