BANK OF ISRAEL
Office of the Spokesperson and Economic Information

June 23, 2014

Press Release

Research Department Staff Forecast, June 2014

Abstract

This document presents the forecast of macroeconomic developments compiled by the Bank of Israel Research Department in June 2014. The forecast was presented to the Monetary Committee on June 22, 2014, during its meeting prior to the decision on the Bank of Israel interest rate for July 2014. According to the staff forecast, gross domestic product (GDP) is projected to increase by 2.9 percent in 2014, and by 3.0 percent in 2015. The rate of inflation over the next year (ending in the second quarter of 2015) is expected to be 1.6 percent. The Bank of Israel interest rate is expected to be 0.75 percent at the end of 2014, and to start rising during 2015, such that the interest rate is expected to reach 1 percent one year from now.

Forecast

The Bank of Israel Research Department compiles a staff forecast of macroeconomic developments on a quarterly basis. The staff forecast is based on several models, various data sources, and assessments based on economists' judgment.[1] The Bank's medium scale DSGE (Dynamic Stochastic General Equilibrium) model developed in the Research Department—a structural model based on microeconomic foundations—plays a primary role in formulating the macroeconomic forecast.[2] The model provides a framework for analyzing the forces which have an effect on the economy, and allows the integration of information from various sources into a macroeconomic forecast for real and nominal variables, with an internally consistent "economic story".

a. The global environment

The assumptions about the global economy are primarily based on forecasts by international financial institutions (the IMF and OECD) and foreign investment houses. This quarter as well, the forecasts reflect the assessment that in 2014 and 2015, the global economy will continue its gradual recovery from the economic crisis. The current assessments of economic growth and trade in the advanced economies in 2014 have declined slightly compared with our assessments when compiling the previous forecast (in March), while assessments concerning 2015 have increased

[1] An explanation of the staff macroeconomic forecast, and an overview of the models on which it is based, can be found in Inflation Report 31 for the second quarter of 2010, section 3-C.

[2] A Discussion Paper on the 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.

slightly. The change reflects the weak National Accounts data for the first quarter of the year, but also reflects the view that the weakness in that quarter was affected by the harsh winter experiences in Europe and in the US, and is therefore considered temporary.[3]

Estimates of inflation rates expected in the next year in advanced economies declined slightly compared to those that were in place when the last forecast was prepared in March, following the further decline in inflation in recent months. On average, the OECD's inflation expectations for its member countries are about 1.6 percent in 2014, and 1.9 percent in 2015.

Oil (Brent crude) continued trading with relative stability in the second quarter of 2014, with the average price during the quarter remaining close to $110[4]. The global food index remained stable during the second quarter, following a sharp increase of about 15 percent in the first quarter, due to the effects of the harsh winter in Europe and the US. At the same time, commodities prices excluding energy and food have declined since the middle of the quarter.

Alongside the general assessment of continued improvement in the global economy, and its slow expansion to the labor market as well, assessments by the OECD and the IMF are that there is a continuing decline in the likelihood of the stress scenarios that threatened the global economy in recent years. Currently, however, there are two major risk factors for the global economy: first, the growth rates in emerging markets, and second, the low inflation rate, primarily in Europe. Low inflation is considered a risk factor against the background of, among other things, the low level of nominal interest rates in the large markets.

b. Real activity in Israel

GDP growth is expected to be 2.9 percent in 2014. Excluding the effect of natural gas production from the "Tamar" site, GDP in 2014 is projected to increase by 2.6 percent.

The GDP growth forecast for 2014 is slightly lower than the estimate in the previous forecast (at the end of March), which was 3.1 percent. This follows the publication of National Accounts data for the first quarter of 2014, which were lower than estimated. These data have a base effect on expected growth rates in 2014, which contributes to the downward revision of our estimate. On the uses side, the declines in investments and in private consumption were particularly prominent.

GDP in 2015 is expected to grow by 3.0 percent. The expected growth in 2015 is led by exports, which are expected to grow with the improvement in the growth rate of global trade, and by investments.[5] At the same time, the growth rate of private consumption is expected to moderate slightly in the next two years.

