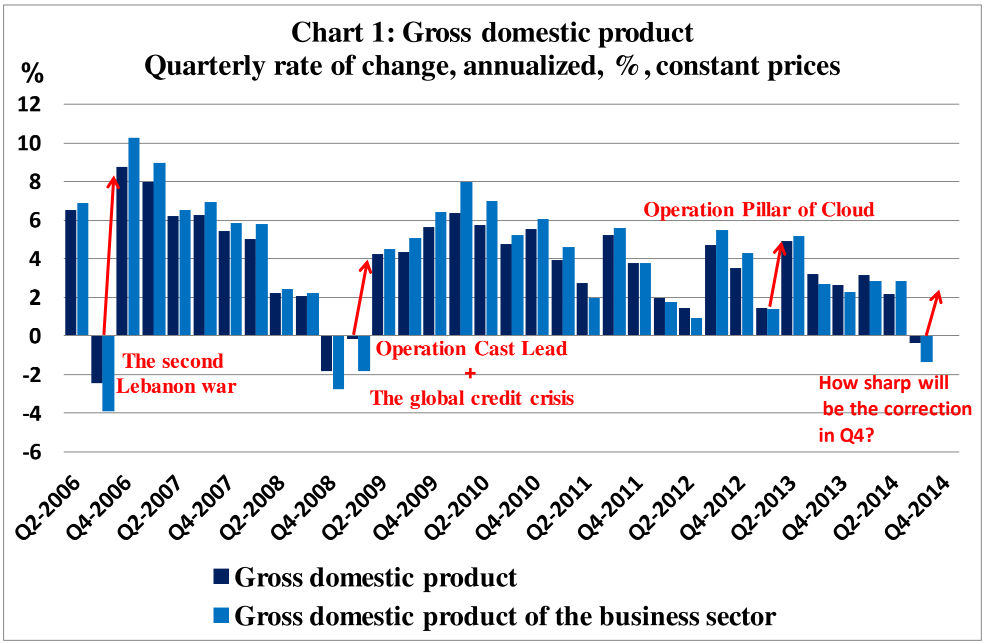
Leumi Economic Weekly

November 19, 2014

Economic activity declined in the third quarter due to Operation Protective Edge; but the use of resources increased. What will be in the rest of the year and in 2015?

Local economic activity declined by a real rate of 0.4% in the third quarter of 2014 compared to the second quarter (in annualized terms, excluding seasonality). The business sector product, which excludes the contribution of government expenditure to the GDP as well as other relatively small components of activity, fell by a sharper rate of 1.4%. The decline in activity, its extent and composition, were in-line with expectations (see our weekly survey from July 30, 2014) and stemmed primarily from the economic consequences of Operation Protective Edge. This was similar to economic developments that occurred during previous periods of military action in Israel (see accompanying graph).

It should be noted that the rate of decline in activity in the third quarter of this year was moderate compared to the rates of decline during previous periods of military action, due to, among other things, the fact that the rate of economic growth in the quarter that preceded the fighting was low (no decline in economic activity occurred during Operation Pillar of Defense because the fighting concluded after a relatively short period of only one week).



An analysis of the components of the total use of resources, which include the GDP and also activity based on goods and services imports, indicates that growth occurred in some components of activity in the third quarter. This more comprehensive look shows that local economic activity grew in the third quarter of the year above what is reflected only in the GDP data. In total, the use of resources increased 3.1% in the third quarter compared to the

