BANK OF ISRAEL
Office of the Spokesperson and Economic Information

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Research Department Staff Forecast, October 2022

Abstract

This document presents the macroeconomic staff forecast formulated by the Bank of Israel Research Department in October 2022[1] concerning the main macroeconomic variables—GDP, inflation, and the interest rate.

According to the forecast, GDP is expected to grow by 6 percent in 2022, and by 3 percent in 2023. The inflation rate in the coming four quarters (ending in the third quarter of 2023) is expected to be 2.7 percent. The inflation rate in 2022 is expected to be 4.6 percent, and inflation in 2023 is expected to be 2.5 percent. According to the forecast, the monetary interest rate is expected to average 3.5 percent in the third quarter of 2023.

The 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. 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.[2] 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 foreign investment houses. Their growth forecasts for the advanced economies were revised downward, mainly for 2023. Accordingly, we assume that GDP growth in the advanced economies will be 2.4 percent in 2022, and 0.4 percent in 2023 (compared with 2.7 percent for 2022 and 1.9 percent for 2023 in the previous (July) forecast). The slowdown in growth is expected to be reflected in world trade as well, regarding which we assume growth of 4.0 percent in 2022, which will moderate to 2.5 percent in 2023 (compared with 5.0 percent and 4.0 percent respectively in the previous forecast). The inflation forecasts for the advanced economies were revised upward, and we assume that inflation in those economies will be 8.3

[1] The forecast was presented to the Bank of Israel Monetary Committee on October 2, 2022, prior to the decision on the interest rate made on October 3, 2022.

[2] 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.

percent in 2022 and 2.9 percent in 2023 (compared with 6.7 percent in 2022 and 2.3 percent in 2023 in the previous forecast). The increase in the inflation forecast was accompanied by an upward revision of the global interest rate forecast, such that the average interest rate in the advanced economies is expected to be 3.0 percent in 2022 and to remain similar until the end of 2023 (compared with 2.2 percent in 2022 and 2.4 percent in 2023 in the previous forecast). The price of Brent oil declined to about $85 per barrel at the end of September, compared with $118 at the time of the previous forecast.

b. Real activity in Israel

GDP is expected to increase by 6 percent in 2022, and 3 percent in 2023 (Table 1). National Accounts data published since the previous forecast (for the period ending in the second quarter of 2022) show that GDP over the past three quarters has been higher than the precrisis trend line. Furthermore, indicators for the third quarter of 2022 continue to show a high level of activity. In view of this, the growth forecast for 2022 was revised upward. In contrast, our assessment is that GDP growth will moderate in 2023, such that its level will be around the trend line or slightly below it. The expected slowdown in growth is due to expected moderations in the growth of world trade, and in GDP growth in advanced economies, as well as an increase in the real interest rate in Israel within the forecast period. The current forecast reflects a higher level of activity in 2022–23 than the previous forecast, as shown by the upward revision of the forecasted deviation of GDP from the trend.

At the forecast's starting point, the labor market is tight, with a higher employment rate in the primary working ages and a lower unemployment rate than before the COVID-19 crisis. Within the forecast period, our assessment is that the labor market will remain tight, but will gradually return to the typical precrisis rates. In particular, we forecast that the employment rate among the primary working ages will decline to an average of 77.9 percent in 2023, and the unemployment rate will increase to an average of 3.5 percent in the same year.

Regarding the State budget, in view of higher-than-expected tax revenues and lower than expected expenditures, the deficit is expected to be lower than our assessment in the previous forecast. The deficit is expected to be 0.3 percent of GDP in 2022, and about 1 percent of GDP in 2023. In view of the uncertainty regarding the timing and composition of the next budget, the forecast for 2023 is based on a working assumption that the 2023 budget will include some increase in the expenditure ceiling. This assumption reflects an estimate of the cost of various programs and actions that the government has approved or is expected to approve.