---

[3] According to the most recent forecast by the OECD, from May 2014, global trade is expected to increase by 4.4 percent in 2014, and by 6.1 percent in 2015. GDP growth in the advanced economies is expected to be 2.2 percent in 2014 and 2.8 percent in 2015.

[4] During the recent days, against the background of geopolitical stress in Iraq, oil prices are increasing to some extent.

[5] Excluding the estimated effect of natural gas production from the "Tamar" site, the GDP growth rate is expected to improve from 2.5 percent in 2013 to 2.6 percent in 2014 and to 3.0 percent in 2015.

Table 1: Economic Indicators
Research Department Staff Forecast for 2014 to 2015
(rates of change, percent, unless stated otherwise)

	Actual 2013	Bank of Israel forecast 2014	Bank of Israel forecast 2015
GDP	3.3	2.9	3.0
Civilian imports (excluding diamonds, ships, and aircraft)	-2.9	3.6	7.0
Private consumption	3.5	2.3	2.8
Fixed capital formation	0.7	2.3	8.8
Public sector consumption (excluding defense imports)	3.1	3.6	0.1
Exports (excluding diamonds and start-ups)	-0.9	5.9	5.7
Unemployment rate[a]	6.3	5.9	6.2
Inflation rate[b]	1.8	0.4	1.8
Bank of Israel interest rate[c]	1.00	0.75	1.50

a) Annual average.
b) Average CPI reading in the final quarter of the year compared with the final quarter average in the previous year.
c) Average for the final quarter of the year.

Source: Data - based on Central Bureau of Statistics and Bank of Israel; forecast - Bank of Israel.

The deficit target for 2014 is 3.0 percent of GDP, and the actual deficit is expected to be at a similar level. During the upcoming period, the government is expected to decide upon the **2015 budget**. The staff forecast builds on the assumption that the government will meet the fiscal targets: the deficit target and the expenditures ceiling. The deficit target for 2015 is 2.5 percent of GDP. In order to meet the deficit target in 2015, the government will be required to adopt policy measures that will lead to increased revenue totaling about 0.5 percent of GDP. This amount is affected by, among other things, the VAT exemption plan on new homes for eligible population groups (which is expected to lead to a loss of tax revenue totaling more than NIS 2 billion) and it was calculated based on the assumption that the government will not exceed the expenditure ceiling set by the fiscal rule, including a reduction in public expenditures in 2015. Such reduction is required as a result of the gap between the inflation expected for 2013–14, at the time the two-year budget was passed, and the actual development of prices during those two years.[6] Due to the surprise in the April CPI reading, which was much lower than the seasonal path, the required size of the adjustment increased, compared to the previous forecast. Therefore, the real growth rate of public consumption in 2015 declines to 0.1 percent (compared to 0.6 percent in the previous forecast in March).[7]

c. Inflation and interest rate estimates

[6] There is an ongoing debate as to whether or not an adjustment of prices is actually required in the specific case of 2015. If it is determined that it is not required, the government will not have to reduce expenditures by the amount of the price adjustment. But if it chooses to do so, it will be required to increase its revenues accordingly, in order to avoid exceeding the deficit ceiling. Such a change is neutral for the forecast for 2015.

[7] Public sector consumption (excluding defense imports) is approximately one-half of total public sector expenditure. The other half comprises transfers and supports, interest payments on the public debt, public sector investments and defense imports. Total public sector expenditure is expected to grow, in real terms, by approximately 1 percent in 2015.

In our assessment, the rate of inflation during the four quarters ending in the second quarter of 2015 will be 1.6 percent, below the center of the inflation target range of 1–3 percent. Inflation as measured over the previous four quarters is expected to be, temporarily, below the lower bound of the target range in the second half of 2014 (Figure 1).

