

BANK OF ISRAEL

Office of the Spokesperson and Economic Information

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**Research Department Staff Forecast, October 2024**

**Abstract**

This document presents the macroeconomic staff forecast formulated by the Bank of Israel Research Department in October 2024[[1]](#footnote-1) concerning the main macroeconomic variables—GDP, inflation, and the interest rate. This forecast was formulated under the assumption that the war’s direct impact on the economy will continue into early 2025. This assumption reflects more intense fighting toward the end of 2024 and in early 2025 than the assumption underlying the July forecast. In particular, the high intensity that has been a feature of the recent period is expected to continue in the near future, with a broader interruption of economic activity on the home front, mainly in the north of the country. The forecast features a particularly high level of uncertainty. In particular, there is an increased probability of more severe security scenarios than those included in the baseline scenario of the forecast such as a further intensification of the fighting on various fronts and a longer extension of the war’s duration. If these come to pass, they are expected to be reflected in a further impairment of economic activity.

According to the baseline forecast, GDP is expected to grow by 0.5 percent in 2024 and by 3.8 percent in 2025, which are 1.0 percent and 0.4 percent lower than our assessment in the July forecast, respectively. The inflation rate in the coming four quarters (ending in the third quarter of 2025) is expected to be 3.2 percent, in view of the more inflationary domestic environment than in our July assessment, partly due to the revised assumptions regarding the intensity of the fighting. Inflation in 2024 is expected to be 3.8 percent (compared with 3.0 percent in the July forecast), and in 2025 it is expected to be 2.8 percent (similar to the July forecast). The expected interest rate path was revised upward, such that in the third quarter of 2025, the interest rate is expected to be 4.5 percent. In view of the high geopolitical uncertainty and the increased probability that we attribute to more severe security scenarios, the risk to the growth forecast tends downward, and the risks to the inflation, interest rate, and government deficit forecasts tend upward.

**The forecast**

The Bank of Israel Research Department compiles a staff forecast of macroeconomic developments based on several models, various data sources, and assessments based on economists’ judgment. The Bank’s DSGE (Dynamic Stochastic General Equilibrium) model—a structural model developed in the Research Department and based on microeconomic foundations—plays a prime role in formulating the macroeconomic forecast.[[2]](#footnote-2) The model provides a framework for analyzing the forces that have an effect on the economy, and allows information from various sources to be combined into a macroeconomic forecast of real and nominal variables, with an internally consistent “economic story”.

In order to formulate estimates of the economic impact of the war, special emphasis was placed on an analysis of real-time data that show the scope of the impact on—and the pace of recovery of—the output of various industries and uses, as well as on an analysis of past confrontations.

1. **The global environment**

Our assessments of expected developments in the global economy are based mainly on projections by international financial institutions and foreign investment houses. These projections—regarding growth, inflation and the interest rates in the advanced economies—remained virtually unchanged relative to those used in the July forecast. Accordingly, we assume that growth in the advanced economies will be 1.4 percent in 2024 and 1.5 percent in 2025 (as we did in the July forecast). Our assumption is that world trade will grow by 3.1 percent in 2024 (compared with 3.0 percent in the July forecast), and by 3.4 percent in 2025 (compared with 3.3 percent in the July forecast). Investment houses’ inflation forecasts for the advanced economies for 2024 were revised slightly downward, to 2.4 percent (compared with 2.6 percent in the July forecast), and the forecast for 2025 is 2.1 percent (similar to the July forecast). Investment houses’ forecasts of the average interest rate in the advanced economies were also revised downward, to 3.9 percent at the end of 2024 (compared to 4.1 percent in the July forecast) and 2.9 percent at the end of 2025 (compared to 3.2 percent in the July forecast). The price of Brent crude oil was volatile, and declined to about $77 per barrel, compared with around $85 at the time of the July forecast.

1. **Real activity in Israel**

**GDP is expected to grow by 0.5 percent in 2024 and by 3.8 percent in 2025** (Table 1).

The forecast is based on the assumption that the war’s direct impact on the economy will continue into early 2025. Thereafter, GDP will gradually converge to its prewar trend, but will remain below the trendline in the medium term. Compared to the previous forecast in July, the growth forecast was revised downward, mainly in view of growth figures for the first half of 2024, which were lower than expected, and due to the effects of the recent security deterioration on economic activity. The revision of the growth forecast for 2025 reflects more intense fighting in early 2025 (relative to the assessment in the July forecast) and a delay in the gradual recovery of economic activity to the second half of 2025.

