BANK OF ISRAEL
Office of the Spokesperson and Economic Information

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Research Department Staff Forecast, July 2021

Abstract

This document presents the macroeconomic staff forecast compiled by the Bank of Israel Research Department in July 2021 concerning the main macroeconomic variables—GDP, inflation, and the interest rate. In this forecast, we assume that lockdowns or marked limitations on activity in respect of COVID-19 will not be required. The forecast reflects our assessment that the economy continues with a process of recovery from the crisis, after the cancelation of a large majority of the limitations, and that by the end of 2022, activity will approach the trend line from precrisis period. According to the forecast, GDP is expected to grow by 5.5 percent in 2021 and by 6.0 percent in 2022, while the broad unemployment rate is expected to decline over the forecast period, to 5.5 percent at the end of 2022. The inflation rate in the coming four quarters (ending in the second quarter of 2022) is expected to be 1.0 percent, and the inflation rate in 2022 is expected to be 1.2 percent, similar to our assessment in the previous forecast. According to this forecast, the monetary interest rate is expected to be 0.1 percent one year from now. We assume that the State budget will be passed by the end of the year and that the fiscal consolidation will be pushed off to 2023. Under these assumptions, the government deficit in 2021 is expected to be 7.1 percent of GDP and in 2022 is expected to be 3.8 percent of GDP. The debt to GDP ratio is expected to be 74 percent in each of those years.

The Forecast

This forecast is based on an analysis of the economy's recovery from the COVID-19 crisis and it 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—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 arena are based mainly on projections by international institutions and foreign investment houses. Accordingly, we assume that GDP growth in the advanced economies will be 5.3 percent in 2021 and

[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.

3.8 percent in 2022—higher than the assessment upon which the previous forecast was based. Our assessment of world trade was revised slightly downward, with growth of 8.2 percent expected in 2021 and growth of 5.8 percent expected in 2022. The forecast of inflation in the advanced economies was revised upward to 3.0 percent in 2021, against the background of rising inflation in the US. However, it remained 1.7 percent for 2022. 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 forecast was based. Since the publication of the January forecast, the price of Brent crude oil increased from about $66 to about $76 per barrel.

b. Real activity in Israel

We estimate that GDP will grow by 5.5 percent in 2021 and by 6.0 percent in 2022 (Table 1). GDP in the first quarter of 2021 contracted by 6.2 percent in annual terms, among other things as result of vehicle purchases being brought forward to the end of 2020; net of this effect, GDP declined by only 2.9 percent. The contraction also derived from a decline in public consumption and its shifts between quarters. Our assessment is that there will only be a moderate effect of Operation "Guardian of the Walls" on growth in 2021 (less than 0.1 percent of GDP). In parallel, the recovery in the scope of employment continues, though at a slower pace than we had assessed; the broad unemployment rate declined to 9.9 percent in May. However, at the end of June, the terms of eligibility for payments to people placed on unpaid leave contracted, and we expect some acceleration in the pace of recovery of employment.

In terms of fiscal policy—we assess that the government budget will be passed by the end of the year and that the fiscal consolidation will be deferred to 2023. Under these assumptions, the government deficit in 2021 is expected to be 7.1 percent of GDP, and in 2022 to be 3.8 percent of GDP. The debt to GDP ratio is expected to be 74 percent in each of those years.

The forecast incorporates our assessment that the economy continues on a path of recovery from the crisis, after the cancellation of a large majority of the limitations. In 2022, the activity level (in annual average terms) will be 1.5 percent lower than its trend from the precrisis period. The main contribution to the deviation of activity from the trend is from private consumption, as in 2020 private consumption was the dominant factor that contracted, due to the lockdowns and limitations. Accordingly, household disposable income increased and created forced savings, so that in the range of the forecast, in light of the removal of the limitations, private consumption will grow and be the dominant factor in growth of GDP.

Table 1
Research Department Staff Forecast for 2021–2022
(rates of change, percent[a], unless stated otherwise)

	2020	Forecast for 2021	Change from the April forecast	Forecast for 2022	Change from the April forecast
GDP	**-2.6**	**5.5**	-0.8	**6.0**	1.0
Private consumption	-9.5	10.5	-0.5	8.0	1.0
Fixed capital formation (excl. ships and aircraft)	-3.5	5.0	-0.5	5.5	1.0
Public consumption (excl. defense imports)	2.9	4.0	–	2.5	–
Exports (excl. diamonds and startups)	1.3	6.0	2.0	4.0	–

