

BANK OF ISRAEL

Office of the Spokesperson and Economic Information

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**Research Department Staff Forecast, July 2024**

**Abstract**

This document presents the macroeconomic staff forecast formulated by the Bank of Israel Research Department in July 2024[[1]](#footnote-1) concerning the main macroeconomic variables—GDP, inflation, and the interest rate. This forecast was formulated under the assumption that the Swords of Iron War’s direct impact on the economy from both the northern and southern fronts, will continue until the beginning of 2025. This assumption reflects more prolonged fighting, and at a greater intensity, than the assumption underlying the April forecast. The forecast features a high level of uncertainty, particularly the greater probability of more serious security scenarios than those included in the forecast such as a further extension of the war’s duration and its increased intensity on various fronts.

According to the forecast, GDP is expected to grow by 1.5 percent in 2024 and by 4.2 percent in 2025—lower than our assessment in the April forecast. The inflation rate in the coming four quarters (ending in the second quarter of 2025) is expected to be 3.2 percent, partly due to the impact of taxation measures that we assume will be approved in the coming year. Inflation in 2024 is expected to be 3.0 percent (compared with 2.7 percent in the April forecast), and in 2025 it is expected to be 2.8 percent (compared with 2.3 percent in the April forecast). The interest rate in the second quarter of 2025 is expected to be 4.25 percent. In view of the increased probability that we attribute to more serious security scenarios such as an increase in the intensity and duration of the war, the risk to the growth forecast tends downward, and the risks to the inflation and interest rate forecasts tend upward.

**The forecast**

The Bank of Israel Research Department compiles a staff forecast of macroeconomic developments based on several models, various data sources, and assessments based on economists’ judgment. The Bank’s DSGE (Dynamic Stochastic General Equilibrium) model—a structural model developed in the Research Department and based on microeconomic foundations—plays a prime role in formulating the macroeconomic forecast.[[2]](#footnote-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”.

In order to formulate estimates of the economic impact of the war, special emphasis was placed on an analysis of real-time data that show the scope of the impact on—and the pace of recovery of—the output of various industries and uses, as well as on an analysis of past confrontations. In addition to the use of the DSGE model, we used industry-level assessments of the volume of the supply-side impact derived partly from the lack of workers during the war period and the security restrictions on activity. On the demand side, data obtained so far were analyzed in order to assess the impact on the various uses, and in order to assess the pace of their recovery so far. The results were integrated into a full forecast of the sources and uses, which contributed to the formulation of the forecast presented herein.

1. **The global environment**

Our assessments of expected developments in the global economy are based mainly on projections by international financial institutions and foreign investment houses. These projections—regarding growth, inflation and the interest rates in the advanced economies—were revised upward relative to those used in the April forecast. Accordingly, we assume that growth in the advanced economies will be 1.4 percent in 2024 (compared with 1.0 percent in the April forecast), and 1.5 percent in 2025 (compared with 1.4 percent in the April forecast). Our assumption is that world trade will grow by 3.0 percent in 2024 (compared with 3.1 percent in the April forecast), and by 3.3 percent in 2025 (compared with 3.4 percent in the April forecast). Investment houses’ inflation forecasts for the advanced economies for 2024 were revised upward to 2.6 percent (compared with 2.4 percent in the April forecast), and the forecast for 2025 is 2.1 percent (compared to 2.2 percent in the April forecast). Investment houses’ forecasts of the average interest rate in the advanced economies were also revised upward, to 4.1 percent at the end of 2024 (compared to 3.8 percent in the April forecast) and 3.2 percent at the end of 2025 (compared to 3.0 percent in the April forecast). The price of Brent crude oil declined slightly to $87 per barrel, compared with around $90 at the time of the April forecast.

1. **Real activity in Israel**

**GDP is expected to grow by 1.5 percent in 2024 and by 4.2 percent in 2025** (Table 1).

The forecast is based on the assumption that the war’s direct impact on the economy, including all fronts, will continue until the beginning of 2025. Compared to the previous forecast in April, the growth forecast was revised downward, mainly due to a revision of the assumption regarding the intensity and duration of the fighting, and in view of the downward surprise in some of the data obtained since April—mainly regarding the developments in April and May. In addition, in view of the continuation of the fighting, the recovery of economic activity during 2025 is expected to be more gradual.

