



BANK OF ISRAEL

Office of the Spokesperson and Economic Information

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Press Release

Research Department Staff Forecast, March 2015

Abstract

This document presents the forecast of macroeconomic developments compiled by the Bank of Israel Research Department in March 2015. The forecast was presented to the Monetary Committee on March 22, 2015, during its meeting prior to the decision on the Bank of Israel interest rate for April 2015. According to the staff forecast, gross domestic product (GDP) is projected to increase by 3.2 percent in 2015, and by 3.5 percent in 2016. The rate of inflation over the next year (ending in the first quarter of 2016) is expected to be 1.1 percent. The Bank of Israel interest rate is expected to remain at its current level of 0.1 percent until the end of 2015.

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 current assessments of expected developments in the global environment are based mainly on projections by international institutions (the International Monetary Fund and the OECD) and of foreign investment houses. The projections reflect assessments that the pace of growth in GDP in the advanced economies will improve in 2015 and 2016 compared to 2014, although at a moderate pace, and with variance between countries. In particular, relative weakness is expected in Europe and Japan, while stronger growth is expected in the US. Projected growth was revised slightly

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.

upwards in Europe and downwards in the US, such that their average remains virtually unchanged from the assessments that underpinned the forecast made in December.

The pace of growth in global trade is expected to accelerate in 2015, alongside the improvement in growth. This assessment is unchanged compared to the assessments in December. Thus, the rate of growth in imports to the OECD in 2015 is expected to be 3.7 percent. Further improvement in global trade is expected in 2016.

Oil prices have fallen further since the publication of the previous staff forecast in December. The price of Brent crude oil has fallen by about 10 percent during the first quarter (until mid-March), compared to the price during the period that preceded the formulation of the previous staff forecast. Global food prices recently fell to a five-year low. Similar to oil prices, the decline in global food prices is explained mainly by supply factors. Inflation in advanced economies continued to fall in recent months, but inflation projections for the coming months remained unchanged.

b. Real activity in Israel

GDP growth is expected to be 3.2 percent in 2015, unchanged from the previous staff forecast. The sharp increase in private consumption in 2014 reflects, *inter alia*, the bringing forward of vehicle purchases against the background of green taxation regulations that came into effect at the beginning of 2015. It is also reflected in a contribution to growth in 2014 due to the high taxation on vehicles that is registered as GDP. Therefore, a certain correction is expected at the beginning of 2015. Despite this, the Research Department is leaving the growth forecast for 2015 unchanged, due to a number of developments that are expected to make a positive contribution to growth: lower than expected oil prices, lower than expected inflation (explained mainly by supply factors), stronger labor market data, and lower interest rates than previously projected.

The growth forecast for 2016 was revised to 3.5 percent, compared to the 3.0 percent forecast in December. Fixed capital formation and exports are expected to lead the improvement in the pace of growth in 2016. Fixed capital formation in 2016 will be affected by an investment by a large company (which will be attributed almost entirely to the import of machinery and equipment), and from the expected expansion of residential construction during the year. The pace of growth in exports is expected to accelerate in 2016, in parallel with the expected acceleration in imports by advanced economies.

During the first half of 2015, the government is expected to operate without an approved budget. In the previous forecast, our assessment was for growth of 4.1 percent in public consumption in 2015, exceeding the expenditure ceiling, in line with the government's proposal. However, it now seems that the expenditure ceiling will not be exceeded. Accordingly, we are revising the real growth rate of public consumption to 2.2 percent in 2015. This change in assessment also has an impact on 2016: Without exceeding the ceiling in 2015, meeting the expenditure ceiling in 2016

implies real growth of 1.9% in public consumption (compared with 0% in our previous forecast for 2016).

Table 1: Economic Indicators

Research Department Staff Forecast for 2015 to 2016

(rates of change, percent, unless stated otherwise)

	Actual 2014	Bank of Israel forecast 2015	Bank of Israel forecast 2016
GDP	2.8	3.2	3.5
Civilian imports (excluding diamonds, ships, and aircraft)	2.4	3.1	6.1
Private consumption	4.0	3.2	3.3
Fixed capital formation	-1.7	2.0	7.2
Public sector consumption (excluding defense imports)	3.9	2.2	1.9
Exports (excluding diamonds and start-ups)	4.7	4.4	5.3
Unemployment rate ^a	6.0	5.5	5.3
Inflation rate ^b	-0.2	-0.1	1.7
Bank of Israel interest rate ^c	0.25	0.10	0.75

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.

c. Inflation and interest rate estimates

In our assessment, the rate of inflation during the four quarters ending in the first quarter of 2016 will be 1.1 percent.

Prices are expected to decline by 0.1 percent during 2015. This decline includes, *inter alia*, the decline of fuel prices and the reduction of electricity and water prices at the beginning of the year. In the coming months, we expect that the pace of price increases will be in accordance with the lower bound of the inflation target, such that at the beginning of 2016—looking at the previous four quarters—inflation will be brought within the target range.

According to the Research Department's assessment, the Bank of Israel interest rate is expected to be 0.1 percent until the end of 2015, and to begin increasing in 2016. Our assessment is that the Monetary Committee will leave the interest rate at its low level in the coming quarters in order to continue supporting economic activity and return of inflation to around the midpoint of the target range. As Figure 2 shows, the expected path of interest rates in 2015 is lower than the path in the forecast published in December, due to the reduction in the interest rate to 0.1 percent.

