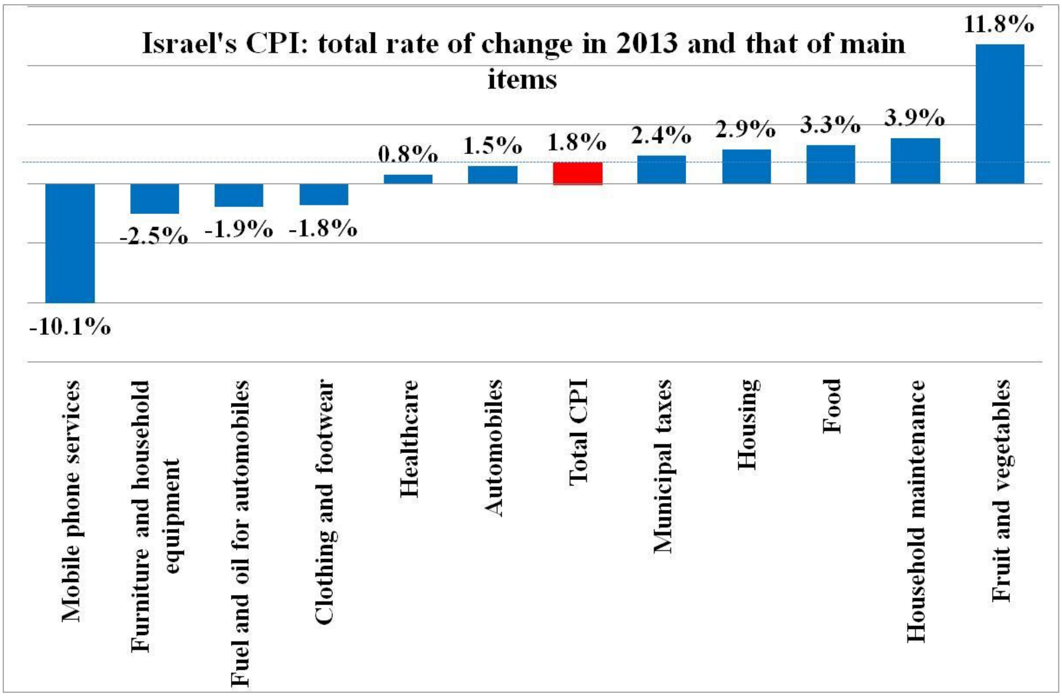
Leumi Economic Weekly

January 23, 2014

The inflation rate in 2013 indicates a moderate "price environment"

The consumer price index (CPI) increased 0.1% m/m in December 2013. The moderate rise stems from a number of primary factors: firstly, the housing services component (housing rental prices according to renewed contracts) fell by a high rate in relation to seasonality. It should be noted this component tends to decline in the winter months each year as a result of the slowdown in the traffic of renters, and this trend is likely to continue also next month. In addition, vegetable prices increased, as expected, in December (4.5%) against the backdrop of the storm damage caused to crops in the preceding month. Additional factors affecting December's CPI include: a fall in hospitality and vacation prices in Israel and overseas (1.4%); a decline in pharmaceuticals prices (-2.8%); a rise in clothing and shoes prices due to seasonality (9.1%); and a moderate increase in food prices (0.1%).



In all of 2013 the CPI increased 1.8%, this following a 1.6% increase in 2012. This rate of increase is slightly below the center of the government's price stability target range (1% - 3%), and is also below the 2.8% average inflation rate from the preceding five years (2008-2012). The main factors contributing to the increase in the index include (see accompanying diagram): a 2.9% increase in the housing component, which accounts for 26% of the general price index (thus on its own contributing 0.73 percentage points to the increase in the general index); a 3.3% rise in food prices, which account for 14% of the consumption basket (contributing 0.45 percentage points to the general price index), and an 11.8% rise in fruits and vegetables prices (contributing 0.33 percentage points to the general index). Tax steps by the government (a VAT rate hike in June 2013, hikes in electricity and water prices) also had a substantial influence on the increase in the CPI. It should be noted that when excluding the housing component and changes in government taxes, we estimate annual inflation would have amounted to a low rate of 1%. All this indicates a moderate price environment in the economy.

Stable or declining commodities prices do not support upward inflation pressures in the local economy in 2014

In 2014 the CPI is expected to increase by a similar rate to that registered in 2013, along the center of the price stability target range. As was the case last year, also this year the housing component is expected to substantially affect the rise in prices in the consumption basket. Retail chain stores and retailers are also likely to raise prices against the backdrop of the hike in corporate taxes, which are likely to be partially rolled over to consumers. However, it should be noted that according to the economic plan of the government and due to positive developments occurring on the fiscal side, no additional tax hikes are expected in 2014. This factor lessens the risk of inflationary pressures.