Civilian imports (excl. diamonds, ships, and aircraft)	-8.0	15.0	4.0	4.5	-1.5
GDP deviation from the precrisis trend (percent)	**-6.0**	**-4.0**	-0.9	**-1.5**	-0.1
Unemployment rate[b]—annual average	15.9	10.8	0.9	6.4	-0.2
Unemployment rate[b]—latest quarter	**16.1**	**8.0**	0.5	**5.5**	-0.5
Adjusted employment rate[b]—annual average	53.3	56.6	0.2	59.1	0.7
Adjusted employment rate[b]—latest quarter	**52.7**	**58.1**	0.4	**59.5**	0.7
Government deficit (percent of GDP)	11.6	7.1	-1.1	3.8	0.2
Inflation[c]	-0.7	1.7	0.4	1.2	–

[a] In the forecast of National Accounts components, the rate of change is rounded to the nearest half percentage point.
[b] Unemployment rate among those aged 15 and over. 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 the 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.

c. Inflation and interest rates

According to our assessment, inflation in the next four quarters (ending in the second quarter of 2022) will be 1.0 percent (Table 2). The inflation rate is expected to be 1.7 percent in 2021 and to be 1.2 percent in 2022 (Table 1). We forecast that in the short term, the inflation rate will accelerate against the background of transitory forces, but that over the rest of the forecast it will moderate to a rate slightly above the lower bound of the target range, against the background of similar conduct of inflation abroad, and domestic inflation as we will discuss below.

Inflation data for the second quarter of 2021 in Israel and abroad were revised upward. In nominal effective terms, the shekel appreciated by approximately only 0.7 percent. Investment houses increased the inflation forecast for the end of 2021 upward by about 1 percentage point (from 2 percent to 3 percent). Accordingly, we revised our forecast for the development of tradables prices at the end of 2021 upward by approximately 0.4 percentage points to a rate of 1.4 percent (in annual terms), but the pace for the end of 2022 remained unchanged—a rate of 1.2 percent.

With regard to the housing prices component in the CPI, our assessment is that it will continue to rise gradually as the COVID-19 crisis passes, but it will not return to its levels of before the crisis. Rather, it will reach a rate of 1.8 percent at the end of 2022 (similar to the forecast in April). This assessment reflects the assumption that the pace of construction will accelerate after the decline in construction activity during the time of the coronavirus. In addition, unemployment at the end of 2022 is expected to be high relative to its level before the coronavirus crisis, and to act toward some restraint on the demand side.

Regarding the other nontradable goods and services, we assess that in the short term, the demand for them will grow rapidly in view of the release of the limitations. However, some adjustment period on the supply side is expected, due to disturbances and frictions such as bottlenecks in supply chains and a shortage in workforce, alongside the increase in goods prices that occurred. Accordingly, we assess that these demand surpluses will contribute to an increase in inflation in the coming year. However, in 2022, our assessment is that supply will adjust itself, and prices of goods and raw materials will moderate, so that the inflation rate will moderate, particularly when the competition in the economy returns and there will likely be technological improvements and increased productivity of the companies.

Our assessment is that the interest rate will be 0.1 percent in a year (Table 2). The low level of the interest rate, which is part of the set of tools used by the Bank of Israel to deal with the crisis and the exit from it, supports the recovery of demand and the anchoring of inflation within the target range. If further accommodation is necessary beyond the accommodation via the monetary interest rate, the Bank of Israel will be able to use existing or additional policy tools.

The Research Department's staff forecast regarding inflation in one year is slightly lower than the average of the private forecasters' projections (1.3 percent), which are markedly lower than expectations derived from the capital market. Those indicate an inflation rate around the middle of the target range in a year and onward, meaning there was an increase in the probability that the inflation rate will rise, and expectations are anchored around the middle of the target range. We note that this indicator is subject to noise, biases, and inflation risk premiums.

Table 2

Forecast of inflation in the coming year and of the interest rate in a year

(percent)

	Bank of Israel Research Department	Capital markets[a]	Private forecasters[b]
Inflation rate[c] (range of forecasts)	1.0	2.12	1.3 (0.7–1.8)
Interest rate[d] (range of forecasts)	0.10	0.15	0.12 (0.0–0.5)

a) Average of inflation expectations derived from the capital market, seasonally adjusted, from June 27 through July 1.
b) The average of forecasts on June 30.
c) Inflation rate in the coming year. Research Department: in the four quarters ending in the second quarter of 2022.
d) The interest rate one year from now. (Research Department: in the second 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

Despite the recent increase in morbidity, our assessment is that the risk to activity from the epidemiological side is small—due both to the high percentage of people vaccinated in the population and to the economy's adjustment to activity in periods of increased morbidity. However, the development of the Delta variant is liable to have an impact on the extent of closure of the economy to incoming and outgoing tourism. There is also a decline in the fiscal uncertainty in view of the forming of the government. In contrast, there is uncertainty regarding inflation abroad during the coming period, and its effects on the inflation rate in Israel.