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Emerging Insight

Israel – Inflation is coming down fast, but BOI is cautious

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GEM Fixed Income Strategy & Economics
Global

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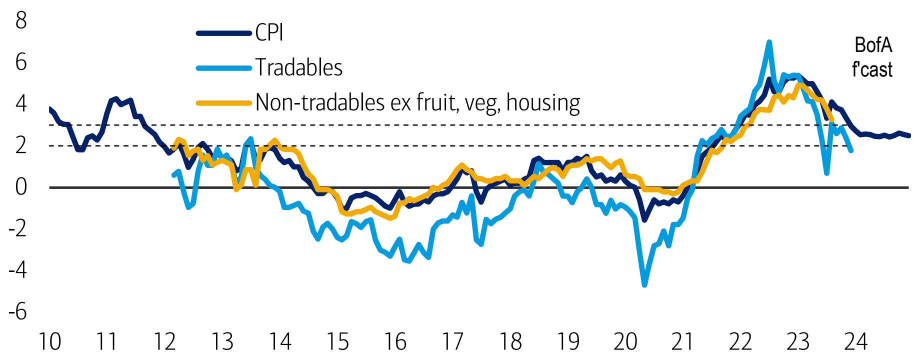
Key takeaways

- Inflation has been surprising on the downside since the conflict started although there are early signs of recovery in demand
- Budget deficit and debt to GDP poised to rise due to high defense spending but we see debt at manageable levels.
- A ceasefire or de-escalation could ease pressure on the ILS and supply side inflation, allowing BOI to cut more.

By Zumrut Imamoglu

Exhibit 1: CPI inflation and components, %
We see year-end inflation at 2.5%



Source: Haver, BofA Global Research

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Israel in Focus

Inflation is coming down fast, but BOI is cautious

Inflation has decreased and hit the upper bound of the target band at 3%. Tradables inflation decreased to 1.77% and non-tradables inflation excluding housing, fruits and vegetables decreased to 2.95%. Hence, BOI started its cutting-cycle in January with a first cut of 25bp and decreased its base rate to 4.5%. However, increase in transport costs and depreciation in the ILS since start of the year pose risk in the short-term. A de-escalation in the conflict could support the ILS, ease supply side inflationary pressures and allow BOI to cut more.

Refer to important disclosures on page 6 to 8.

Inflation is easing further

CPI inflation decreased from a peak of 5.4% at start of 2023 to 3.0% in December. Almost all measures of inflation show a significant decrease. CPI excluding food and energy was 2.8%, excluding housing it was 2.9%. Tradables inflation dropped to 1.8% and non-tradables inflation excluding fruits, vegetables and housing continued its downward trend to 3% (Exhibit 1). Our estimate of core inflation, the CPI excluding food, energy and housing decreased to 1.5% showing the overall weakness in demand. Our estimates of instantaneous inflation also point to an easing momentum both for headline and core inflation (Exhibit 14 and Exhibit 15).

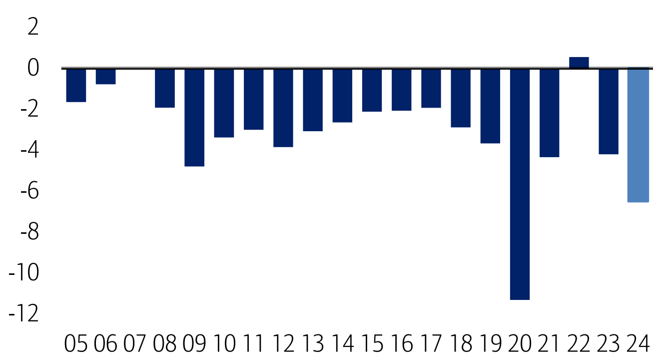
Most of the decrease in inflation so far stemmed from demand side effects. However, supply side impact on housing and recent increase in transport costs, energy prices and depreciation in the ILS weigh on inflation outlook. Hence 12-month inflation expectations increased to 2.6% from 2.4% in January. Although house prices continued to decrease, housing inflation edged higher by 0.3% mom in December for the first time since the conflict started (Exhibit 5). Given the short-term risks we see year-end inflation at 2.5%.

Budget deficit is widening but still manageable

The conflict that started in October is expected to cause a slowdown in the economy and weigh on the fiscal balance. The budget deficit widened to 4.2% of GDP in December on a 12-month basis. Expenditures increased 14.2% while revenues decreased 6.4%. Tax revenues decreased 5.5% yoy and interest expenditures increased 6.1%.

We increase our budget deficit forecast for 2024 from 5% to 6.5%. Depending on how long the conflict goes on, costs could be higher, a ceasefire or de-escalation on the other hand could help ease expenditures. Israel has a low debt to GDP ratio of 62% which we expect now to go up to 67.4% in 2024 but we do not expect any difficulty in financing the deficit. Depending on the course of the conflict, we expect deficit to start decreasing in 2025.

