

Israel

Still on a solid footing

The strength of internal demand remains the main engine of economic activity, which is growing at over 3% per year. This is feeding through into a resurgence of inflationary pressures, although these have been very modest so far. The budget deficit is growing but it remains within the limits set by the government. International trade is seeing some significant shifts. A loss of momentum in goods exports has reduced Israeli products' market share; at the same time exports of hi-tech services have become the real driving force behind the country's international trade. Changes in oil prices continue to be a key determinant of the current account balance, despite the exploitation of gas resources.

■ Envable economic fundamentals

Economic growth slowed slightly in 2018 but remains strong. The first official estimates put GDP growth at 3.2% in real terms, from 3.3% in 2017. Private consumption and productive investment were the two main engines of growth. According to the Bank of Israel (BoI), the economy is close to full employment, which is putting pressure on supply and explains the strong growth in imports and the negative contribution of international trade to growth. This is unlikely to change in 2019, despite accelerating growth of exports of goods and services. In 2019, private consumption is likely to remain strong against a background of pressures in the labour market. The unemployment rate remains low (4.1% in November 2018) and the job vacancy rate remains near record highs. As a result, we are seeing relatively strong growth in real wages (2.5% y/y in October 2018).

Consumer price inflation has accelerated, but remains well under control (0.8% on average over 2018). After the deflationary periods of 2015 and 2016 (-0.6% in both years), prices were more or less stable in 2017 (+0.3%), thanks in particular to the strength of the shekel. Full employment and continued wage growth are likely to feed through into inflationary pressure, but this will remain modest due to the expected further gains by the shekel (inflation expectations remain in a range between 1.3% and 1.6%). Against this background, in December the BoI raised its policy rates to 0.25%, the first increase since February 2015. This normalisation of monetary policy, which took the market somewhat by surprise, was largely preventive and reflects both more inflationary domestic conditions and external uncertainties linked to oil prices and monetary policy in the US and Europe. This said, both actual and expected levels of inflation remain close to the lower end of the BoI's target range (1% to 3%). The tightening of monetary policy will probably therefore remain very gradual.

The budget deficit widened significantly over 2018, and is estimated to have reached 2.9% of GDP, from 1.9% in 2017, but remained in line with the government's ceiling of 2.9% of GDP. The increase in the deficit stemmed from bigger than expected increases in expenditure, notably in the military sector. It was also explained by an absence of exceptional income. 2017 saw significant sales of Israeli assets to foreign investors as well as exceptional levels of dividend tax receipts. The current political uncertainty and the

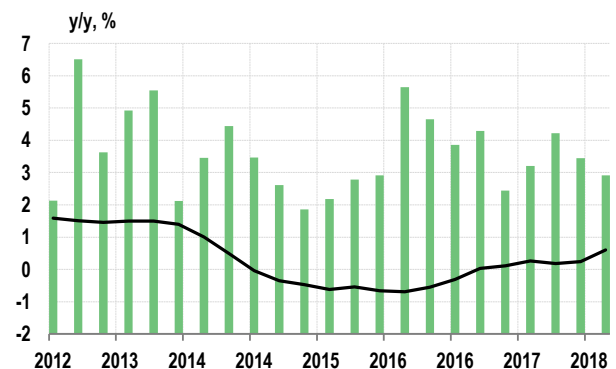
1- Forecasts

	2017	2018e	2019e	2020e
Real GDP growth (%)	3.3	3.2	3.4	3.5
Inflation (CPI, year average, %)	0.3	0.8	1.3	1.8
Cent. Gov. balance / GDP (%)	-1.9	-2.9	-3.3	-3.0
Cent. Gov. debt / GDP (%)	59	61	61	61
Current account balance / GDP (%)	2.8	2.0	2.2	2.5
External debt / GDP (%)	25	25	24	24
Forex reserves (USD bn)	113	115	118	122
Forex reserves, in months of imports	12	13	12	12
Exchange rate USDILS (year end)	3.5	3.7	3.6	3.5

e: BNP Paribas Group Economic Research estimates and forecasts

2- Economic growth and inflation

■ Real GDP — CPI Inflation



Sources: Central Bureau of Statistics, BNP Paribas

planned parliamentary elections in April look unlikely to help the process of controlling the deficit. As a result, we expect it to grow further, reaching 3.3% of GDP in 2019. Government debt is likely to remain at slightly above 61% of GDP.

Overall, therefore, economic prospects still look good despite a slight deterioration. As is often the case in this country, a volatile political climate is likely to have only a marginal impact on the economy.



