BANK OF ISRAEL
Office of the Spokesperson and Economic Information

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Research Department Staff Forecast, October 2021

Abstract

This document presents the macroeconomic staff forecast formulated by the Bank of Israel Research Department in October 2021 concerning the main macroeconomic variables—GDP, inflation, and the interest rate. The forecast assumes that the process of removing restrictions in Israel will continue in parallel with the gradual abatement of the pandemic globally in the coming two years, alongside the outbreak of further waves of morbidity in Israel and around the world that will be accompanied by relatively "soft" restrictions that will have a limited economic impact.

According to the forecast, GDP is expected to grow by 7 percent in 2021 and by 5.5 percent in 2022, while the adjusted employment rate is expected to increase throughout the forecast period, to 59.5 percent by the end of 2022. The inflation rate in the coming four quarters (ending in the third quarter of 2022) is expected to be 1.7 percent, and inflation in 2022 is expected to be 1.6 percent. According to this forecast, the monetary interest rate is expected to be between 0.1 and 0.25 percent one year from now. The forecast assumes that the State budget will be approved in final form by the end of the year. Under this assumption, the government deficit in 2021 is expected to be 6.4 percent of GDP, while the deficit in 2022 is expected to be 4 percent of GDP. The debt to GDP ratio is expected to be about 73.5 percent in 2021 and about 73 percent in 2022.

The Forecast

The forecast is based on an analysis of developments in the economy in view of the COVID-19 crisis thus far, and contains information from various indicators and models. The Bank's DSGE (Dynamic Stochastic General Equilibrium) model developed in the Research Department—a structural model based on microeconomic foundations—which provides a framework for analyzing the forces that have an effect on the economy, was used to combine them into a coherent macroeconomic forecast of real and nominal variables.[1]

a. The global environment

Our assessments of expected developments in the global economy are based mainly on projections by international institutions (the International Monetary Fund and the OECD) and by foreign investment houses. Accordingly, we assume that GDP growth

[1] An explanation of the macroeconomic forecasts formulated by the Research Department, as well as a survey of the models upon which it is based, appear in Inflation Report number 31 (for the 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.

in the advanced economies will be about 5 percent in 2021 and about 4.5 percent in 2022 (compared with 5.3 percent and 3.8 percent respectively in the previous forecast in July). Our assessment is that world trade is expected to grow by about 9 percent in 2021 and by about 7 percent in 2022 (an upward revision of about 1 percentage point compared with the previous forecast). The forecast of inflation in the advanced economies was revised upward to 3.8 percent in 2021 in view of the continued increase in inflation in the US, while the forecast for 2022 was revised downward to 1.8 percent. The average interest rate of the central banks is expected to increase to about 0.2 percent by the end of 2022, similar to the assessments upon which the previous forecasts were based. Since the publication of the July forecast, the price of oil has maintained a similar price environment, although in recent weeks the price has trended upward.

b. Real activity in Israel

Our assessment is that **GDP will increase by 7 percent in 2021 and by 5.5 percent in 2022** (Table 1). GDP in the second quarter of 2021 grew by 16.6 percent in annual terms, a pace that was higher than our assessment in previous forecasts. In parallel, the recovery in the volume of employment continues. The adjusted employment rate increased to 58.8 percent in August, and September data provide a similar picture.

Regarding fiscal policy, our assessment is that the State budget will be passed by the end of the year. The government deficit is expected to be 6.4 percent of GDP in 2021 and 4 percent of GDP in 2022. The debt to GDP ratio is expected to be about 73.5 percent in 2021 and about 73 percent in 2022.

Table 1
Research Department Staff Forecast for 2021–2022

(rates of change, percent[a], unless stated otherwise)

	2020	Forecast for 2021	Change from the July forecast	Forecast for 2022	Change from the July forecast
GDP	**-2.2**	**7.0**	**1.5**	**5.5**	**-0.5**
Private consumption	-9.2	11.5	1.0	7.0	-1.0
Fixed capital formation (excl. ships and aircraft)	-2.6	7.0	2.0	6.5	1.0
Public consumption (excl. defense imports)	2.7	4.0	--	2.5	--
Exports (excl. diamonds and startups)	1.1	7.5	1.5	4.0	--
Civilian imports (excl. diamonds, ships, and aircraft)	-7.3	15.0	--	7.5	3.0
GDP deviation from the precrisis trend (percent)	**-6.2**	**-3.6**	**0.4**	**-2.1**	**-0.6**
Unemployment rate[b] (average for the year)	15.9	10.4	-0.4	5.8	-0.6
Unemployment rate[b] (fourth quarter)	**16.1**	**7.1**	**-0.9**	**5.2**	**-0.3**
Adjusted employment rate[b] (average for the year)	53.3	56.8	0.2	59.2	0.1
Adjusted employment rate[b] (fourth quarter)	52.7	59.0	0.9	59.5	--
Government deficit (percent of GDP)	11.6	6.4	-0.7	4.0	0.2
Debt to GDP ratio	71.5	73.5		73.0	
Inflation[c]	-0.7	2.5	0.8	1.6	0.4

[a] In the forecast of National Accounts components, the rate of change is rounded to the nearest half percentage point.
[b] The broad unemployment rate among those aged 15+. In accordance with the Central Bureau of Statistics broad definition, the unemployment rate includes the unemployed under the normal definition (someone who has not worked, wanted to work, was available for work, and looked for work), as well as employees temporarily absent for an entire week for reasons having to do with COVID-19 (including those on furlough), and those not participating in the labor force for reasons having to do with COVID-19.
[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.