Exhibit 2: Central Government budget balance, % of GDP
Largest deficit since the Covid crisis, 2024 forecast



Source: Haver, MoF

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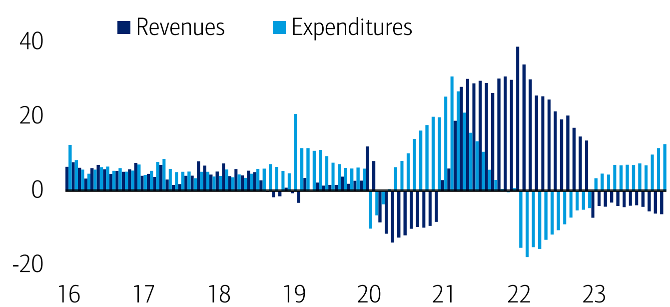
Exhibit 3: Central Government budget revenues and expenditures, yoy % change
Since growth will remain weak, budget cuts are vital to decrease the deficit



Source: Haver, MoF

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Although credit card spending shows signs of revival, we expect demand conditions to remain weak and growth to revive gradually. Although revenue losses are not as big as during the Covid crisis, growth and hence, revenue recovery may not be as fast (Exhibit 3). Employment data shows that broad unemployment rate increased to 10.2% when the conflict started and is still elevated at 7.2%. Although this is much lower than the Covid peak of 36%, an important share of the labor force still serves in the army. Lack of foreign employees in the housing and agriculture sectors as well as security concerns around the South and North borders also keep some productive capacity at bay. Hence, government revenue growth may not bounce back as strongly as it did after the Covid crisis. This makes spending cuts excluding defense vital to keep budget deficit under control. We see the cuts so far and increases in taxes as positive for the budget outlook.

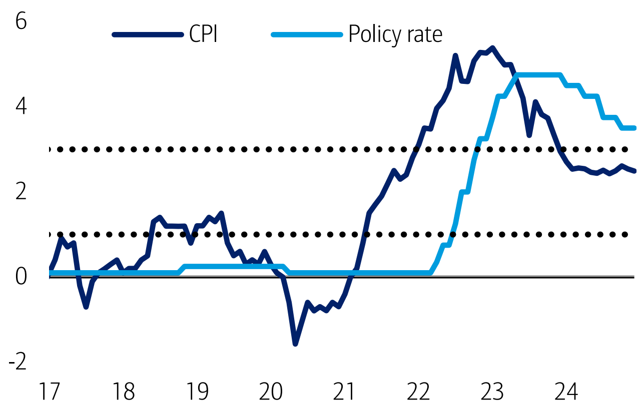
How fast will BOI cut?

BOI is still cautious as uncertainty around the conflict continues and its guidance points to a moderate pace of cuts. It sees year-end base rate at 3.75/4.00%. A ceasefire or de-escalation of the conflict could ease the impact of supply side effects and support the currency thus help bring down inflation faster.

Credit card spending is already above that of pre-conflict levels (Exhibit 11 and Exhibit 12) except for travel services (Exhibit 13), however, overall demand is still weak. Budget cuts excluding defense expenditures and tax increases will likely keep demand subdued and revival in the economy will be slow allowing BOI to cut more aggressively. In addition, as the Fed and ECB starts to cut rates, BOI might be in a better position to cut as well, especially if US equity performance and USD weakness supports the ILS. Therefore, we see the base rate at 3.50% at year-end.

Exhibit 4: BofA base rate and CPI forecast*, %

We see year-end inflation at 3.9% and first rate cut in 1Q



Source: Haver, CBS, BOI, BofA Global Research. *Forecasts from June 2023 onwards

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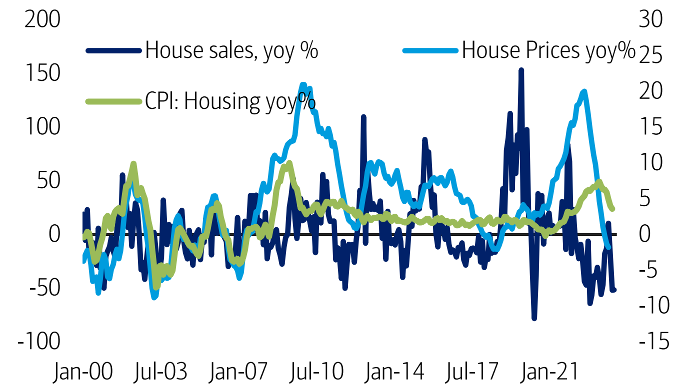
Exhibit 5: House sales and prices vs. housing inflation

House prices have been decreasing however rent ond owner spending in CPI remains elevated