An additional factor that is likely to moderate inflationary pressures in 2014 includes developments in global commodities markets. Despite expectations for increased global demand in 2014, the prices of a number of commodities are likely to decline or remain stable, similar to the trend experienced over the last two years. According to data from the International Monetary Fund (IMF), the price of oil is expected to remain stable in 2014 (-0.3%), but to decline in 2015 (-5.2%); food prices are expected to drop in light of forecasts for surplus supply against the backdrop of an increase in global output; and metals prices are expected to decline, continuing the trend of downward prices in the second half of 2013.

Risks facing these forecasts mainly revolve around the potential for supply shocks (a rise in geo-political tensions would affect oil prices, extreme climate conditions would affect agricultural commodities prices, and artificial regulation of supply would also likely affect commodities prices), and/or acceleration in global demand above the current expectations. A decline in commodities prices, or at least stability, is another factor that may moderate inflationary pressures in the economy.

The interest rate is expected to remain unchanged in the near term

The interest rate of the Bank of Israel (BoI) has remained at 1% since October 2013. There are several factors that supported keeping the local interest rate unchanged, including the stability in real activity in the local economy and the certain improvement in international trade activity, against the backdrop of the improvement in activity in the US and the recovery in Europe (see further information on this issue below, on the topic of the composite state-of-the-economy index). In addition, it should be noted the moderation in the rate of increase in housing prices during the recent period (see below under the topic of housing prices) improves the flexibility of monetary policy makers and their preference to focus on economic growth.

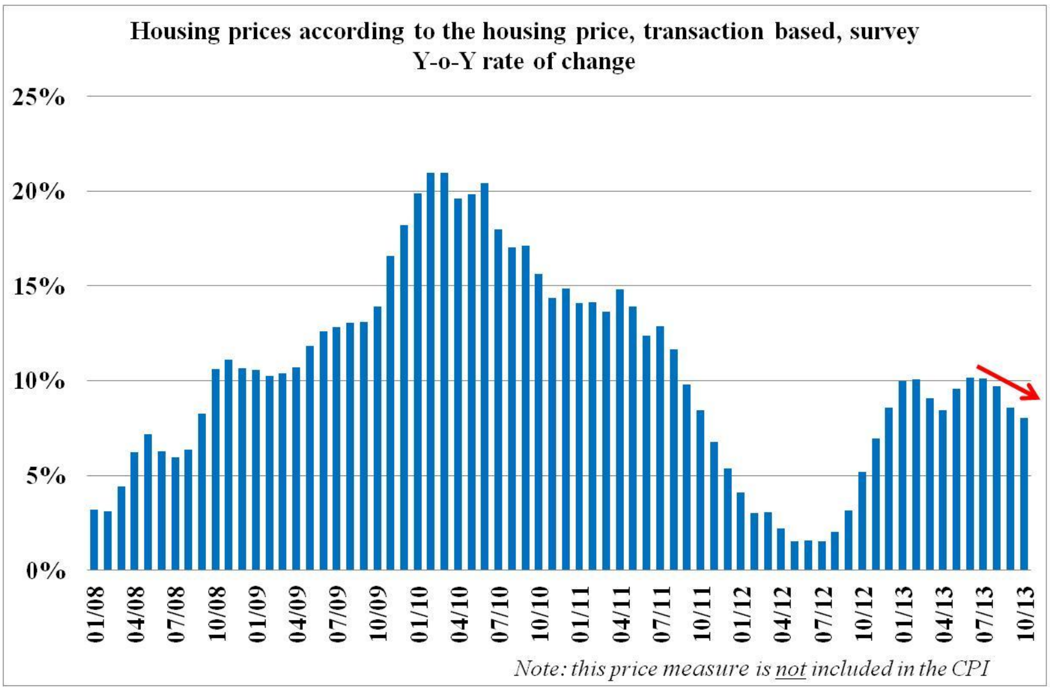
On the other hand, there are other factors that continue to support an interest rate cut, including the moderate inflation environment and the appreciation in the real effective exchange rate of the shekel vis-à-vis the basket of currencies in recent months, a development that erodes profitability in the export sector, especially in the vulnerable industries, most of which are labor-intensive. However, at these low interest rate levels the effectiveness of additional interest rate cuts, with the purpose of reducing the pressures for appreciation of the shekel and of supporting economic growth, is apparently limited, and additional rate cuts are likely to support a continued upward trend in prices of real and financial assets, a development that would likely increase financial risks in the economy.

Based on the combination of all these factors, and lacking any significant changes in the analysis of the underlying conditions, we estimate the interest rate level is expected to remain unchanged in the near term.

The rate of increase in housing prices has moderated; this trend is likely to continue

Housing prices, according to the monthly housing survey of the Central Bureau of Statistics (CBS), increased 0.5% in October-November compared to prices in September-October, while over the trailing 12-month period prices climbed 8%. This is a low annual rate of increase compared to the average since the beginning of 2013 and also compared to the rates of price increases in recent years (see accompanying diagram). In addition, it should be noted that a decline occurred in the rate of increase in housing prices over the past four months, this apparently against the backdrop of a slowdown in the rate of mortgages granted in the September-November period, and a decline in new housing unit sales in October-November.