As long as the war continues, GDP growth is expected to be impaired mainly on the supply side (with a more moderate impact on the demand side). While fewer reserve soldiers are currently mobilized than at the beginning of the war, reserve mobilization continues to impair the supply of labor in all industries. Labor supply is a particular problem in the construction industry, due to the significant restrictions on the entry of Palestinian laborers from Judea and Samaria and the complete halt to the employment of laborers from Gaza. In addition to the decline in the supply of labor, production capacity in the confrontation areas and in regions that are under threat has been impaired due to interruptions in regular activity and the ability to work. While the impact in the southern area has been reduced in view of the gradual return of residents, the evacuation of residents from the north and interruptions to economic activity there have expanded, and are expected to continue making it difficult to return to normal activity.

On the demand side, the volume of incoming tourism has been significantly impaired, and experience from previous security incidents shows that this impact is expected to be prolonged. In contrast, an increase in demand in the construction industry is expected within the forecast range, partly due to the need to rehabilitate buildings that were damaged in the war. This increase is expected to be reflected in higher construction costs until a response is found to the shortage of workers.

In view of the supply constraints in the labor market, our assessment is that the broad unemployment rate among the main working ages will remain low this year, and will be 3.2 percent in 2025. A reduction in the number of soldiers in reserve duty in 2025 will ease the supply restrictions in the labor market and support a return of the volume of employment toward its prewar trend.

**The government budget deficit is expected to be 7.2 percent of GDP in 2024 and 4.9 percent of GDP in 2025. Public debt is expected to rise to about 68 percent of GDP in 2024, and about 69 percent of GDP in 2025.** Relative to the previous forecast in July, the current forecast projects an increase in temporary defense expenditures in 2024 and 2025, in view of recent security developments and in view of the revision to the working assumption regarding the intensity of the fighting. In addition, we assume that part of the American assistance grant will be diverted from 2024 to the coming years. However, the forecast of government revenues for 2024 was revised upward in view of the faster-than-expected growth in the volume of actual revenue, which is moderating the increase in the deficit.

The forecast was compiled under the working assumption that the government will make permanent adjustments totaling NIS 30 billion beginning in 2025—beyond the increase in VAT that has already been approved, to lower the structural deficit in the medium term. Our working assumption is that the adjustments will be spread out similarly between the expenditures side and the revenues side of the budget. Assuming that the defense budget is increased in accordance with the programs to increase manpower in the military, including in the reserves, and before the budget increment being discussed by the “Nagel Committee” to assess the force structure and the defense budget, these adjustments will help moderate the increase in the debt to GDP ratio in 2025, and are expected to help reduce it beginning in 2026. Without making these adjustments, the public debt ratio will continue to increase in the medium term.

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| **Table 1**  **Research Department Staff Forecast for 2023–2025**  (rates of change, percenta, unless stated otherwise) | | | | | |
|  | 2023  Actual | Forecast for 2024 | Change from the July forecast | Forecast for 2025 | Change from the July forecast |
| **GDP** | **2.0** | **0.5** | **-1.0** | **3.8** | **-0.4** |
| Private consumption | -0.9 | 3.0 | 1.0 | 7.0 | 2.0 |
| Fixed capital formation (excl. ships and aircraft) | -2.0 | -10.0 | -1.0 | 12.0 | 4.0 |
| Public consumption (excl. defense imports) | 7.2 | 13.0 | 5.0 | -4.0 | 1.5 |
| Exports (excl. diamonds and startups) | -0.2 | -6.0 | -4.5 | 4.0 | -0.5 |
| Civilian imports (excl. diamonds, ships, and aircraft) | -7.2 | -6.0 | -1.0 | 11.5 | 8.0 |
| Broad unemployment rate (average for the year, ages 25–64)b | 4.4 | 3.5 | -0.5 | 3.2 | -0.6 |
| Adjusted employment rate (average for the year, ages 25–64)b | 77.8 | 77.9 | 0.3 | 78.3 | 0.6 |
| Government deficit (percent of GDP) | 4.0 | 7.2 | 0.6 | 4.9 | 0.9 |
| Debt to GDP ratio (percent) | 61.4 | 68.0 | 0.5 | 69.0 | 0.5 |
| Inflation (percent)c | 3.3 | 3.8 | 0.8 | 2.8 | 0.0 |
| a The forecasts of the National Accounts components and the debt to GDP ratio are rounded to the nearest half percentage point.  b According to the Central Bureau of Statistics definition, the broad unemployment rate includes the unemployed under the normal definition (someone who has not worked, wanted to work, was available to work, and searched for work), as well as employees who were temporarily absent from their jobs for economic reasons (including furloughed workers). Accordingly, the adjusted employment rate does not include those temporarily absent from their jobs for economic reasons.  c The average of the Consumer Price Index in the last quarter of the year compared with the average in the last quarter of the previous year. | | | | | |

1. **Inflation and interest rates**

According to our assessment, **inflation in the coming four quarters (ending in the third quarter of 2025) is expected to be 3.2 percent** (Table 2)**.** Inflation in 2024 is expected to be 3.8 percent (compared with 3.0 percent in the July forecast), and inflation 2025 is expected to be 2.8 percent, similar to July (Table 1).

