BANK OF ISRAEL
Office of the Spokesperson and Economic Information

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Research Department Staff Forecast, May 2020

Abstract

In view of continued developments due to the corona crisis, the Research Department is publishing a special update to the macroeconomic forecast that was published on April 6, 2020. The projected developments according to the updated forecast are similar to those presented in the April forecast, but include data revisions and assessments in accordance with the policy measures adopted and occurrences since then.

According to the updated staff forecast, gross domestic product (GDP) is expected to contract by 4.5 percent in 2020, compared with 5.3 percent in the April forecast, and to grow by 6.8 percent in 2021, compared with 8.7 percent in the April forecast. The inflation rate in 2020 is expected to be -0.5 percent (compared with -0.8 percent in the April forecast), and in 2021, it is expected to total 0.7 percent (compared with 0.9 percent in the April forecast). The Bank of Israel interest rate **in a year** (the second quarter of 2021) **is expected to be in the 0–0.1 percent range.**

In view of the uncertainty regarding the spread or halt of the virus in the future, and in view of the policy measures taken and that are still being taken in Israel and abroad to prevent the spread of the disease and to support the recovery of the economy, this forecast is characterized by an unusual amount of uncertainty concerning the depth of the crisis, its duration, and its economic ramifications in the medium-to-long term.[1]

Forecast

In this forecast, as in the forecast published in April, special emphasis was placed on an analysis by industry in order to understand the economic impact of the crisis and of the policy measures on the economy. In particular, the forecast is based on an assessment regarding the shutdown of various industries as a result of government measures to fight the spread of the coronavirus. In addition, the Bank of Israel Research Department's staff forecast is based on several models, various data sources, and the Bank's DSGE (Dynamic Stochastic General Equilibrium) model developed in the Research Department—a structural model based on microeconomic foundations—which allows information from various sources to be combined into a macroeconomic forecast of real and nominal variables.

[1] The data and assessments regarding the development of the crisis are based on information as of May 24, 2020.

a. The global environment

Our assessments of expected developments in the global economy are based mainly on forecasts by international institutions and foreign investment houses. With the outbreak of the crisis, there was a significant decline in the forecasts of GDP growth, inflation and the interest rates in advanced economies in 2020, with very significant growth in uncertainty regarding these forecasts and assessments.

In our assessment, GDP in the advanced economies will contract by about 6 percent this year, and is expected to increase by about 4 percent in 2021. In particular, we assume that advanced economies' imports will contract by about 10 percent in 2020 (similar to our assessment in the April forecast), but that in 2021, it will expand by about 6 percent (compared with 8 percent in the April forecast). In all of the major markets, the interest rates are at near-zero levels, and we assume that they will remain in this environment until the end of 2021. Oil prices declined sharply in view of the crisis, from around $60 per barrel to around $20, but in May, these prices have been in an upward trend, to a weekly average of about $35.

b. Real activity in Israel

The measures adopted in Israel and abroad in view of the spread of the coronavirus pandemic have a notable impact on GDP and on employment. The effect on the various industries is uneven, and while certain industries have barely been affected, there are industries where activity has been completely halted.

In the April forecast, we assumed that most of the restrictions intended to prevent the spread of the virus would be lifted gradually by the end of June. The actual pace of lifting the restrictions has been more rapid than we assessed, but our estimate remains that by the end of June, most of the restrictions will be removed. In addition, similar to the April forecast, we project that starting in the second half of the year, the economy will enter a process of gradual recovery, but the recovery is expected to be longer than in our April assessment, due to the greater impact of soft "social distancing" restrictions that are expected to create friction in economic activity, such as the necessary adjustments by business to meet "purple badge" guidelines (that had not yet been set out in the April forecast). In accordance with these changes in our assessment, the path of expected growth has changed, such that GDP in 2020 is expected to contract by 4.5 percent—a slightly more moderate contraction than in the April forecast (Table 1) in view of the more rapid pace of lifting restrictions, but growth in 2021 is expected to be slower than in our previous forecast, and is expected to be 6.8 percent, due to the more prolonged recovery, as noted.