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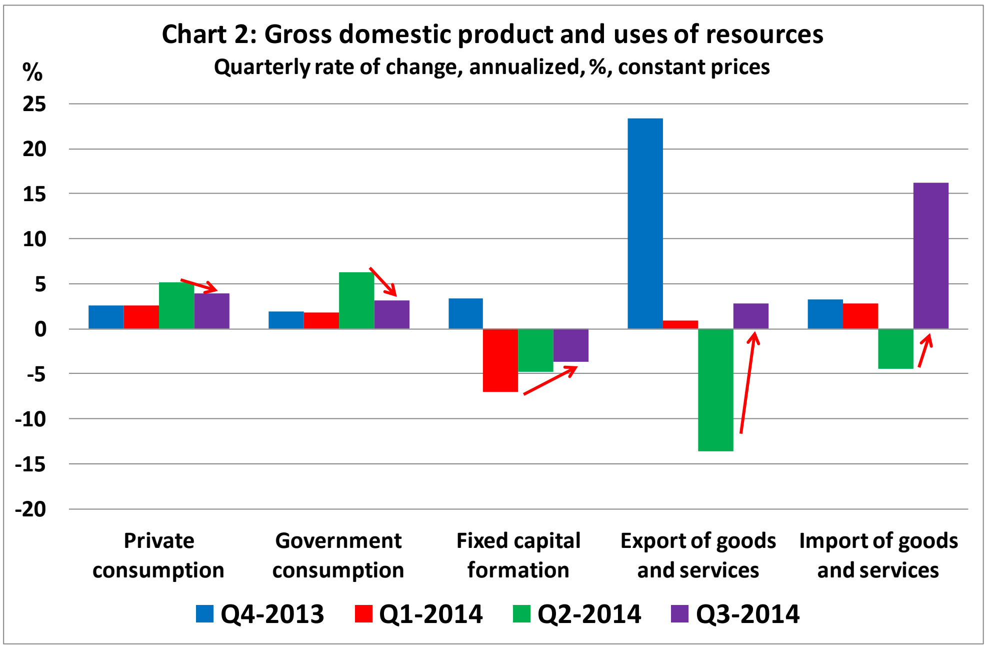
second quarter, and by 2.4% when excluding the component involving changes in inventory. The domestic use of resources, which does not include exports, and thus serves as an indicator of local demand, increased also by a positive rate, of 2.6%.

Diagram 2 shows that private consumption, which accounts for 60% of GDP, increased in the third quarter by an annualized rate of 2.9% compared to 5.2% in the preceding quarter. An analysis of the data on private consumption shows a slight decline in consumption excluding durable goods. In contrast, a substantial increase occurred in the consumption of durable goods, for the third consecutive quarter. Looking forward, we estimate the rate of increase of private consumption per capita in 2015 will be moderate compared to the long-term average for Israel.



Another notable component is the export of goods and services, which accounts for one-third of GDP. The accompanying diagram shows that in the third quarter of the year there was a transition from negative growth to positive growth; however, the growth was relatively low. The main reason for this is the decline in the export of tourism services (primarily income from foreign tourists) against the backdrop of Operation Protective Edge. This decline, in the third quarter vis-à-vis the second quarter, amounted to 78% in annualized terms. If not for this decline in incoming tourism, the economy would have grown 2.0% in the third quarter, instead of a decline of 0.4%.

It should be noted that in the months September – October there was a slight recovery in incoming tourism, and this trend is likely to continue also in the coming months, as occurred following previous periods of military action. A continuation of the deterioration in the security situation in Israel is likely to hurt the recovery in tourism activity. It should be noted that services exports excluding tourism, and goods exports increased in the third quarter of the year, and this trend is likely to continue at least in the short-term (see details below).

One GDP component that negatively stands out is investment in fixed assets, which declined 3.6% in the third quarter compared to the second quarter. The main reason for this is the drop in investments in construction and the decline in investment in machinery and equipment.

The reasons for the decline lie partially in the drop in the expectations of businesses against the backdrop of the military action in July – August. It should be noted that the decline in investment in various sectors of the economy has been occurring already for three quarters (a cumulative drop of 20%), while a decline in residential construction has been occurring for six consecutive quarters, stemming from a drop in demand in the housing market against the backdrop of households waiting for the implementation of various government housing plans, and also the uncertainty felt among real estate developers.

