



BANK OF ISRAEL
Office of the Spokesperson and Economic Information

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Press release:

Research Department Staff Forecast, July 2019

Abstract

This document presents the forecast of macroeconomic developments compiled by the Bank of Israel Research Department in July 2019¹ regarding the main macroeconomic variables—GDP, inflation and the interest rate. According to the staff forecast, gross domestic product (GDP) is projected to increase by 3.1 percent in 2019, slightly lower than the previous forecast, and by 3.5 percent in 2020. The inflation rate in the four quarters ending in the second quarter of 2020 is expected to be 1.4 percent, similar to the previous forecast, and inflation in 2020 is expected to be 1.6 percent. The Bank of Israel interest rate is expected to increase to 0.5 percent in the third quarter of 2019, and to continue increasing gradually to 1.0 percent by the end of 2020.

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.² The Bank's 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.³ 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”.

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. These institutions' forecasts for interest rates in advanced economies, and imports to those economies, were revised downward. Accordingly, we assume that growth in advanced economies will be about 1.9 percent

¹ The forecast was presented to the Monetary Committee on July 7, 2019 during its meeting prior to the decision on the Bank of Israel interest rate reached on July 8, 2019.

² An explanation of the macroeconomic staff forecasts compiled by the Research Department, as well as a review of the models on which they are based, appear in Inflation Report number 31 (for the second quarter of 2010), Section 3c.

³ 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 2019 and 1.6 percent in 2020, and that the advanced economies' imports will increase by 3.0 percent in 2019 and by 3.2 percent in 2020. Our assumption is that inflation in the advanced economies will total 1.6 percent in 2019 and 2.0 percent 2020. According to the average of investment houses' most recent assessments before the forecast was prepared, the US federal funds rate is expected to decline, to 2.1 percent at the end of 2019, and to remain at that level during 2020. The declared interest rate in the eurozone is expected to be 0 percent at the end of 2019 and during 2020. The average price of Brent crude oil was about \$68 per barrel in the second quarter of 2019.

b. Real activity in Israel

GDP is expected to grow by 3.1 percent in 2019 and by 3.5 percent in 2020 (Table 1). There is no change in our general assessment that the economy is in a full employment environment, and GDP is growing at around its potential rate. The activity of a number of large companies will contribute to a slightly higher GDP growth rate.

The forecast of GDP growth in 2019 is slightly lower than the previous forecast, influenced by the decline in world trade that has led to a decline in the expected growth rate of exports for 2019. The export forecast was revised downward by 0.5 percent, to 3.5 percent in 2019. There is no change in the export forecast for 2020, with exports expected to grow by 6 percent in that year. Private consumption is expected to grow by 3 percent each year in 2019 and 2020. Fixed capital formation is expected to increase by 3 percent in 2019, but is expected to contract by 2 percent in 2020 as a result of the conclusion of a number of large investments in the economy. Since these investments are import-intensive, their completion is expected to make a negative contribution to imports such that imports are expected to grow at the relatively moderate rate of just 0.5 percent in 2020.

Table 1
Economic Indicators
Research Department Staff Forecast for 2019–2020

(rates of change, percent, unless stated otherwise)

	2018 ^a	Bank of Israel forecast for 2019	Change from the previous forecast	Bank of Israel forecast for 2020	Change from the previous forecast
GDP	3.4	3.1	-0.1	3.5	-
Private consumption	3.8	3.0	--	3.0	-
Fixed capital formation (excluding ships and aircraft)	2.0	3.0	--	-2.0	-
Public sector consumption (excluding defense imports)	3.5	3.5	--	2.5	-
Exports (excluding diamonds and start-ups)	4.4	3.5	-0.5	6.0	-
Civilian imports (excluding diamonds, ships, and aircraft)	5.2	3.0	--	0.5	-
Unemployment rate ^b	3.5	3.4	-0.3	3.3	-0.4
Inflation rate ^c	1.1	1.6	0.1	1.6	--
Bank of Israel interest rate ^d	0.25	0.50	--	1.00	--

a) National Accounts data—first estimate by the Central Bureau of Statistics.

b) Annual average of unemployment in the prime working ages (25–64).

c) Average CPI reading in the final quarter of the year compared with the final-quarter average in the previous year.

d) End of the year.

c. Inflation and interest rate estimates

According to the staff forecast, the inflation rate in the next four quarters is expected to be 1.4 percent, inflation at the end of 2019 is expected to be 1.6 percent, and inflation at the end of 2020 is expected to be 1.6 percent, similar to the previous forecast. The expected path of inflation remains unchanged relative to the previous forecast. Our assessment is that the tight labor market will continue to support wage increases and the continued convergence of inflation to the midpoint of the target range. However, the increase in inflation is expected to remain gradual, in view of processes that have apparently not been exhausted: the continued increase in competition, and the development of e-commerce.

