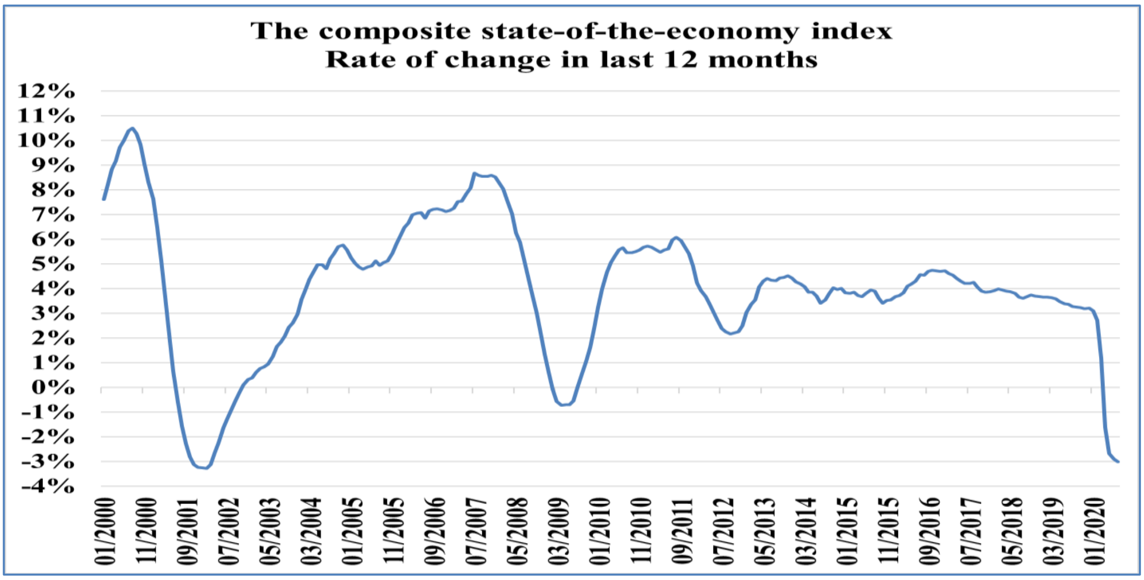
Leumi Economic Weekly

August 26, 2020

The composite state-of-the-economy index increased slightly in July, yet its annual rate indicates a sharp decline

The July 2020 composite state-of-the-economy index, published by the Bank of Israel (BoI), increased 0.15%, this following declines starting back in February this year that intensified in March-May. In June, after a return to activity in most sectors of the economy, economic activity stabilized, and in July, as mentioned, there was a slight increase. A similar picture arises when analyzing revenues in the different sectors of the economy (each month compared to the parallel period in the preceding year, due to the absence of seasonally adjusted data that would enable comparisons throughout the year). Analysis of the data shows that following the decline in revenues in April, an improvement began in May, and in June some of the sectors (including in the overall economy) registered a similar or greater level of revenues (June 2020 compared to June 2019). Most of the sectors that still indicate a decline in revenues (June 2020 compared to June 2019) are from the services sectors.

As mentioned, the composite state-of-the-economy index for July indeed increased slightly, yet as can be seen in the accompanying chart, its annual rate of change indicates a sharp drop similar to that which occurred in the beginning of the millennium. The recoveries from previous crises to a level of growth similar to the pre-crisis level lasted a number of years in each case. In view of the special characteristics of the current crisis, which does not stem from unique and/or structural economic problems in the Israeli or global economies, it is difficult at this current time to estimate an "end point" for the current crisis, yet it appears that it will not be shorter than previous crises.



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There is no change in the BoI interest rate, or in the other instruments that support expansionary monetary policy

On August 24th the BoI announced there will be no change to the central bank interest rate and that it will remain at 0.1%. In backdrop to this decision stands, on one hand, the July and August indicators that show a slowdown in the recovery in activity following a relatively rapid recovery in June, and also the unemployment rate that increased slightly in July. Furthermore, the fact was pointed out that the exchange rate, at its current level, makes a recovery in exports difficult. The current exchange rate also makes a return of inflation to its target rate quite difficult, with inflation currently at a very low level. On the other hand, the BoI pointed out in its announcement, the forecasts of investment houses for positive growth in the world in the second half of the year, and the stability in the financial markets. These factors have a positive impact on the economy.

In the summary of the BoI announcement, the central bank noted that:
"In view of the magnitude of the crisis's adverse impact on economic activity, the Committee continues to implement a range of tools in order to increase the extent of the monetary policy accommodation and to ensure the continued orderly functioning of the financial markets. The Committee will expand the use of the existing tools, including the interest rate tool, and will operate additional ones, to the extent that it assesses that the crisis is lengthening and that it is necessary in order to achieve the monetary policy goals and to moderate the negative economic impact created as a result of the crisis."

What all this means is that the BoI is likely to broaden the monetary tools under its authority, including an interest rate cut, in the event such a move will be required. It appears, based on the announcement, that the conditions have not yet formed for the changes as mentioned, and that currently there is a wait-and-see approach to making additional decisions, alongside the continued use in the existing instruments. However, in view of the presentation of the two scenarios of the macro-economic forecasts that the research department of the BoI presented, parallel to the interest rate announcement, and which we will address below, it appears that in a situation that represent the pessimistic scenario, there is likely to be a change, coupled with the use of additional policy instruments.

