ISRAEL

AMONGST TOP OECD ECONOMIC PERFORMERS

Israeli economic performance was particularly strong in 2022 and remained above OECD average. Growth was very buoyant thanks to the dynamism of consumption and investment, while the fiscal year should end with a surplus. Although relatively moderate, inflation accelerated during 2022 and forced the Central Bank to tighten significantly its monetary policy. Against this backdrop, which is not favourable to consumption and investment, activity should slow this year. The continued depreciation of the shekel was an additional inflationary factor. The fall in the exchange rate against the USD reflects the general strengthening of the dollar, but also Israeli investors' management of their assets in dollars. External accounts remain solid, thanks to strong competitiveness in some key sectors. The short-term outlook for public finance is more uncertain. The recent formation of a new government is delaying the adoption of a new budget, which will limit its positive impact on economic activity.

MODERATE ECONOMIC SLOWDOWN EXPECTED FOR 2023

Economic activity remained very strong in 2022. The consequences of the international energy crisis were very limited given the country's gas self-sufficiency. More generally, Israeli leadership in some high-tech sectors mitigates vulnerability to changes in the international economy.

In the third quarter of 2022, real GDP grew by 5.8% year-on-year, confirming Israel's status of being one of the most dynamic economies in OECD countries (2.5% on average for OECD countries). Over the first three quarters of the year, growth reached 7.8%, mainly supported by household consumption and investment (in production and real estate). After a continuous reduction since 2021, the unemployment rate has risen slightly since June 2022 but remains very low (3.9% in November). Given the acceleration of inflationary pressures, the trend in real wages has been negative since October 2021. At the same time, consumer credit is not very dynamic in real terms, rising 1.5% year-on-year in June 2022. On the other hand, housing loans to households (around 75% of total lending) grew strongly (+14% year-on-year in real terms during the first quarter). Residential real estate investment has therefore experienced two-digit growth over the past 2 years (+18% over Q1-Q3 2022 compared to the same period in 2021 after +15% over the year in 2021); it accounted for around 30% of total investment in 2022. Growth in exports of goods and services also remained sustained (+13% on average over the last four quarters), but the net contribution of external trade should be negative in 2022. For 2022 as a whole, the Central Bank of Israel expects growth of 6.3%.

The outlook for the next two years is less positive. Given the expected slowdown in global activity (the IMF forecasts growth of only 0.7% in the European Union, Israel's main trading partner, and barely 1% for the United States), exports of goods and services should slow down (+2% in 2023 according to the central bank). Furthermore, the tightening of monetary conditions will contribute to the slowdown in domestic activity, in particular household consumption and real estate investment. Nevertheless, the increase in public spending announced by the new government should be a supportive factor, provided that the new budget is approved within a reasonable time frame and the government coalition remains stable. Against this backdrop, the Central Bank forecasts a drop in growth to 2.8% in 2023, before a moderate recovery to 3.5% in 2024, linked in particular to the recovery of the global economy.

... DESPITE THE EASING OF INFLATION

Inflationary pressures increased in 2022, but remained well below the average of other OECD countries. Both domestic factors (increase in property prices) and external factors (price of fuel and food and the depreciation of the shekel) are driving the price increase. This reached 5.3% year-on-year in November.

In 2023, inflationary pressures should ease against a backdrop of expected lower oil prices on international markets and rising domestic interest rates. Inflation in tradable goods prices has already started to decrease since last July's high, due in particular to the drop in hydrocarbon prices.

FORECASTS

	2020	2021	2022e	2023e	2024e
Real GDP growth (%)	-1.9	9.9	6.3	2.8	3.5
Inflation (CPI, year average, %)	-0.6	3.1	4.4	3.0	2.0
Cent. Gov. balance / GDP (%)	-11.4	-4.5	0.3	-2.5	-2.0
Cent. Gov. debt / GDP (%)	73	69	61	60	58
Current account balance / GDP (%)	5.6	4.4	3.7	3.8	4.5
External debt / GDP (%)	32	33	30	31	32
Forex reserves (USD bn)	173	213	196	225	240
Forex reserves, in months of imports	22	21	16	17	19