According to the Research Department's assessment, the Bank of Israel interest rate is expected to increase to 0.5 percent in the third quarter of 2019, similar to the previous forecast. Two further increases are expected in 2020, such that the interest rate is expected to be 1 percent at the end of 2020. The increase in the interest rate is expected to be gradual, thereby supporting the continued increase of inflation and GDP growth in accordance with the long-term rate.

Table 2 indicates that the forecast compiled by the Research Department regarding inflation in the coming year is close to the average of the private forecasters and expectations derived from the capital market. However, the Research Department's forecast regarding the interest rate in one year is higher than the assessments of the professional forecasters and expectations derived from the capital market.

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)	1.4	1.4	1.2 (0.6–2.0)
Interest rate ^d (range of forecasts)	0.75	0.4	0.5 (-0.10–1.0)

a) Average following publication of the Consumer Price Index for May. Inflation expectations are seasonally adjusted.

b) The forecasts for 2019 published following the publication of the Consumer Price Index for May.

c) Inflation rate in the coming year. Research Department: in the four quarters ending in the second quarter of 2020.

d) The interest rate one year from now. (Research Department: in the second quarter of 2020.)

Expectations from the capital market are based on the Telbor market.

SOURCE: Bank of Israel.

d. Main risks to the forecast

Several factors may lead to economic developments that differ from those in the forecast.

Regarding the global environment, the IMF and the OECD noted in their recent publications that the downward risks to growth and world trade have increased. The main risks include the possibility that trade tensions between the US and China may worsen, uncertainty regarding the UK's departure from the European Union, and fiscal pressures in the US and in a number of European countries.

In the domestic environment, the dispersal of the Knesset and the calling of new elections in September led to a delay in the government's decision over measures that would return the deficit to the target set by the government, and there is uncertainty regarding the measures that will be taken and their effects on growth and inflation.

Figures 1 to 3 present fan charts around the inflation rate, interest rate and GDP growth forecasts. The center of the fan (the white line) reflects the Research Department's staff forecast. The broken line represents the baseline forecast from the previous quarter. The width of the fan does not reflect a judgmental assessment of the risks to the forecast or their distribution, but is derived from the estimated distribution of the shocks in the Research Department's DSGE model. The fan encompasses 66 percent of the expected distribution.

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

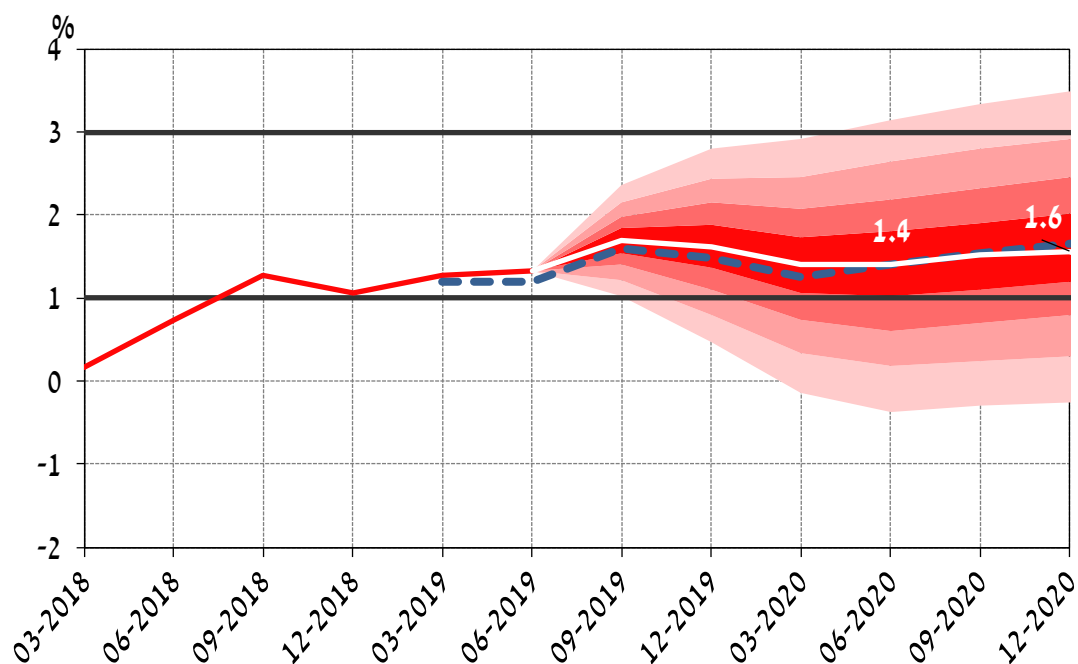


Figure 2
Actual Bank of Israel Interest Rate and Fan Chart of Expected Interest Rate