Many factors are expected to moderate inflation. First, there are no signs of inflationary pressure from domestic demand (through the cost of the factors of production), and in view of the moderate growth, it seems that this situation will remain in place in the coming year. Second, further to the trend that has become apparent this year, the housing component of the Consumer Price Index (based on rents), which in recent years has been a contributing factor to inflation, is expected to continue moderating. Third, the shekel continued appreciating in the first half of the year, and it is reasonable to assume that its effect on inflation has not yet fully materialized. Fourth, low global inflation against the background of surplus manufacturing capacity is also contributing to restraining inflation (and global food prices, contrary to their increase in the previous quarter, also are not seen as an inflationary factor this time).

The **Bank of Israel interest rate** is expected, according to the staff forecast, to be 0.75 percent at the end of 2014, to increase during 2015, and to reach 1.5 percent at the end of 2015. This increase is expected against the background of improved global economic conditions that will be accompanied by an increase in the global interest rate environment. Yet, Figure 2 indicates that the expected interest rate path has been revised downward in relation the path that was presented as part of the previous forecast, against the background of similar developments globally, to a great extent due to the decline in inflation (both in Israel and globally).

Table 2 indicates that, with regard to the coming year, **the Research Department's forecast of the inflation rate is similar to that of private forecasters and expectations derived from capital markets**, although it is slightly higher than them. Regarding the interest rate forecast for one year from now, expectations derived from capital markets are lower than the Research Department’s forecast and the average of the private forecasters' forecasts.

Table 2

Forecasts for inflation rate and interest rate for the coming year

(percent)

	Bank of Israel Research Department	Capital markets[a]	Private forecasters[b]
Inflation rate[c]	1.6	1.4	1.4
(range of forecasts)			(1.1-1.6)
Interest rate[d]	1.00	0.6	0.9
(range of forecasts)			(0.5-1.5)

a) Average for the month of June (through June 18). Seasonally adjusted inflation expectations.

b) Inflation and interest rate forecasts are after the publication of the CPI reading for May.

c) Inflation rate over the next 12 months (Research Department: in the next four quarters).

d) The interest rate one year from now. Capital markets forecast derived from Telbor rates.

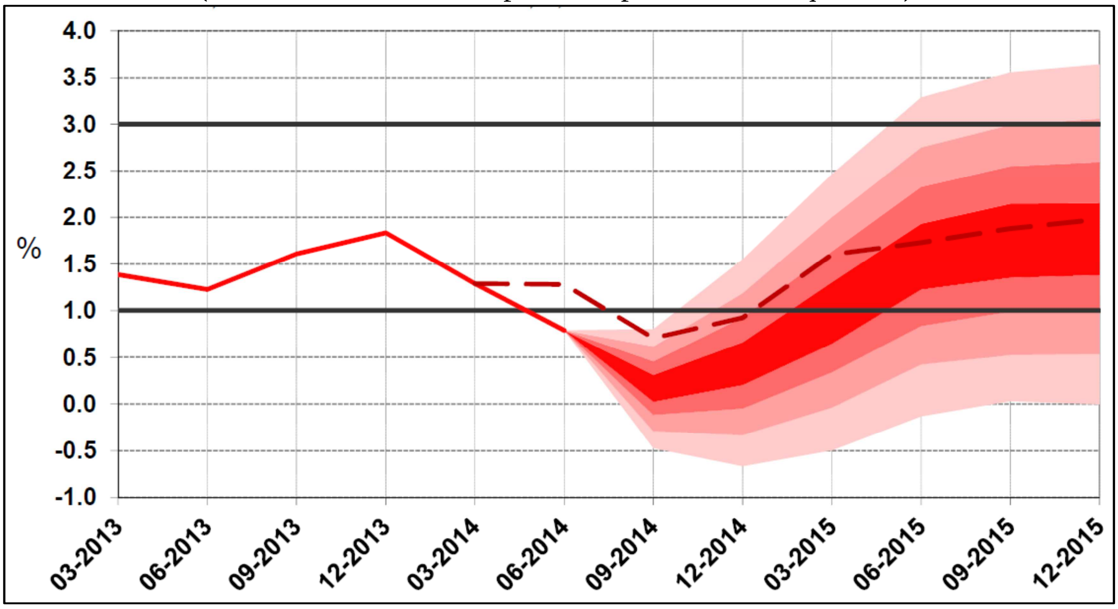
Source: Bank of Israel.

