ISRAEL

FAVOURABLE OUTLOOK

The Israeli economy goes into 2022 in a favourable position. After a strong recovery in 2021, growth is likely to receive continued support from household consumption and exports. Although inflation is rising, it remains under control, which should allow the continuation of an accommodative monetary policy. Macroeconomic fundamentals remain very favourable for the shekel, although monetary tightening in the US and a possible correction in US equity markets could slow its rise. The vulnerability of public finances to an increase in interest rates remains limited, due to the essentially domestic financing of the budget deficit and the low risk of any substantial monetary tightening in the short term.

A STRONG ECONOMIC RECOVERY

The Israeli economy has held up well in the face of the pandemic. Real GDP contraction in 2020 (-2.2%) was one of the smallest in the OECD and there was a strong recovery in 2021. Real GDP growth reached an estimated 6.7% over the year as a whole. Private consumption and investment were the two main engines of the recovery. The effectiveness of the vaccine campaign (at least over the first three quarters of the year) allowed restrictions on mobility to be lifted. Household purchasing power has been sustained by moderate inflation and the reduction in unemployment over the course of the year. The unemployment rate (on its broad definition, which includes those deprived of work, even on a temporary basis, due to the pandemic) was 6.3% at the end of 2021, down from 13.2% a year earlier, whilst the employment rate has almost returned to its pre-pandemic level. Strong growth in investment (+14% y/y in Q3 2021, from +16% in Q2) was driven both by investment in residential real estate and productive investment in industry. Conversely, although exports, particularly of hi-tech services, remain an important source of support (+13% y/y over the first three quarters), the recovery in domestic demand has boosted imports (+20% y/y over the first three quarters), thus implying a negative contribution of net foreign trade to growth.

In the short term, economic activity is likely to remain strong, with growth projected at 5% in 2022. However, the resurgence of Covid-19 with the omicron variant could threaten this forecast. The variant is spreading in Israel, lagging Europe somewhat, but the government has so far opted in favour of mobility, by keeping restrictions as light as possible. However, infections are rising rapidly and some indicators argue for caution. Mobility indicators have once more been moving downwards since the beginning of the year and are well below their levels at the end of 2019. According to the Bank of Israel, credit card purchases have been losing steam since the end of 2021. Household consumption's capacity to continue to support growth could thus diminish, at least in the short term. Moreover, government support measures to households and corporates are gradually being scaled back. On the supply side, many sectors are suffering from difficulties in recruitment, particularly in services, whilst industry and construction are experiencing supply disruptions for materials and certain capital goods.

Medium-term growth prospects are favourable, thanks particularly to the competitiveness of certain sectors, most notably hi-tech. The limited economic recession seen in 2020 relative to other OECD members highlights the solidity of the Israeli economy. This said, a number of structural weaknesses remain and could hold back potential growth. Growing inequality remains a major weakness, fuelled by continued increases in property prices. There was a strong rebound in residential real estate prices over the course of 2021: they rose 10.3% y/y in October 2021, their biggest jump since mid-2011. Meanwhile, the OECD has highlighted the low level of labour productivity, which is 35% below that of the best performing OECD members. This is notably due to the marked dichotomy between hi-tech sectors and the more traditional economy, which has a domestic focus.

FORECASTS

	2019	2020	2021e	2022e	2023e
Real GDP growth (%)	3.4	-2.2	6.7	5.0	3.5
Inflation (CPI, year average, %)	0.8	-0.6	1.5	1.7	1.5
Cent. Gov. balance / GDP (%)	-3.6	-11.4	-4.5	-3.6	-3.4
Cent. Gov. debt / GDP (%)	60	73	68	67	67
Current account balance / GDP (%)	3.4	4.9	4.3	4.2	4.0
External debt / GDP (%)	26	33	31	30	30
Forex reserves (USD bn)	126	173	210	230	240
Forex reserves, in months of imports	14	22	23	23	21

e: ESTIMATE & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

REAL GDP GROWTH (CONTRIBUTIONS)

