ISRAEL

FAVOURABLE PROSPECTS DESPITE FISCAL UNCERTAINTY

Fiscal support and the resilience of exports helped limit the economic recession in 2020. A strong recovery is likely in 2021, thanks primarily to a rapid vaccination campaign. The shekel has strengthened on the back of a growing current account surplus and massive capital inflows. The situation for public finances is more uncertain. In addition to the structural deterioration of recent years, the lack of a budget law against a background of repeated government instability is not helpful for budget consolidation. Although solid solvency indicators eliminate any short-term risk, a lack of reforms could weigh on potential growth over the medium to long term.

RECOVERY EXPECTED ON THE BACK OF THE VACCINATION CAMPAIGN

Economic activity held up pretty well in 2020, with a likely fall in real GDP of just 3.7% according to the latest Bank of Israel (BoI) estimates. After a drop in GDP of 1.1% year-on-year (y/y) in Q3, a second lockdown dented the country's economic performance in the final quarter. Over the full year, and given the fall in household consumption and investment, the scale of the recession was limited by public spending and the positive contribution from foreign trade. With imports shrinking by 15% y/y in the third quarter, exports grew by 6%. The strong export performance in 2020 was due in particular to the competitiveness of high-tech services exports and the start of gas exports to Egypt and Jordan.

The labour market deteriorated over the course of 2020, particularly during lockdowns. The Israeli statistical service has introduced a broad unemployment rate to better reflect the unusual economic circumstances. This definition adds to the standard definition of unemployment those people temporarily out of work due to coronavirus-related reasons and those who have withdrawn from the labour market because of the pandemic. From a level of less than 4% before the pandemic began, the broad unemployment rate hit a peak of 37% during the first lockdown in April. According to the BoI, it probably averaged 16% in the final quarter of 2020.

The economic recovery expected for 2021 is highly dependent on the speed and effectiveness of the vaccination campaign. Since the beginning of the year, the country has the OECD's highest rate of vaccination of its population. Some 20% of Israelis have now received the first dose of the vaccine, and the government aims to vaccinate everyone over 16 by the end of January. This said, it would be wise to remain cautious about the timing of economic recovery. The acceleration of the second wave of infections in December forced the government to introduce new lockdown measures, from 6 January for at least two weeks. Under the BoI's optimistic scenario, with a vaccination campaign that is completed in the second quarter, thus allowing the gradual removal of all restrictive measures, real GDP could grow by 6.3% in 2021. This scenario takes account of the uncertainties surrounding the recovery at a global level. Israeli exports account for around one-third of GDP and depend largely on the US and European markets. The BoI's growth forecast for advanced economies (3.4%) remains cautious. All in all, provided that the vaccination campaign is effective, it is this favourable scenario that currently looks the most likely.

Against a background of a sharp fall in household consumption, lower oil prices and a stronger shekel, consumer price inflation was negative in 2020 (estimated at -0.6%).

FORECASTS

	2019	2020e	2021e	2022e
Real GDP growth (%)	3.4	-3.7	6.3	5.0
Inflation (CPI, year average, %)	0.8	-0.6	0.5	1.0
Cent. Gov. balance / GDP (%)	-3.9	-11.5	-7.5	-4.5
Cent. Gov. debt / GDP (%)	60	75	79	79
Current account balance / GDP (%)	3.5	4.2	3.9	3.5
External debt / GDP (%)	27	30	30	31
Forex reserves (USD bn)	126	168	200	210
Forex reserves, in months of imports	14	20	22	21
Exchange rate USDILS (year end)	3.5	3.2	3.2	3.3

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

ECONOMIC ACTIVITY (%, Y/Y)

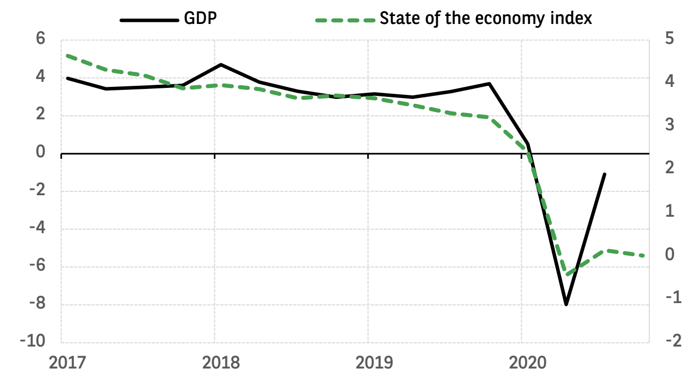

CHART 1

SOURCE: BANK OF ISRAEL, BNP PARIBAS

RECORD EXTERNAL SURPLUSES SUPPORT THE SHEKEL

The current account surplus could hit a record level in 2020 (at 4.2% of GDP, from 3.5% in 2019). On the one hand, imports collapsed. On the other, the growing share of high-tech services exports in total exports of goods and services makes the total figure less sensitive to international conditions. Over the first three quarters of the year, the volume of exports of goods and services grew by 0.3% on average, whilst that of imports fell by 10.5%. At the same time, capital inflows were very substantial in 2020. Foreign direct investment reached USD 19.4 billion (up 56% on 3Q 2019), and portfolio investment was USD 17 billion (from USD -1.1 billion in 3Q 2019) thanks to the government's Eurobond issue.