Table 1
Research Department Staff Forecast for 2022–2023

(rates of change, percent[a], unless stated otherwise)

	2021	Forecast for 2022	Change from the April forecast	Forecast for 2023	Change from the April forecast
GDP	**8.6**	**6.0**	**1.0**	**3.0**	**-0.5**
Private consumption	11.1	8.0	0.5	3.5	-1.0
Fixed capital formation (excl. ships and aircraft)	12.2	8.0	3.0	3.0	0.0
Public consumption (excl. defense imports)	3.7	4.0	0.0	4.0	1.0
Exports (excl. diamonds and startups)	11.8	8.0	5.0	2.5	0.0
Civilian imports (excl. diamonds, ships, and aircraft)	18.2	12.5	5.0	3.5	0.5
GDP deviation from the precrisis trend (percent)	**-1.4**	**0.5**	**1.1**	**-0.5**	**0.4**
Unemployment rate (average for the year, age 25–64)	4.6	3.1	-0.2	3.5	0.0
Employment rate (average for the year, ages 25–64)	75.7	78.7	0.4	77.9	0.2
Government deficit (percent of GDP)	4.4	0.3	-0.4	1.0	-0.2
Debt to GDP ratio (percent)	68	65	-1.0	63	-1.0
Inflation (percent)[b]	2.5	4.6	0.1	2.5	0.1

[a] In the forecast of National Accounts components, the rate of change is rounded to the nearest half percentage point.
[b] 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 third quarter of 2023) is expected to be 2.7 percent** (Table 2). Inflation in 2022 is expected to be 4.6 percent (compared with 4.5 percent in the previous forecast), and inflation in 2023 is expected to be 2.5 percent (compared with 2.4 percent in the previous forecast). In our assessment, the recent increase in inflation is due to both supply-side pressures from outside the domestic economy and high domestic demand. Within the forecast range, we expect that the Bank of Israel interest rate will continue to increase, which will aid the stabilization of inflation. In addition, the decline that has taken place in oil prices and the forecasted decline in inflation in the advanced economies are expected to moderate inflation in the prices of tradable goods. The inflation forecast was revised slightly upward from the previous forecast. While the revision was affected by the increase in inflation forecasts in the advanced economies, the forecast for the Bank of Israel interest rate was revised upward, and oil prices declined since the previous forecast.

Our assessment is that **the interest rate will average 3.50 percent in the third quarter of 2023** (Table 2). This assessment reflects a continued increase from its current level, due to the inflation level that is higher than the upper bound of the target range and the high level of activity.

Table 2 shows that the Research Department's staff forecast regarding the interest rate in one year is higher than the average of the private forecasters' projections, and the inflation forecast is lower. The Research Department's forecasts regarding both the interest rate and inflation in one year are lower than the forecasts derived from the capital market.

Table 2
Inflation forecast for the coming year and interest rate forecast for one year from now

(percent)

	Bank of Israel Research Department	Capital markets[a]	Private forecasters[b]
Inflation rate[c] (range of forecasts)	2.7	3.1	2.9 (1.2–3.3)
Interest rate[d] (range of forecasts)	3.5	4.1	3.2 (1.5–3.75)

a) Inflation expectations are seasonally adjusted (average, September 25, 2022–October 2, 2022).
b) The average of forecasts published following the publication of the Consumer Price Index for August.
c) Inflation rate in the coming year. Research Department: in the four quarters ending in the third quarter of 2023.
d) The interest rate one year from now. (Research Department: in the third quarter of 2023.) Expectations derived from the capital market are based on the Telbor market (average, September 25, 2022 to October 2, 2022).
SOURCE: Bank of Israel.

d. Main risks to the forecast

Global developments pose a significant risk to the forecast. There is considerable uncertainty regarding the continued confrontation between Russia and Ukraine and its impact on energy and food prices. The drought in Europe, which is expected to contribute to limited supply on the continent, is an additional factor. Despite the fact that certain assumptions regarding these developments are factored into the forecasts by the investment houses and international institutions that underpin our forecast, a lot of uncertainty remains. A crisis that is worse than what is already factored into the forecasts is expected to contribute to an increase in the prices of tradable goods in Israel beyond what is factored into the forecast, and may also hamper demand for Israeli exports.

In terms of risks in the domestic environment, there is uncertainty regarding the policy measures that the new government will take in all areas of its operation. In particular, there is uncertainty regarding the wage agreements that will be signed in the forecast period and how they will deal with the inflation that will have occurred and that will occur in the future.