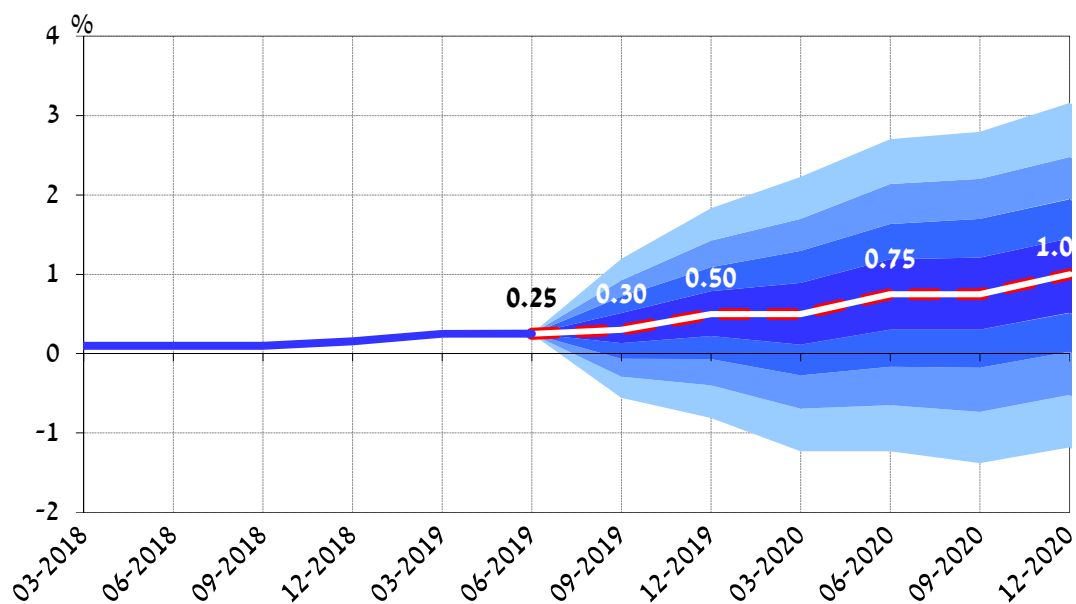
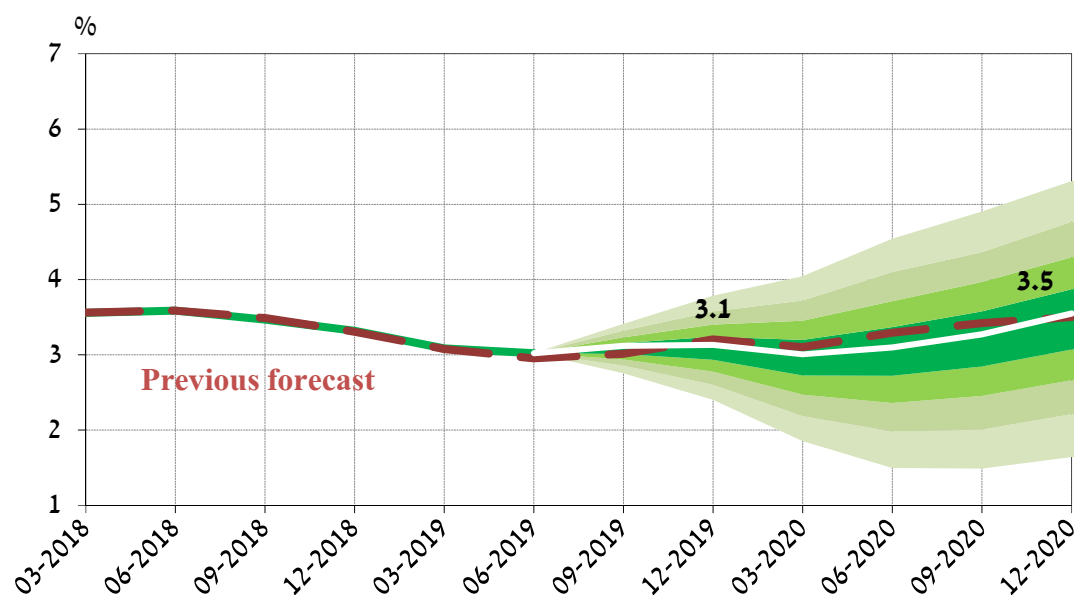


Figure 3
Actual GDP Growth Rate in the Past Four Quarters and Fan Chart of Expected Growth Rate

(Total GDP over the past four quarters relative to GDP in the preceding four quarters)



Regarding GDP growth (Figure 3), until June 2019, the broken line reflects the data and estimates that were known at the time the previous forecast was formulated, while the solid line reflects the updated data and estimates (the difference between them derives from new data and revisions to the data by the Central Bureau of Statistics).