■ A loss of competitiveness has had a marginal effect on the current account

External accounts have seen a significant shift over the past few years. The first notable change has been the deterioration of the core trade balance¹; the trade deficit hit a record level in 2018 at around USD 25 bn, or 6.9% of GDP (from 4.3% of GDP in 2017). Exports of goods are sluggish, whilst imports have followed the rising trend in domestic demand. It is noteworthy that export growth by volume has been negative since 2012. According to IMF estimates, exports fell by an average of 0.4% per year between 2013 and 2017. Since its peak in 2000, Israel's export market share in global trade has fallen steadily (from a high of 0.46% to 0.30% in 2018). The increase in the real effective exchange rate (REER) since 2012 is probably the main explanation for this loss of competitiveness for exported goods. Relative to its long-term trend, the REER² is currently overvalued by more than 10%.

Trends in goods exports (in value) according to their technological content do not show any clear trend. Exports of low-tech goods (7% of the total) have been relatively stable, whilst medium and hi-tech goods (53% and 40% of the total respectively) have been fairly volatile, with no particularly clear trend emerging. It seems however that the fall in hi-tech exports in 2018 (-6% in value y/y) was due primarily to a drop in exports of pharmaceuticals. The split of goods exports by destination has been relatively stable since 2012. Europe and the USA remain Israel's main export markets (35% and 30% of the total respectively), followed by Asia (25%).

In contrast to exports, imports by volume rose by an average of 3.2% between 2012 and 2017, driven by private consumption and investment. The exploitation of substantial gas reserves has not yet reduced the country's dependence on imported hydrocarbons to any significant extent. Thus, for the time being, oil products continue to dominate energy imports and drive the volatility of the trade balance. In 2018, the cost of imported energy was probably more than USD 10 bn, an increase of 35% on 2017. Overall, the trade deficit is likely to persist over the medium term.

The strength of services exports contrasts with the performance of goods and reflects a change in the structure of international trade. In 2017, Israel had a record surplus on trade in services at more than USD 15 bn (11.2% of GDP). Since 2010, exports of high-tech services³ have transformed the structure of the current account. Such exports generated USD 33.6 bn in 2017, meaning the figure has doubled in less than a decade. In net terms, hi-tech services generated a surplus of more than USD 20 bn in 2017, compared to USD 7.5 bn in 2010.

Tourism has also recovered well since 2016, but its net contribution to trade in services has been negative for the past three years. The number of visitors increased by 25% in 2017 and 14% in 2018. However, given the sharp rise in tourist travel by Israelis over the same period, the net balance on tourism was negative to the tune of nearly USD 1 bn in 2017.

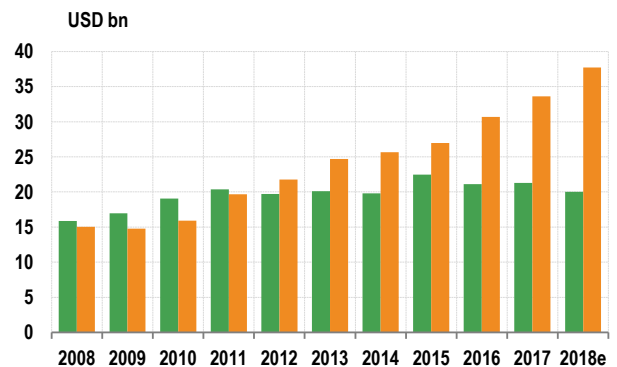
¹ Excluding ships, planes and diamonds.

² Based on consumer price inflation.

³ Notably in sectors such as communications, security, medicine and computing.

3- Hi-tech exports

■ Goods ■ Services



Sources : Central Bureau of Statistics, BNP Paribas

Given the stability in the balance of revenue (-USD 3.7 bn in 2017) and transfers (+USD 7.8 bn), the current account surplus remained significant in 2018, at 2% of GDP, even though it contracted slightly in comparison with the two previous years due to higher oil prices. In 2019 the current account surplus is likely to increase slightly, to 2.2% of GDP.

In the short term the main threats to external balances are rising oil prices and security conditions in the country, which could affect tourism. Over the medium term, the competitiveness of services exports and the potential for gas exports (limited for the time being) could help shore up export revenues. Lastly, the exchange rate will remain a key determinant of external accounts. Although the Bol has a number of tools at its disposal to influence exchange rates (interest rates, foreign currency reserves) they continue to be determined largely by structural changes in the Israeli economy which, over and above the current account surplus, continues to attract substantial capital inflows.

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