Israel

Strong shekel creates monetary policy challenge

Economic growth was still robust in 2019 despite a less favourable local and international environment. Healthy external performances fuelled a significant upturn in the shekel, which in turn curbed inflationary pressures. The start-up of natural gas exports in 2020 should support this trend. Under this environment, the central bank has few policy instruments available. It resumed currency market interventions to try to curb the shekel's appreciation. After the budget overruns of 2019, however, we do not expect public finances to improve significantly given the high level of political uncertainty.

Robust economic growth

Despite an uncertain political situation locally and a less favourable economic environment internationally, GDP growth remained strong in 2019. According to the first official estimates, growth was 3.3% in real terms, which is practically the same level as in 2018 (3.4%). Household consumption and public expenditure were the main growth engines.

Two factors bolstered household purchasing power: the unemployment rate has fallen below 4% since July 2019, while real wage growth is still positive (+2.7% in October 2019) thanks to persistently low consumer price inflation (0.9% on average in the first 11 months of 2019). Public expenditure continued to increase at a regular pace (+4.1% in 2019). In contrast, investment barely grew in 2019 (+0.3%) due to a slump in productive investment, while housing investment continued going strong.

In 2020, GDP growth is expected to slow slightly, falling below 3%, due to the expected slowdown in the global economy and the constraints curbing public spending, at least in the first part of the year. Moreover, once a new government is formed, general budget policy trends are likely to increase fiscal pressure to reduce the deficit. This could have a mild impact on household consumption.

From a sector perspective, new developments in the natural gas sector should boost growth. Production started up at the Leviathan offshore gas field in late 2019. According to the central bank, its contribution to GDP growth is estimated at 0.3% in 2020. Since most of the local demand for natural gas is covered by the Tamar offshore gas field, Leviathan's production will be geared mainly towards exports to Egypt and Jordan. Production should be ramped up regularly through 2022.

Low inflation

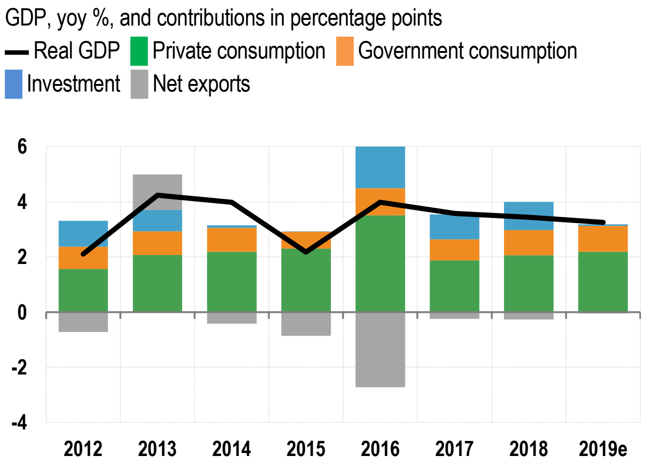
Despite quasi-full employment, consumer price inflation is still low and is expected to average 0.9% in 2019. Prices of tradeable goods are expected to be virtually flat on average in 2019 (+0.11% during the first 11 months of 2019), while prices of non-tradeable goods rose an average of 1.2% over the same period. Mild inflation can be attributed to lower oil prices, the shekel's appreciation against the currencies of its main trading partners (the nominal effective exchange rate rose 8.3% in 2019), and the steady deregulation of the economy in general. In 2020, consumer price inflation could increase slightly, thanks to a mild increase in oil prices, while holding near the lower end of the Bank of Israel's target range (1%-3%). Looking beyond cyclical factors, for the moment it is hard to discern what might trigger higher inflation in the short term. The expected improvement in the external accounts should bolster the shekel, while significant public finance overruns (via a sharp increase in current spending, for example) seem unlikely.