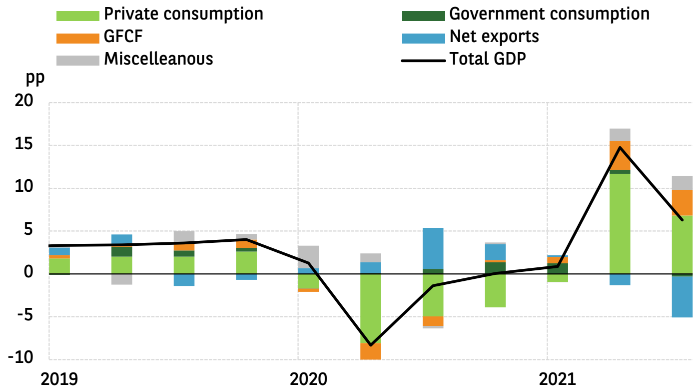

CHART 1 SOURCE: BNP PARIBAS

INFLATION IS UNDER CONTROL

Consumer price inflation accelerated during 2021, but remained well below the average for OECD countries. It was 2.4% y/y in November 2021, against an average of 5.8% for OECD members. Underlying inflation reached 2.5%, confirming the moderate inflationary pressures. Spending on housing (including energy) and transport have been the main contributors to the increase in inflation, whilst the continued appreciation in the shekel has helped keep it in check. More structurally, progress towards energy self-sufficiency, made possible by the exploitation of national gas reserves, has reduced vulnerability to rises in international energy prices. For 2021 as a whole, inflation is likely to have averaged 1.5%. In 2022 it is likely to rise a little to 1.7%, with the introduction of certain taxes, a smaller rise in the shekel and persistent pressure on international supply chains. Wage inflation remains under relatively good control for the time being, but some sectors (construction and the IT and communications industry) have seen increases in average wages of more than 13% since the end of 2019.

MONETARY POLICY REMAINS ACCOMMODATING

According to the conclusions of the most recent monetary policy committee (3 January 2022), the policy stance will remain accommodating. First, because of the continued uncertainty over the economic recovery; secondly, inflation forecasts remain within the Bank of Israel's target range of 1% to 3%. The policy interest rate has been stable at 0.1% since mid-2020. Although a tightening is possible in 2022, it is likely to be limited. Meanwhile, pandemic-related liquidity support measures have been reduced significantly since mid-2021. Repo arrangements backed by bonds had been cut to a residual amount by the end of 2021 (NIS 0.1 billion). Purchases of government bonds increased through to December 2021, reaching NIS 85 billion (5.6% of GDP), the target level set by the BoI when the programme was introduced in 2020.

As far as the exchange rate policy is concerned, the central bank has not so far announced a precise amount for foreign currency purchases in 2022 (USD 30 billion in 2021). The BoI's foreign currency reserves are at record highs (USD 209 billion in November 2021), equivalent to nearly two years of imports of goods and services. Having reached a twenty-year high against the dollar in November last year, the shekel has been more volatile since then, with no clear trend. On the one hand, macroeconomic fundamentals (current account surpluses and strong inflows of foreign direct investment) continue to be powerful sources of support for the shekel. Despite strong import growth in 2021, the current account surplus remained substantial (estimated at 4.3% of GDP) thanks in particular to the strength of exports of services. It is likely to remain above 4% of GDP in 2022. In addition, funds raised by hi-tech companies in 2021 (73% came from non-residents) again set a new record of USD 26 billion (40% higher than 2019 and 2020 combined). On the other hand, financial factors could slow the shekel's rise in 2022. In the short term, the shekel's appreciation will depend on the pace of monetary policy tightening by the Fed (which looks likely to be out of sync with any move by the BoI) and the performance of US equity markets, which affect the performance and thus the foreign currency positions of Israeli investment funds.

USD/ILS EXCHANGE RATE

CHART 2 SOURCE: BANK OF ISRAEL

FISCAL CONSOLIDATION

The budget deficit was reduced significantly in 2021, taking it to 4.5% of GDP from the record level of 11.4% seen in 2020. This was due both to a reduction in Covid-related expenditure (a reduction of 0.9% of GDP), allowing more or less stable total fiscal spending (up 0.6% y/y) and, more significantly, a sizeable increase in revenue (30%), particularly from property taxes and VAT. Debt service costs increased rapidly (+36%), but remained below 7% of total fiscal revenue.

The new government elected in June 2021 adopted the budget for 2021 and 2022 in November 2021. The 2022 budget does not include any significant reforms but puts an emphasis on spending relating to human capital (notably in order to improve access to labour markets for marginalised segments of the population) and infrastructure (particularly transport). The budget deficit is set to continue to shrink in 2022 and 2023 (to 3.6% and 3.4% of GDP respectively according to government estimates) but will not return to its pre-crisis levels (an average of 2.3% of GDP between 2015 and 2019).

From a peak of 73% of GDP in 2020, government debt is estimated at 68% of GDP in 2021. It is likely to stabilise at around 67% of GDP in 2022 and 2023. Despite this relatively high level of debt, sensitivity to an increase in interest rates is limited in the short term. As the government's debt is mainly held by domestic investors (84% of the total), local financial conditions are its main determinants. The BoI's programme of quantitative easing has held ten-year rates at fairly low levels. Meanwhile, with more than 45% of domestic bond debt being indexed to inflation, the modest level of inflationary pressures in the short term reduces the risk of a sharp rise in the government's debt service costs.

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