Source: Haver, BofA Research

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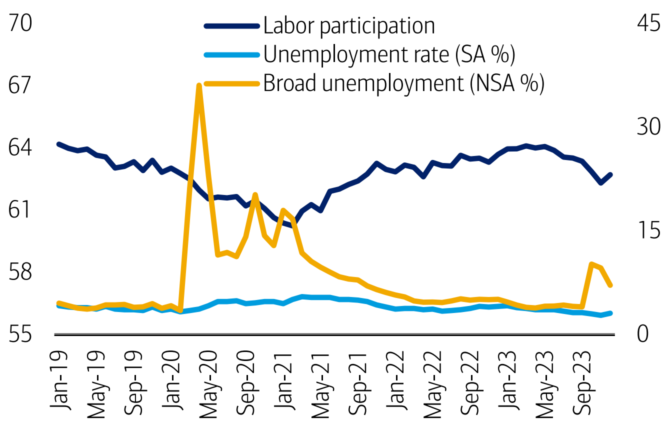
Exhibit 6: Labor force participation and unemployment rates

Broad unemployment started to decrease (rhs)



Source: Haver, CBS

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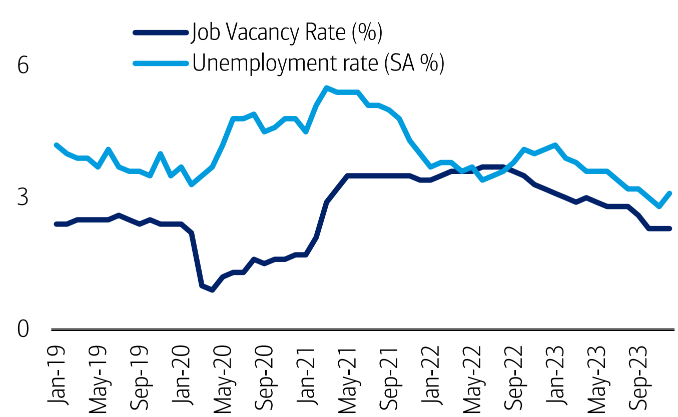
Exhibit 7: Job vacancy rate %

Weak participation in part explains why vacancy rate and unemployment rate has been decreasing at the same time



Source: Haver, CBS

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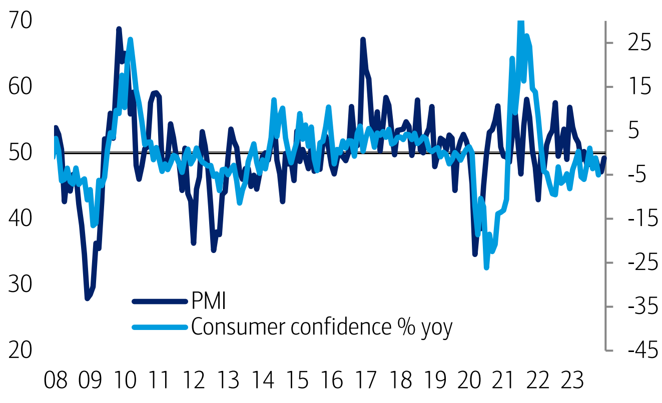
Inflation and economic activity

Exhibit 8: PMI and consumer confidence
Confidence is weak and PMI is still below 50



Source: Haver

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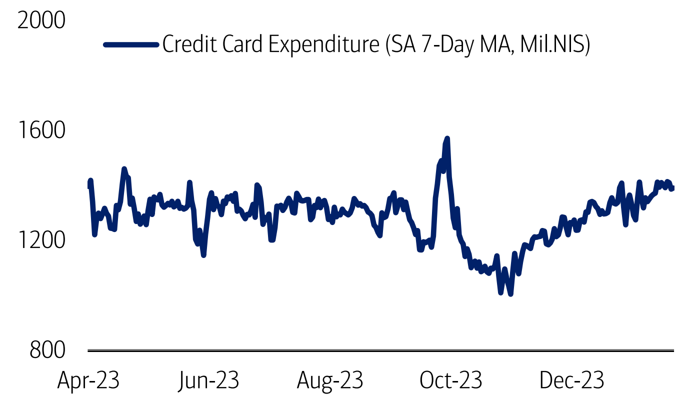
Exhibit 9: Credit card expenditures, total SA 7-Day MA, NIS mn
Recovered and surpassed the pre-conflict levels