In accordance with our revised assessment, and based on an analysis of industries that are highly likely to remain vulnerable even after the lifting of the restrictions (tourism and hospitality, export manufacturing, startup companies), we expect that unemployment (among the prime working ages) in the second half of 2020 will increase to 8.5 percent (compared with 8 percent in the previous forecast), and that during 2021 there will be a decline, so that unemployment toward the end of 2021 will be 5.5 percent (compared with 4 percent). In other words, even by the end of 2021, the economy is not expected to return to full employment.

In order to decrease the strength and shorten the duration of the economic crisis, particularly expansionary fiscal policies have been adopted both in Israel and abroad. Alongside marked growth in government expenditures, a significant decline in tax revenues is also expected this year as a result of the action of the automatic stabilizers. The combination of these two is expected to be reflected in an anomalous deficit of about 11.5 percent of GDP in 2020. Accordingly, the debt to GDP ratio is expected to grow to approximately 74 percent at the end of the year.

Table 1
Economic Indicators
Research Department Staff Forecast for 2020–2021

(rates of change, percent, unless stated otherwise)

	2019[a]	Bank of Israel forecast for 2020		Bank of Israel forecast for 2021	
		April forecast[d]	May forecast	April forecast[d]	May forecast
GDP	3.5	-5.3	-4.5	8.7	6.8
Unemployment rate (average)[b]	3.4	6.0	6.3	5.5	6.7
(last quarter)	3.1	8.0	8.5	4.0	5.5
Inflation rate[c]	0.4	-0.8	-0.5	0.9	0.7

a) According to amended Central Bureau of Statistics estimates.
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) April 5th forecast.

c. Inflation and interest rates

According to the staff forecast, the inflation rate during 2020 is expected to be -0.5 percent, and during the next four quarters (the third quarter of 2020 through the second quarter of 2021) **it is expected to be 0.1 percent.** Due to the crisis, inflation is expected to be low as a result of the negative impact on demand, particularly by the sharp decline in the prices of oil and other commodities, unemployment and its effect on wages, and some restraint in the rate of rent increases.

The inflation forecast for 2020 is about 0.3 percentage points higher than in the April forecast, partly as a result of the increase in oil prices (since the previous forecast was formulated). Furthermore, this path is in line with the development of our assessment of the crisis, where growth and demand in 2020 are expected to be higher, and inflation is also expected to be higher, than in our previous forecast, and in 2021, growth and the increase in demand are expected to be lower than in our previous forecast, as is inflation. Table 2 shows that the Research Department's forecast of inflation is lower than that of the private forecasters.

According to the Research Department's assessment, **the Bank of Israel interest rate in a year** (in the second quarter of 2021) **is expected to be in the range of 0–0.1 percent** (Table 2). Recall that alongside the interest rate, the Bank of Israel uses other policy tools to provide a response to the economy's liquidity needs and to moderate the increase in yields in the credit market, both in shekels and in foreign currency.

According to expectations derived from the capital market, the interest rate in a year will be 0.1 percent, and the average of forecasters' projections is that it will be 0.05 percent.

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)	0.1	0.5	0.4 (-0.7–1.1)
Interest rate[d] (range of forecasts)	0–0.1	0.1	0.05 (-0.5–0.1)

a) As of May 24, 2020. Inflation expectations are seasonally adjusted.
b) As of May 24, 2020. The average includes only the forecasters that revised their forecasts since the publication of the April CPI.
c) Inflation rate in the coming year. (Research Department: in the four quarters ending in the second quarter of 2021.)
d) The interest rate one year from now. (Research Department: in the second quarter of 2021.) Expectations from the capital market are based on the Telbor market.
SOURCE: Bank of Israel.

d. Main risks to the forecast

The coming period is characterized by particularly high levels of uncertainty, because the global and domestic crisis—in view of the coronavirus pandemic—is unprecedented in scope and nature. It is therefore difficult to assess precisely the duration or intensity of its economic impact. We emphasize that the high level of uncertainty is due to the possibility of a slower or more rapid recovery than we assume.

In the event of a second wave of the pandemic in the fourth quarter of the year, a further negative impact to economic activity is expected. In such a case, our assessment is that in 2020, GDP is expected to contract more sharply, by about 8 percent, and unemployment is expected to be higher and to increase in the fourth quarter to 11 percent (annual average of 7 percent).