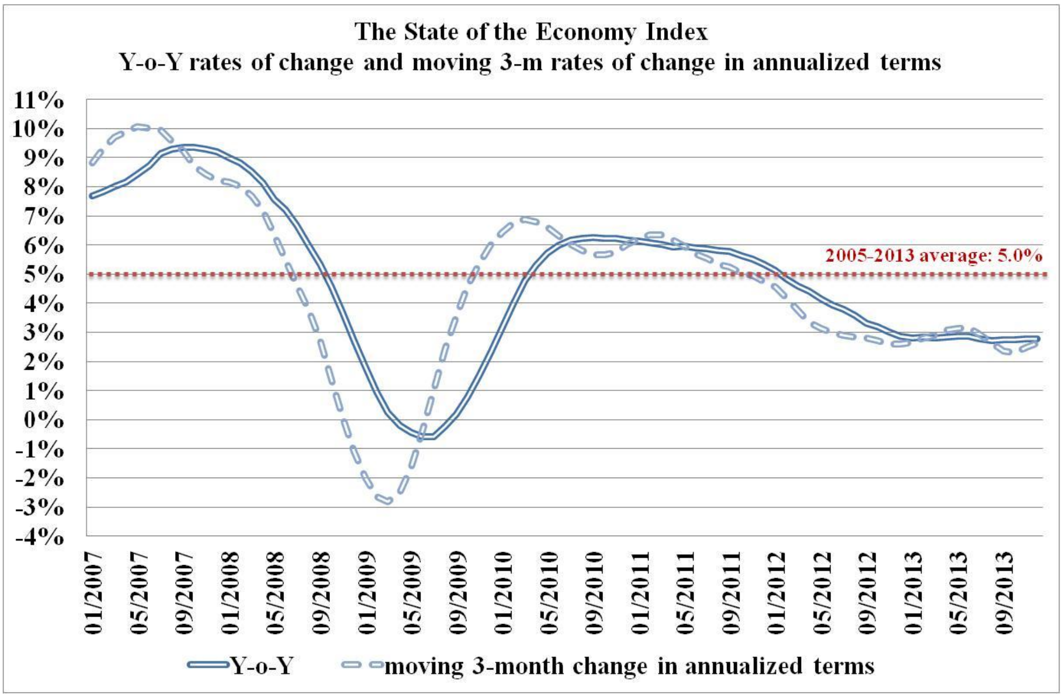
The decline in mortgages granted and in housing sales stems from, among other things, the new restrictions on mortgages implemented by the Supervisor of Banks, a very moderate increase in real wages in the economy, and from concerns on the part of potential home buyers regarding future developments in the state of the economy and in the employment market, especially due to downsizing measures in the industrial sectors.



Simultaneously, on the supply side the downward trend is continuing in the inventory of unsold housing units, which is affected primarily by the low number of residential construction starts relative to the demand needs in the economy, which are estimated to be 45,000 housing units per year. These trends on the supply side continue to support, at the present time, surplus demand in the housing market; therefore, housing prices are expected to continue to climb. However, in the event the slowdown in demand and the rate of housing sales will continue, and on the supply side there will be an increase in the number of permits and in new construction starts in accordance with government plans, then the rate of increase in prices will likely moderate.

Data from the composite state-of-the-economy index indicate stability in real activity; the IMF revised downwards its forecasts on international trade

The composite state-of-the-economy index increased 0.2% m/m in December 2013. This level is similar to the average monthly increase since the beginning of last year. Consequently, it can be concluded that the trend of stable economic growth has been continuing in the recent period. An analysis of the indicators that affected the index show high volatility in the monthly data; therefore, it is preferable to analyze developments in the different components over periods of three months each.



In the months September-November there was an increase in proceeds from the trade and services sectors following a certain slowdown in the three preceding months. On the other hand, data on the number of salaried positions and also on available positions in the economy show a certain weakness in the employment market, and are likely to slightly negatively affect consumption trends in the coming months.

In addition, industrial production increased in September-November, similar to the trend in goods exports during this period, and this following the weakness that characterized the industrial sectors and exports in the three preceding months due to the weakness in demand for Israeli products against the backdrop of the appreciation in the shekel. The improvement in exports and in industrial production is likely to continue against the backdrop of the positive economic developments among Israel's main trade partners.

The IMF published on January 21st an update to its forecast on economic growth and global trade. The organization revised upwards its global economic growth forecast moderately

(+0.1%), and now expects the global economy will grow 3.7% in 2014, compared to 3% in the preceding year. It should be noted that the IMF revised downwards its forecast on the volume of global trade and on the import activity of developed countries, compared to the previous forecast from October 2013.

This downward revision is not positive for the Israeli economy; however, it is important to remember that international trade volume is expected to increase 4.5% in 2014 compared to 2.7% last year, and the imports of the developed countries and the developing countries are expected to increase 3.4% and 5.9%, respectively, in 2014, compared to increases of 2.4% and 5.3%, respectively, in 2013. The increase in demand from the developed countries is supposed to positively affect the export sectors and industrial production throughout the current year, and to support growth in the Israeli economy.

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