1-Forecasts

	2018e	2019e	2020e	2021e
Real GDP growth (%)	3.4	3.3	2.9	3.2
Inflation (CPI, year average, %)	0.8	0.9	1.0	1.2
Cent. Gov. balance / GDP (%)	-2.8	-3.6	-3.5	-3.0
Cent. Gov. debt / GDP (%)	59	62	64	65
Current account balance / GDP (%)	2.7	2.2	3.1	3.0
External debt / GDP (%)	25	25	26	25
Forex reserves (USD bn)	115	126	145	155
Forex reserves, in months of imports	13	12	13	13
Exchange rate USDILS (year end)	3.7	3.5	3.3	3.2

e: BNP Paribas Group Economic Research estimates and forecasts

2- Contributions to real GDP growth



Source: BoI, BNP Paribas

The shekel continues to look bullish

Israel has reported an almost structural current account surplus thanks to ongoing increases in exports of services, buoyed by the high tech sector, and tourism, albeit to a lesser extent. The service sector surplus should offset the trade deficit. In 2019, we estimate the current account surplus at 2.2% of GDP (down from 2.7% in 2018). In the short term, the trade deficit could narrow thanks to higher natural gas exports. Even so, this impact should remain relatively small since gas exports represent only 1.6% of total exports of goods.

The Israeli market is still highly attractive for non-resident investors, especially in high technology. Foreign direct investment (FDI) in Israel amounted to more than 5% of GDP in 2017 and 2018, and is expected to remain strong in the medium term. Portfolio investment flows are more volatile and harder to predict. As of April 2020, domestic sovereign bonds will be incorporated in the WGBI[1], which should have a positive impact on capital inflows. All in all, the balance of payments surplus is likely to be maintained, fuelling the shekel's appreciation. Although portfolio flows risk making the shekel fluctuate more erratically in the short term, several factors are likely to facilitate the appreciation of the Israeli currency: a narrower spread between the Bank of Israel's key rate and the US Fed funds rate, ongoing monetary easing in the eurozone, and the US dollar's downward slide against the main OECD currencies. Consequently, structural and short term factors both seem to be working to drive up the shekel.

Monetary policy

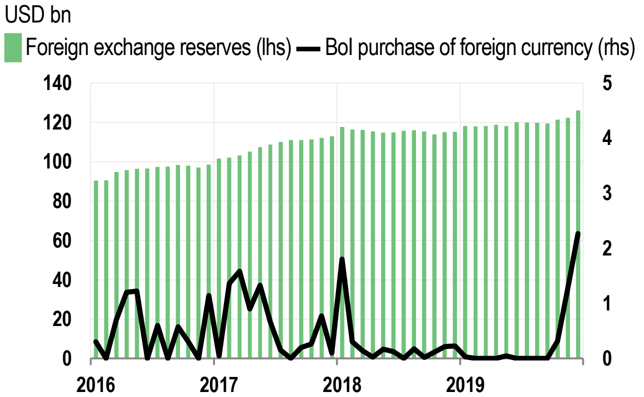
As in previous years, the inflation rate is still fluctuating outside of the Bank of Israel's target range. The central bank must decide whether to take measures that would let inflation rise towards the middle of its target range, without jeopardising the economy's dynamic momentum. According to the OECD, the output gap was slightly positive in 2019 (+0.4% higher than the potential growth rate).

The Bank of Israel has maintained its key rate at 0.25% since November 2018. The central bank barely intervened in the foreign exchange market in the first 10 months of the year[2]. Whereas monthly purchases averaged more than USD 500 m between 2013 and 2017, they amounted to only USD 277 m in 2018 and USD 40 m in the first 10 months of 2019. Given the significant appreciation of the shekel during this period and its impact on domestic prices, the Bank of Israel began making currency purchases again in November and December 2019 (USD 1.3 bn and USD 2.3 bn, respectively). To neutralise the impact of these currency purchases on money supply growth, the central bank uses open market operations and the time deposits of the commercial banks with the BoI. These forex market interventions are expected to continue this year to ease some of the upward pressure on the shekel.

Budget uncertainty

The 2019 fiscal year was marked by a notable surge in the public deficit to 3.6% of GDP, from 2.8% in 2018. According to government estimates, revenues increased by 2.5% while public expenditure rose by 5.9%. In the absence of a government before the March 2020 elections, the finance bill cannot be adopted and a system of provisional twelfths must be set up. Given the high political uncertainty and renewed regional tensions, a significant reduction in the deficit seems unlikely. Our scenario calls for the deficit to level off at 3.5% of GDP this year. Under these conditions, government debt should increase to about 64% of GDP in 2020. Most of the deficit is financed locally. About 85% of the total debt is local, and about two thirds is owned by institutional investors.

3-Bank of Israel foreign exchange assets



Sources: BoI, BNP Paribas

Pascal Devaux
pascal.devaux@bnpparibas.com

[1] World Government Bond Index
[2] The Bank of Israel set up a currency purchasing programme in 2013 to reduce the impact of natural gas production on the shekel via the trade balance.