Source: Haver

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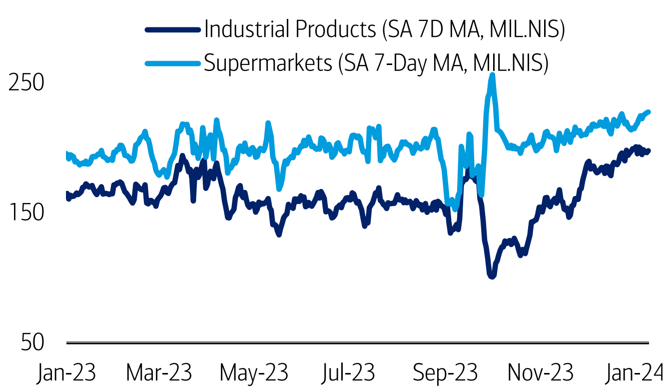
Exhibit 10: Credit card expenditures, markets and products
Expenditure on tradables has recovered



Source: Haver

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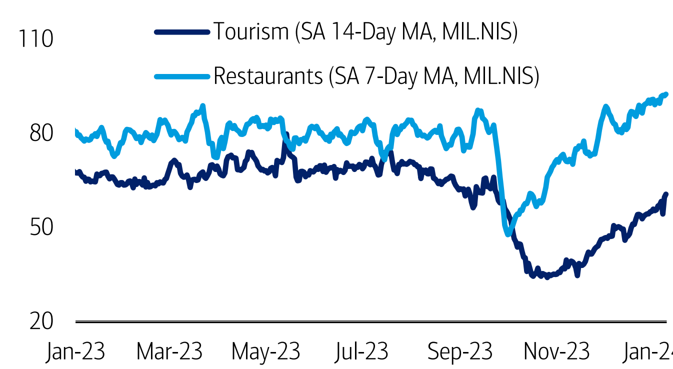
Exhibit 11: Credit card expenditures, services
Expenditure on travel services remains weak



Source: Haver

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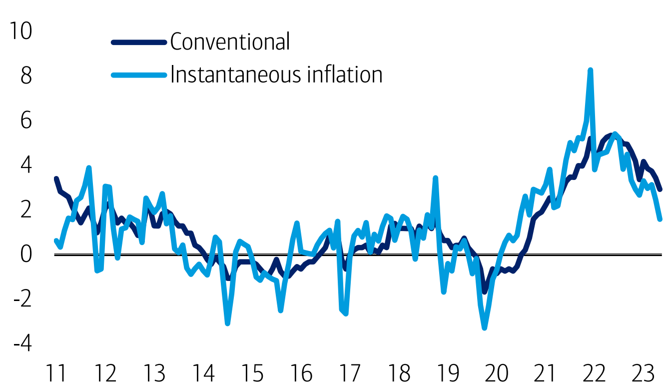
Exhibit 12: Instantaneous inflation, %
With larger weights attached to more recent data, decrease in inflation is more pronounced



Source: Haver, CBS, BofA Global Research

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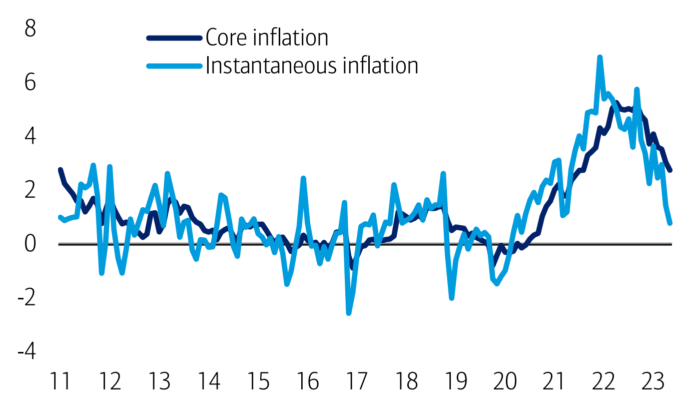
Exhibit 13: Core instantaneous inflation
Core inflation is decreasing faster



Source: Haver, CBS, BofA Research

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News and Views

Brazil: Central government ended 2023 with a primary deficit of R$230.5bn

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The Central Government reported a primary deficit of R$116.1bn in December (vs R$38.2bn deficit in November), slightly lower than market expectations of R$117.3bn. With this, 2023 primary balance registered a deficit of R$230.5bn (-2.1% of GDP), from a surplus of R$46.4bn (0.5% of GDP) in 2022. While net revenues reached to R$1.90tn in 2023 (from R$1.86tn in 2022) - a decline of -2.2% in real terms, total expenditures were R$2.13tn (from R$1.81tn) – a real increase of 12.5% yoy. When we don't consider court-ordered debts (or "Precatórios") in the print, the result is a deficit of R$138.1bn (or 1.3% of GDP), below the primary balance target set for the year (R$213.6bn). Recall that the Supreme Federal Court (STF) allowed the payments of court-ordered debt stock to be out from the fiscal target and spending limit calculation until 2026.

- **To follow:** Though all the revenues boosting measures proposed by the government were approved last year, the 2024 zero deficit target remains challenging – as we expect a central government primary deficit of 0.4% of GDP for this year.

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