Table 2 shows that **the Research Department's inflation projection and interest rate projection for the next year are slightly higher than expectations derived from the capital market, but slightly lower than the average assessment of private forecasters.**

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	1.1	0.8	1.2
(range of forecasts)			(0.6-1.7)
Interest rate ^d	0.25	0.14	0.28
(range of forecasts)			(0.0-0.5)

a) Average for the month of March (through March 22). Seasonally adjusted inflation expectations.

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

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

d) Capital markets forecast derived from Telbor rates. Forecasters and market: the interest rate one year from now. Research Department: Interest rate in the first quarter of 2016.

Source: Bank of Israel.

d. Balance of risks in the forecast

Domestic and global factors may lead to developments in the domestic economy that are different than those in the baseline forecast. The European Union, which at the outset suffers from weakness in activity and in inflation, is coping with considerable challenges and risks. In contrast, it is possible that the effect of the sharp decline in oil prices on activity in oil-importing economies will be stronger than assessed thus far, and that global growth rates, and with them trade volumes, will be higher. With that, in countries where inflation is low the concern of deflation is increasing, particularly in view of the near-zero level of short-term interest rates. Another risk factor has to do with the volatility of the exchange rate of the shekel, which has increased recently. We also note the uncertainty surrounding the fiscal policy of the government yet to be formed.

Figures 1 and 2 present fan charts around the inflation rate and interest rate forecasts. (The broken line represents the baseline forecast of December 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)

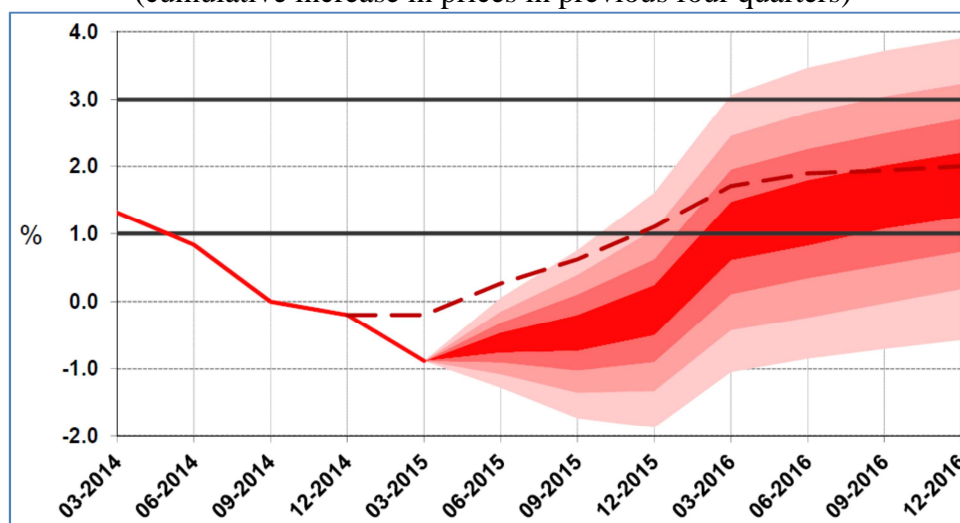
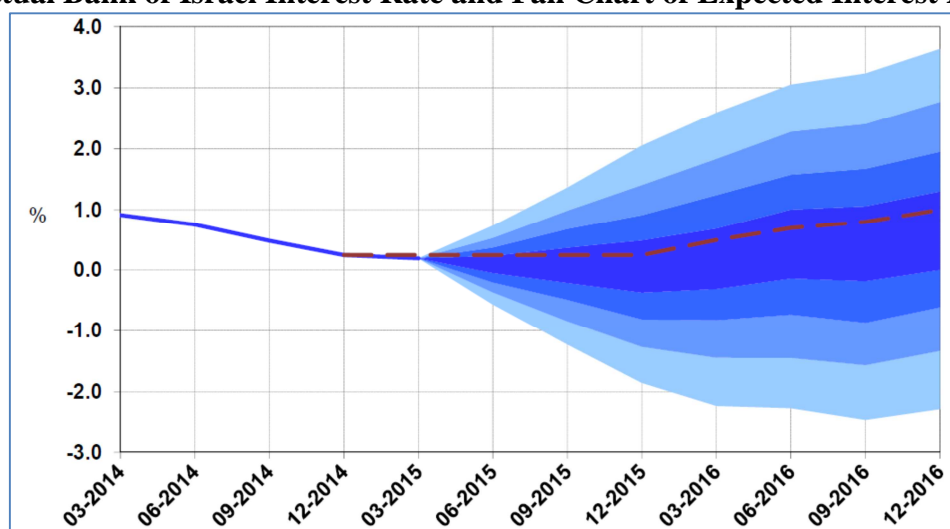


Figure 2
Actual Bank of Israel Interest Rate and Fan Chart of Expected Interest Rate



The center of the fan charts 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 distributions. The dotted line corresponds to the previous staff forecast (published in December 2014).

Source: Bank of Israel.