The forecast includes our assessment that the economy will continue its recovery from the crisis. In 2022, economic activity (yearly average) is expected to be about 2 percent lower than its precrisis trend. The main contribution to the deviation from the trend is from private consumption, which was the dominant factor that contracted in 2020 due to the lockdowns and restrictions. Accordingly, household disposable income increased, creating forced savings. In view of the removal of restrictions, private consumption is expected to grow in the forecast period, and to be the dominant factor in the growth of demand for output.

c. Inflation and interest rates

According to our assessment, **inflation in the next four quarters (ending in the third quarter of 2022) is expected to be 1.7 percent** (Table 2)**. Inflation in 2021 is expected to be 2.5 percent, and in 2022 it is expected to be 1.6 percent** (Table 1). We expect that in the short term, inflation will remain at its current level in view of the continued limitations on supply and problems in the supply chain, but that it will moderate later on to a pace slightly below the midpoint of the inflation target.

Since the publication of the previous forecast, the shekel appreciated by about 1.9 percent in terms of the nominal effective exchange rate. Our assessment is that the prices of tradable goods will remain high, and that inflation of those prices throughout the forecast horizon will be about 1.5 percent. This rate is lower than in previous months, but higher than the rate that was prevalent prior to the COVID-19 crisis.

The forecast assumes that the housing component of the CPI will continue to increase gradually following the end of the crisis. However, our assessment is that it will not return to the levels that were typical of the precrisis period, but will reach a level of slightly less than 2 percent at the end of 2022 (similar to the July forecast). This assessment includes an assumption that the pace of construction will accelerate following the decline in construction activity during the crisis.

Regarding the other services and the nontradable goods, the forecast assumes that prices will increased by about 1 percent per year during the forecast horizon, similar to their pace during the precrisis years (and similar to the assumption underlying the July forecast).

Our assessment is that **the interest rate will be between 0.1 and 0.25 percent one year from now** (Table 2).

Table 2 shows that the Research Department’s staff forecast regarding inflation in one year is similar to the average of the private forecasters’ projections (1.5 percent), and lower than expectations derived from the capital market, which indicate higher inflation of about 2.7 percent in one year. It should be noted that this indicator is prone to volatility, deviations, and inflation risk premia.

Table 2
Inflation and interest rate forecasts for the coming year

(percent)

	Bank of Israel Research Department	Capital markets[a]	Private forecasters[b]
Inflation rate[c] (range of forecasts)	1.7	2.7	1.5 (1–2.2)
Interest rate[d] (range of forecasts)	0.10–0.25	0.20	0.10 (0.0–0.5)

a) Average expectations derived from the capital market seasonally adjusted or from the interest rate in the Telbor market between October 5 and 6.
b) The average of forecasts published on October 6.
c) Inflation rate in the coming year. Research Department: in the four quarters ending in the third quarter of 2022.
d) The interest rate one year from now. (Research Department: in the third quarter of 2022.) Expectations derived from the capital market are based on the Telbor market.
SOURCE: Bank of Israel.

d. Main risks to the forecast

It should be noted that despite the existence of a fourth wave of morbidity, there was in the end no need to impose a general lockdown as there was during the previous waves. However, there is still a significant level of uncertainty in view of the increase in morbidity, the need to expand vaccinations as part of dealing with the ramifications of infection, and the possibility of the development of new waves of morbidity that may have a more significant impact on the economy than the current wave. It should be emphasized that in view of existing knowledge, the apparent morbidity and vaccination trends, and the on-going learning process by the medical system, the government, and the public that has been going on since the beginning of the pandemic, the chance of such a scenario coming to pass currently appears relatively low. However, if morbidity waves do break out and lead to significant restrictions on activity, there is a basis to assume that those waves will have less of an economic impact than that of the second and third waves. Accordingly, our assessment is that the development of significant morbidity waves will result in about one percentage point being shaved from the forecast growth in 2022.

In terms of other risks to the forecast, the budget that was approved by the government anchors fiscal certainty during the forecast period. However, in recent months, we have seen a continued increase in the global inflation environment. This is apparently a temporary adjustment process. However, since the scope of restrictions on economic activity in various countries changes frequently, supply difficulties may continue for longer than expected, which increases the uncertainty surrounding inflation and monetary policy around the world.