d. Balance of risks in the forecast

There are many factors, domestic and global, which can lead to developments that are different than those in the baseline forecast. Globally, the estimates of major international institutions are that the risks to growth forecasts still tend to the downside. A major risk is disappointing developments in real activity in various countries worldwide, such that the improvement may be slower than expected in the baseline forecast. In particular, there are concerns regarding the recovery in major emerging markets and in Europe. In addition, the low inflation rates globally have recently been seen as a significant risk factor, particularly against the background of the low interest rates of central banks in the major economies.

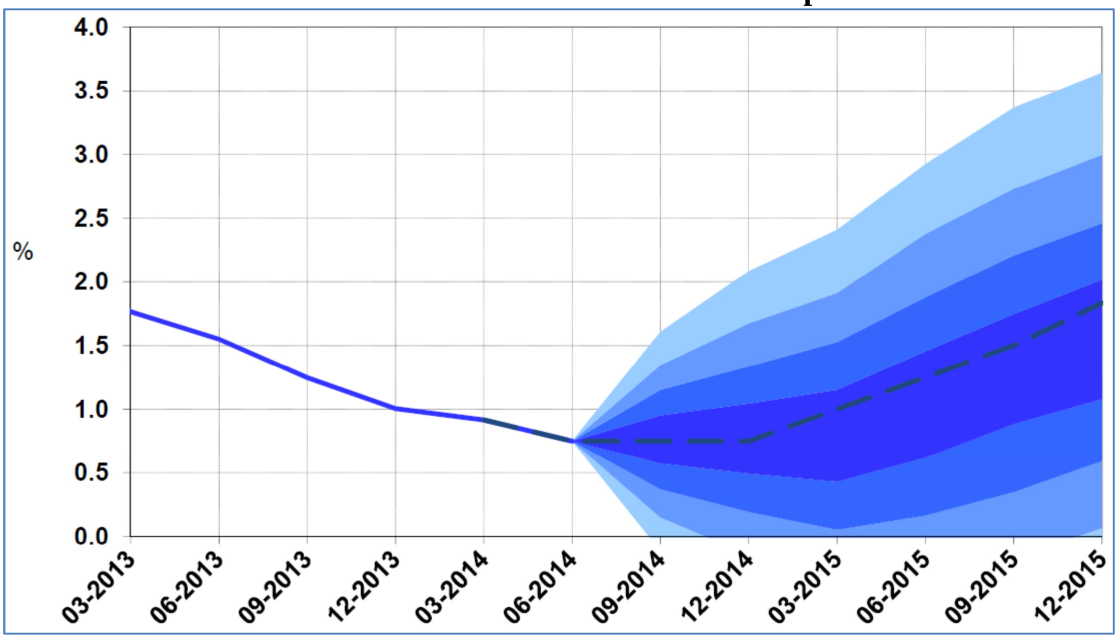
Figures 1 and 2 present fan charts around the inflation rate and interest rate forecasts (the broken line represents the baseline forecast of March 2014). The width of the fan is derived from the **estimated** distributions of the shocks in the Research Department's DSGE model.

Figure 1
Actual Inflation and Fan Chart of Expected Inflation
(cumulative increase in prices in previous four quarters)



The center of the fan chart is based on the Bank of Israel Research Department assessment. The width of the fan is based on the Department's medium-scale DSGE (dynamic stochastic general equilibrium) model. The full fan covers 66 percent of the distribution of expected inflation.
The dotted line corresponds to the previous staff forecast (published in March 2014).
Source: Bank of Israel.

Figure 2
Actual Bank of Israel Interest Rate and Fan Chart of Expected Interest Rate



The center of the fan chart is based on the Bank of Israel Research Department assessment. The width of the fan is based on the Department's medium-scale DSGE (dynamic stochastic general equilibrium) model. The full fan covers 66 percent of the distribution of expected interest rate.
The dotted line corresponds to the previous staff forecast (published in March 2014).
Source: Bank of Israel.