The inflation forecast was revised upward relative to the July forecast, due to a revision of the working assumptions regarding the intensity of the fighting, and due to inflation figures that were higher than expected. The inflation figures for recent months reflect a high inflation environment in view of the supply restrictions in the economy. Looking forward, the constraints on the supply of labor are expected to remain significant in early 2025, mainly due to the mobilization of reserve soldiers, and are expected to continue contributing to domestic price increases. In addition, similar to the July forecast, we assume that increases in indirect taxes on consumption goods will contribute to temporary increases in measured inflation. These tax increases mainly include the expected increase in VAT (From 17 percent to 18 percent), which has already been passed by the Knesset. Net of the impact of indirect taxes, our assessment is that annual inflation in 2025 will be close to the midpoint of the target range.

**The interest rate is expected to be 4.5 percent in the third quarter of 2025** (Table 2). Due to the higher inflation environment than our July assessment, in view of the continuation and expansion of the war, our assessment is that a high interest rate will be necessary for a longer period in order to stabilize inflation.

| **Table 2** | | | |
| --- | --- | --- | --- |
| **Inflation forecast for the coming year and interest rate forecast for one year from now** | | | |
| (percent) | | | |
|  | Bank of Israel Research Department | Capital marketsa | Private forecastersb |
| Inflation ratec | 3.2 | 3.2 | 3.0 |
| (range of forecasts) |  |  | (2.6–3.3) |
| Interest rated | 4.5 | 4.5 | 4.25 |
| (range of forecasts) |  |  | (4.0–4.5) |
| 1. Inflation expectations are seasonally adjusted (as of October 8, 2024). 2. Data as of October 8, 2024. 3. Research Department: the inflation rate during the four quarters ending in the third quarter of 2025. | | | |
| 1. Research Department: the average interest rate in the third quarter of 2025. Expectations derived from the capital market are based on the Telbor market (as of October 8, 2024).   SOURCE: Bank of Israel. | | | |

Table 2 shows that the Research Department’s inflation and interest rate forecasts are similar to expectations derived from the capital market and slightly higher than the average projections of the private forecasters.

1. **Main risks to the forecast**

As stated, the baseline forecast is based on the assumption that the direct economic impact of the war will continue into early 2025. However, uncertainty during the current period is high, and there is increased likelihood that more severe scenarios than the baseline forecast will be realized. Therefore, we also analyzed alternative scenarios that examine the expected effect of various developments concerning the duration and intensity of the war, which also may have an impact on economic developments. As expected, these scenarios indicate that the more the war intensifies and the longer it lasts, the more severe its impact could be and the greater its macroeconomic implications could be. For example, we examined a scenario involving a further significant temporary escalation in the war, which would require a reserve mobilization similar in scale to the beginning of the war. This would lead to an expansion of the constraints on economic activity and the shutdown of the education system for several weeks, particularly in the northern region but also in the central part of the country. According to this scenario, the worsening security situation would negatively impact annual growth, causing a significant decline in GDP in the fourth quarter of 2024. In such a scenario, with the reduction in the number of reservists and the lifting of severe activity restrictions in 2025, growth that year would be higher than in the baseline scenario. However, the level of GDP in 2025 would still be lower than in the baseline scenario. If the war extends further into 2025, supply constraints will continue to hinder the recovery of economic activity, resulting in more moderate growth and a widening gap from the baseline scenario. In such a scenario, the continuation and intensification of the war would lead to a further increase in the deficit and debt due to higher defense expenditures and the impact on activity and tax revenues, necessitating additional budgetary adjustments. These could delay the convergence of inflation to its target.

Another risk is that the government may only partially make the necessary fiscal adjustments, primarily in view of the potential further increase in war expenses and in permanent defense expenditures. These may lead to a further increase in Israel’s risk premium as a result of the markets’ concern that the debt to GDP ratio is on a divergent path. Such a situation may lead to an impact to the economy’s growth path in the long term as well, a weakening of the shekel, and increasing inflationary pressure, which would also be reflected in higher interest rates.

In view of these risks, our assessment is that the balance of risks relating to the growth forecast tends downward, while in relation to the inflation, deficit, and interest rate forecasts, the balance of risks tends upward.

1. The forecast was presented to the Bank of Israel Monetary Committee on October 8, 2024, prior to the decision on the interest rate made on October 9, 2024. [↑](#footnote-ref-1)
2. An explanation of the macroeconomic forecasts formulated by the bank of Israel Research Department, as well as a review of the models on which they are based, appear in the Bank of Israel’s Inflation Report 31 (second quarter of 2010), Section 3c. A Discussion Paper on the DSGE model is available on the Bank of Israel website, under the title: “MOISE: A DSGE Model for the Israeli Economy,” Discussion Paper No. 2012.06. [↑](#footnote-ref-2)