TABLE 1 e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

ISRAEL: CONTRIBUTION TO REAL GDP GROWTH

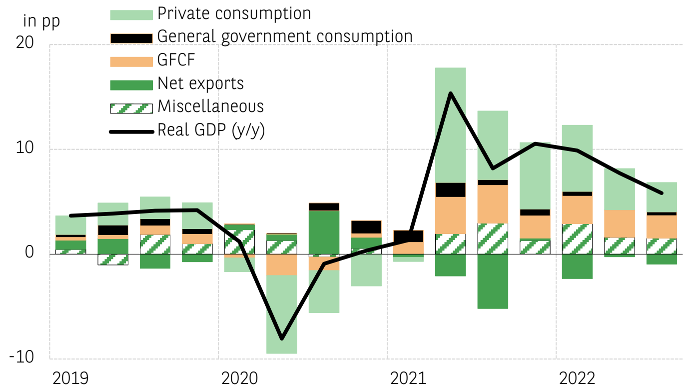

CHART 1 SOURCE: CENTRAL BUREAU OF STATISTICS, BNP PARIBAS

By contrast, inflation in non-tradable goods (essentially domestic services) continues to rise, mainly due to tensions on the property market. According to the Central Bank, residential property prices rose 20% year-on-year in November 2022. Nevertheless, even if the rise in property prices is expected to continue, the rise in interest rates could dampen its extent.

MONETARY POLICY TIGHTENING

In 2022, inflation overshot the central bank's target zone (1%-3%). Against this backdrop, the latter increased its main interest rate by 365 bp from March 2022 to reach 3.75%, which is its highest level since 2008. Further monetary tightening is possible until at least the first quarter of 2023, but should remain limited given the expected fall of inflationary pressures and the uncertainties weighing on the growth outlook. Furthermore, the Central Bank still has the means to intervene on the foreign exchange market if there is excessive depreciation of the shekel. If necessary, the Central Bank's means of intervention are significant since its foreign exchange reserves amount to around USD 200 billion, i.e. 15 months of imports of goods and services.

In 2022, the shekel depreciated 12.5% year-on-year against the USD and 5.6% against the euro, fuelling inflationary pressures. As budgetary and external performance was solid, and beyond the dollar appreciation against all major currencies in 2022, it was mainly international asset market developments that favoured the depreciation of the shekel. In fact, Israeli institutional investors' exposure to the US equity market obliges them, in the event of falling markets, to provide margin to cover their losses and to maintain target equity exposure by buying assets denominated in foreign currencies. In 2022 the 20% drop in the S&P500 index therefore mechanically translated into dollar purchases.

SOLID EXTERNAL ACCOUNTS

In a challenging international environment in 2022, Israeli external accounts remained strong. Over the first eleven months of 2022, the trade deficit widened by 6%, mainly due to the rise in the oil bill. Nevertheless, in 2022, the current account is expected to be in surplus thanks to the continued rise in exports of services (mainly in the high-tech sector), which have become one of the main sources of current revenue for several years (around 40% of total current-account revenue). The current account surplus should reach 4% of GDP in 2022.

In 2023, despite the expected decline in commodity prices, the current account surplus should fall to around 3% of GDP due to the main trading partners' slowdown. But in the medium term, the current surplus should widen. The development of new gas capacity of production and renewable sources of energy (7.7% of the energy mix in 2021 and a target of 30% in 2030) will maintain relative energy independence, and therefore limit the consequences of possible new disruption in the global energy market. Furthermore, exports of high-tech goods and services will remain a structural advantage.

Regarding capital flows, the competitiveness of the Israeli economy attracts a significant volume of foreign investment, mainly in high-tech sectors. Net foreign direct investment reached 3.5% of GDP on average between 2017 and 2021. It should remain at around 2.5% of GDP in 2022 and 2023. Portfolio investment flows were also significant over the course of 2022 (USD 11.5 billion over Q3 2022). The balance of payments fundamentals therefore remain strong and are still a factor supporting the shekel in the medium term.

ISRAEL: SHEKEL EXCHANGE RATE

CHART 2 SOURCE: CENTRAL BANK, BNP PARIBAS

BUDGET DEFICIT CONTAINED IN 2023

The government's budget is in surplus over the first eleven months of 2022 and although December is traditionally a month of significant increase in spending, the fiscal surplus should reach 0.3% of GDP over the year as a whole. These good performances can be explained by the increase in direct taxes and the drop in pandemic-linked expenditure. Government debt is expected to fall to around 61% of GDP in 2022.

Given the recent formation of the government coalition (end of December 2022), the 2023 budget has not yet been voted on and an approval is not expected before the second quarter at the earliest, which prevents the current government from engaging in new spending. Although the expected economic slowdown will result in a limited increase in budgetary revenue, the situation is favourable to a moderation in the fiscal deficit. In 2023, it should amount to around 2.5% of GDP, and the government debt ratio should continue to reduce (60% of GDP expected) thanks to nominal GDP growth.

Nevertheless, the political constraint on budgetary spending could amplify the economic slowdown by depriving growth of a needed engine.

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