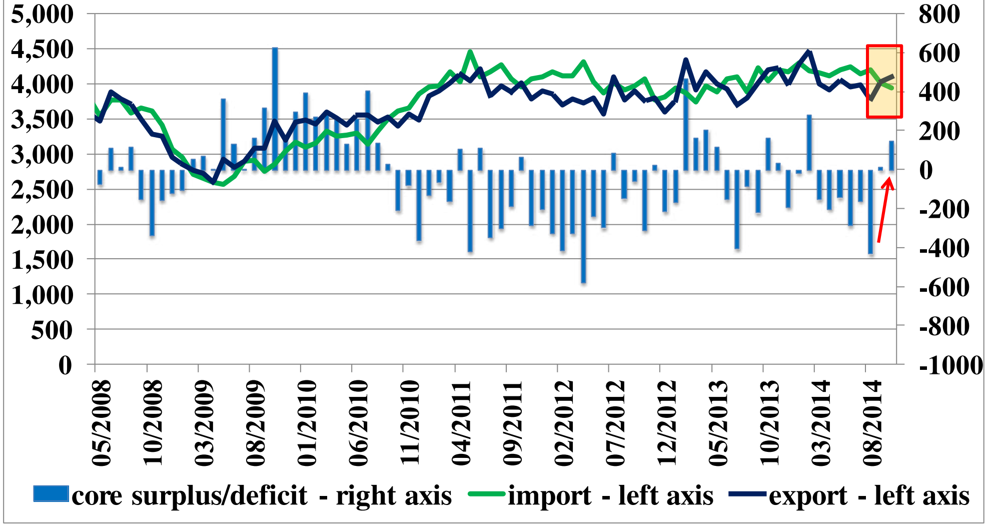
In our opinion, investment activity will recover in the short-term, against the backdrop of the recent improvement that has occurred in the expectations of businesses, due to the expected increase in demand for housing following approval of government housing plans, and the initiation of significant projects that make use of natural gas, alongside the expected investments in the new Intel factory.

Looking forward, we estimate Israel's growth rate will equal 2.2% in 2014 (1.8% excluding the impact of natural gas production), and in 2015 growth will accelerate to a rate of 3.4%, primarily against the backdrop of the expected acceleration in the rate of growth in export activity and in activity involving investment in fixed assets.

Goods exports increased in October; exports are expected to continue to increase in the short-term due to the shekel depreciation and increased demand from the US

Goods exports increased in October, amounting to US$4.1bn (excluding seasonality; and excluding ships, aircraft, and diamonds). This is the second month in which an increase in export activity has occurred, following a gradual downward trend in activity since the beginning of the year. The improvement in activity over the last two months stems primarily from an increase in the export of electronics and computer products, which account for one-quarter of industrial exports (excluding diamonds). It is possible that the improvement in activity stems from, among other things, the moderate increase in demand for technology products in the US in recent months, as reflected in the US Tech Pulse index.

Chart 3: The core trade balance
(total excluding ships, diamonds, aircrafts and fuel)
Million of USD per month, seasonally adjusted



Export activity was also affected by the depreciation in the exchange rate of the shekel vis-à-vis the basket of currencies, and especially vis-à-vis the US dollar in recent quarters. An analysis of the data over a longer period shows that during January – October there was a moderate 1.8% increase in US dollar terms in export activity compared to the same period in 2013.

Looking forward, Israeli export activity is expected to increase against the backdrop of the expected expansion in import activity of goods and services in 2015 (4.3% growth compared to 3.7% in 2014) by developed countries, which represent Israel's main target export markets. This development, along with the recent depreciation in the shekel vis-à-vis the US dollar, is likely to support an increase in demand for Israeli products in the coming year.