All of these elements contributed to an increase in the balance of payments surplus and the strengthening of the shekel against the US dollar. This trend was further strengthened by the weakness of the US dollar on international markets and by the rise of international asset markets, both of which are traditionally associated with a stronger shekel. The BoI continued to buy foreign currency in 2020 (USD 21 billion) to help limit the currency's appreciation. It has announced its willingness to increase market interventions in 2021 (USD 30 billion scheduled). This should limit shekel appreciation in a context of narrowing current account surpluses as the economy recovers.

THE FISCAL OUTLOOK IN AN UNCERTAIN POLITICAL CLIMATE

Unsurprisingly, the budget deficit is expected to be significant in 2020, due to a fall in tax receipts (-9.6% in the first 11 months) and more importantly the increase in spending (20% over the same period). Exceptional fiscal measures to support the economy were worth some 7% of GDP, according to the IMF. The total deficit for 2020 is thus likely to have been around 12% of GDP. In 2021 the reduction in the deficit will probably be modest, despite the return to growth. At least some of the economic support measures should be maintained. On the receipts side, continuing restrictions will reduce income from VAT (21% of total government receipts). All in all, we expect a budget deficit of 7.5% of GDP in 2021.

The lack of a budget law since 2019, due to political volatility, is a source of uncertainty over the future path of public finances. The government operates on the basis of a budget passed two years ago that is rolled over from month to month. However, this baseline budget was increased in 2020 in order to adapt to the economic context in 2021.

In the short term, we believe that the consequences of the absence of an approved budget can be managed and that the deterioration of deficit and debt ratios will not result in any increase in sovereign risk. The political trend remains favourable to the control of budget deficits, notably through the introduction of a mechanism for the control of spending that ties any new commitment to an identified source of revenue. However, the structural budget deficit, as calculated by the IMF, has been rising steadily since 2015. It reached 4.1% of GDP in 2019, from 0.7% of GDP in 2015, mainly due to higher social spending and investment. It is currently difficult to predict the trajectory of public spending over the coming years. Even if the government succeeds in controlling the spread of the virus in the short term, its economic consequences will be long-lasting and will require some form of fiscal support to be maintained.

The fiscal position benefits from significant sources of support, which should allow any increase in the cost of financing to be contained. In the short term, the BoI looks set to continue its policy of purchasing government papers and private-sector securities. In November 2020, the BoI held 7% of the tradable Treasury bonds issued by the government (from 0.4% at the end of 2019). The impact on money supply is negligible (money supply increased by 0.7%). This is likely to help limit possible upward pressure on the rates at issuance. In addition, although the trend in government debt was not favourable in 2020 (from 60% of GDP in 2019 to 75% in 2020), its structure remains an element of strength of public finances. The average maturity of the stock of debt was 8.2 years in 2019 (6.8 in 2008). Debt service costs have fallen from 10.7% of total government receipts in 2010 to 5.6% in 2019. The majority of the budget's financing comes from the local market. At the end of 2019, around 85% of government debt was in local hands, with 31% off the market. Israeli mutual and pension funds are significant holders of the tradable part of the debt (43% of the total).

The effect of political volatility on public finances could be more significant over the medium to long term. In order to boost potential growth, a number of structural reforms are needed, to improve productivity across the economy and reduce inequalities. These reforms will be costly and will require some difficult decisions to be made, particularly in terms of tax policy. For the time being, the lack of political stability limits the chances of putting such reforms in place.

GOVERNMENT BUDGET BALANCE (ILS BN)

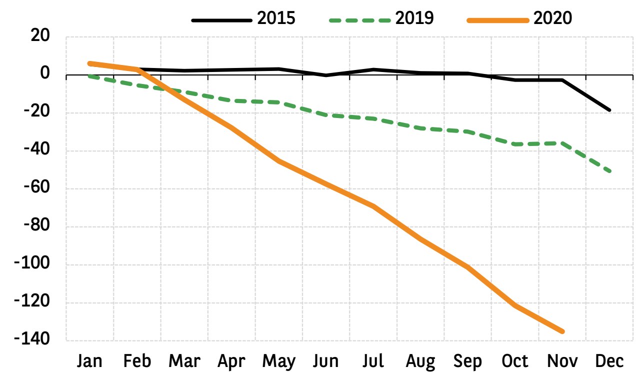

CHART 2 SOURCE: MINISTRY OF FINANCE, BNP PARIBAS

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