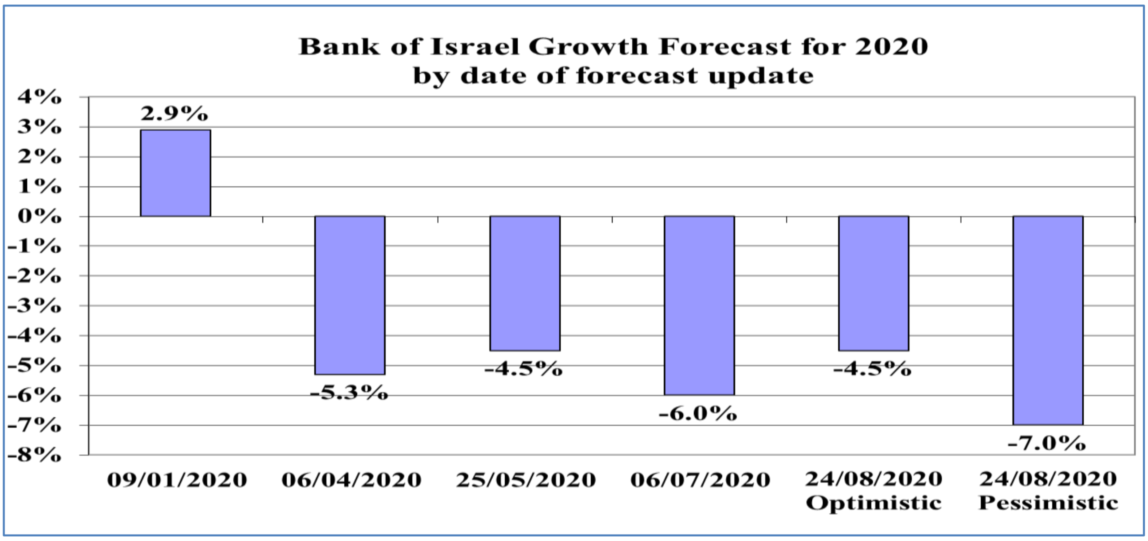
On this regard, with respect to the use of other instruments, in addition to the interest rate tool, the BoI appears, according to the BoI announcement, to be satisfied with the improvement until now in the functioning of the credit markets with the stability in interest rates, in the support of the BoI measures and the state guaranteed credit funds. Furthermore, the BoI pointed out the fact that the yield on government bonds remains low, and the intervention of the BoI in the corporate bond market contributed to a substantial decline in margins. In other words, it appears that the use of the various tools implemented by the BoI, which support the credit channel through which monetary policy operates, is achieving its goals.

Revision to the macro-economic forecast of the BoI research department

The research department of the BoI presented, together with the interest rate announcement, two main scenarios that serve as the basis for its 2020-2021 macro-economic forecasts. The optimistic scenario is based on the assumption that the level of morbidity will be brought under control, such that there will be no additional substantial restrictions above and beyond the current restrictions, while the pessimistic scenario assumes the morbidity level will remain high, such that economic activity will moderate as a result of additional restrictions (up to the point of a formal closure), or via the voluntary avoidance of activity by the public in light of the intensified level of morbidity. The pessimistic scenario includes in parallel also a second wave of morbidity overseas.

In the optimistic scenario the 2020 GDP is expected to contract 4.5%, which is 1.5 percentage points less negative compared to the prior forecast, while in 2021 growth is expected to reach 6.0% (*Bank Leumi*'s forecast, in the baseline scenario, estimates a contraction of 5.5% in 2020 and 5.8% growth in 2021). The volatility in the BoI forecasts, throughout the period of the crisis, as can be seen in the accompanying graph, as well as among other forecasting bodies in which *Leumi* is included, stems from the high level of uncertainty regarding the impact of the coronavirus pandemic.

The upward revision in the forecast on real activity in 2020 is explained by the starting point, according to which the damage of the crisis on the economy is below that which the BoI estimated in the basis for its July forecast; by the government assistance plans (that support expansion in activity); and by the restriction of inactivity that represents an obstacle to growth until the discovery of a vaccine. The expected increase in GDP in 2020, compared to the preceding July forecast, is reflected in all the uses of resources, except for private consumption. Especially notable is the positive change in the forecast on exports, as the current forecast estimates a 4% decline, compared to a 13% reduction in the forecast from July. This is against the backdrop of, among other things, relatively positive data coming out of the first half of the year.



The 2020 government deficit is expected to reach, according to the BoI forecast, 13.2% of GDP, and the debt/GDP ratio is expected to climb to 75% (similar to the July forecast). In 2021 the deficit is expected to reach 8.2% of GDP and the debt/GDP ratio is expected to climb to 78%. In our opinion, these forecasts are very sensitive to the level of implementation of government expenditures, while in the background to these developments there is the rejection of the approval of the budget for this year that increases uncertainty, also regarding the timing of the approval of the 2021 budget. The result is likely to cause the less-than-optimal use of fiscal policy instruments in a manner that may impose an additional burden on monetary policy, in its role as a complimentary policy instrument in the use of economic policy.

In the pessimistic scenario presented by the BoI research department, GDP in 2020 is expected to contract 7%, and next year growth will reach only 3%, such that the average level of activity will be 10% below the trend prior to the crisis. In both scenarios, the research department estimates that in another year, the central bank interest rate will stand at 0.0-1.0%. This figure is consistent with the forecast of *Bank Leumi*.

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