A decline in import activity over the past two months; the trade deficit fell slightly

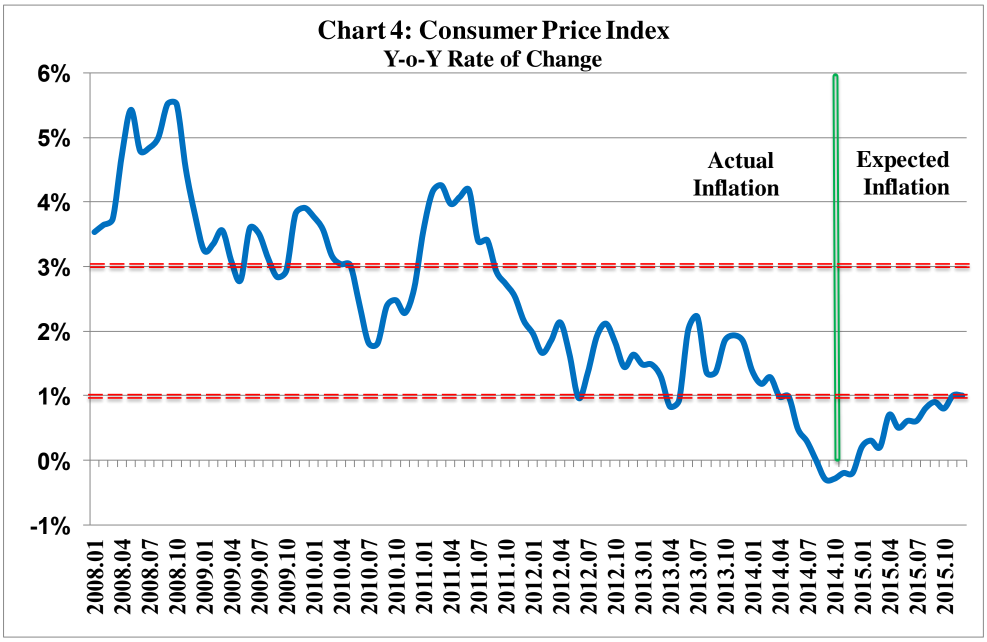
Goods imports amounted to US$3.9bn in October (excluding seasonality; and excluding ships, aircraft, diamonds, and energy products), below the US$4.1bn monthly average over the past year. October was the second consecutive month in which a decline in goods imports was registered. An analysis of the data over a longer period shows that in January-October there was a 4.4% increase compared to the same period in 2013; however, the rate of growth has been moderating recently. This is primarily due to a downward trend in recent months in the import of raw materials and investment products. In the last two months there has also been a slight decline in the import of consumption goods, in contrast to the trend from the beginning of the year.

Due to the gap between exports and imports in October, a surplus of US$150m was measured in Israel's core trade account (the overall trade account excluding ships, aircraft, diamonds, and fuel). However, since the beginning of the year there is a US$950m deficit, compared to a US$93m surplus in the same period of 2013. It should be noted that the high deficit since the beginning of the year, and in the third quarter in particular (US$580m), is likely to cause a decline in the surplus in the current account of the balance of payments in 2014. We currently expect a surplus amounting to 1.3% of GDP in the current account of the balance of payments, compared to a surplus of 2.5% of GDP in 2013.

Inflation is expected to reach the price stability target range (1-3%) towards the end of 2015

The consumer price index (CPI) increased 0.3% in October compared to the preceding month, as most of the main components in the index registered a rise in prices. The most significant price increases occurred in the following components: clothing and shoes, due to seasonality; owned dwellings services, this in contrast to the seasonal trend; and in food prices, in contrast to the trend from recent months. The most significant price declines occurred in the fuel and oils for automobiles component, against the backdrop of a drop in global oil prices; car insurance; and leisure and recreation.

In total, the CPI declined 0.3% over the trailing 12-month period, similar to the previous month. The decline in prices over the past year stems from a number of primary reasons, among them being the slowdown in local demand; the heightened competition among retail chains, primarily in the food and fashion markets; a decline in communication services; a decline in prices of energy products; and the slowdown in the rate of increase in housing rental prices (primarily in renewed rental contracts). Excluding the housing component, the CPI would have declined by a more substantial rate of 1.1%.



In our opinion, the annual rate of change in the CPI is expected to be negative in the coming months, to climb to above zero in the first quarter of next year, and to return to within the price stability target range of 1-3% towards the end of 2015.

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