As long as the fighting lasts, GDP growth is expected to be impaired both on the supply side and on the demand side. On the supply side, while fewer reserve soldiers are currently mobilized than at the beginning of the war, reserve mobilization continues to impair the supply of labor in all industries. Labor supply is a particular problem in the construction industry, due to the significant restrictions on the entry of Palestinian laborers from Judea and Samaria and the complete halt to the employment of laborers from Gaza. Our assessment in this forecast is that the recovery in the supply of labor will take longer, in view of the revision to our assumption regarding the intensity of the fighting during the forecast period. This is due to the need for greater and longer mobilization of reserve soldiers, and due to the assessment that it will take longer to solve the shortage of laborers in the construction industry. In addition to the decline in the supply of labor, production capacity has been impaired in the combat and threatened areas due to the impact to physical capital and the ability to work. The impact in the southern areas is declining in view of the gradual return of residents, while the evacuation of residents from the north is expected to continue for longer than our assessment in the April forecast was.

On the demand side, our assumption is that in 2025, the government will make significant adjustments to its budget, both on the expenditure side and on the revenue side, in order to restrain the increase in the debt to GDP ratio (details below). The adjustments in government expenditures and the decrease in defense expenditures are expected to be reflected in a significant slowdown in public consumption in 2025, while tax increases are expected to restrain demand for private consumption. In addition, demand for the export of tourism services (incoming tourism) has been significantly impacted, and experience from previous security incidents shows that this impact is expected to be prolonged, mainly insofar as the fighting on the various fronts continues. In contrast, an increase in demand in the construction industry is expected within the forecast range, partly due to the need to rehabilitate buildings.

In view of these developments, our assessment is that the broad unemployment rate among the main working ages will moderate only gradually, to 4.0 percent in 2024 and 3.8 percent in 2025.[[3]](#footnote-3)

**The government budget deficit is expected to be 6.6 percent of GDP in 2024 and 4.0 percent of GDP in 2025. Public debt is expected to rise to 67.5 percent of GDP in 2024, and 68.5 percent of GDP in 2025.** Relative to the previous forecast in April, there is an upward revision of about half a percent of GDP in the forecast of defense expenditures in view of the revision to the working assumption regarding the intensity and duration of the fighting. In addition, the forecast was compiled under the working assumption that the government will make permanent adjustments totaling NIS 30 billion to lower the deficit in 2025, and that any additional expenditure decided upon by the government, including a permanent increase in the defense budget, will be balanced by additional measures. As a working assumption, our assessment is that 60 percent of the adjustments (NIS 18 billion) will be on the revenue side, and 40 percent (NIS 12 billion) will be on the expenditure side. These adjustments will moderate the increase in the debt to GDP ratio in 2025, and are expected to lead to a decline in the ratio beginning in 2026. Without making these adjustments, our assessment is that public debt will continue to increase gradually in the medium term. In addition, in a risk scenario that the Research Department examined, in which the fighting continues even longer than what is accounted for in the base forecast, the public debt may reach about 72 percent of GDP. A significant worsening on the northern front may lead to even higher debt levels.

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| **Table 1**  **Research Department Staff Forecast for 2023–2025**  (rates of change, percenta, unless stated otherwise) | | | | | |
|  | 2023  Actual | Forecast for 2024 | Change from the April forecast | Forecast for 2025 | Change from the April forecast |
| **GDP** | **2.0** | **1.5** | **-0.5** | **4.2** | **-0.8** |
| Private consumption | -0.7 | 2.0 | -2.5 | 5.0 | -0.5 |
| Fixed capital formation (excl. ships and aircraft) | -2.9 | -9.0 | -5.5 | 8.0 | -2.5 |
| Public consumption (excl. defense imports) | 7.2 | 8.0 | 3.5 | -5.5 | -3.5 |
| Exports (excl. diamonds and startups) | 0.1 | -1.5 | -0.5 | 4.5 | 0.5 |
| Civilian imports (excl. diamonds, ships, and aircraft) | -7.2 | -5.0 | -1.0 | 3.5 | -4.5 |
| Broad unemployment rate (average for the year, ages 25–64)b | 4.4 | 4.0 | 0.3 | 3.8 | 0.5 |
| Adjusted employment rate (average for the year, ages 25–64)b | 77.8 | 77.6 | 0.3 | 77.7 | -0.5 |
| Government deficit (percent of GDP) | 4.1 | 6.6 | 0.0 | 4.0 | -0.6 |
| Debt to GDP ratio (percent) | 62.0 | 67.5 | 0.5 | 68.5 | 1.5 |
| Inflation (percent)c | 3.3 | 3.0 | 0.3 | 2.8 | 0.5 |
| a The forecasts of the National Accounts components and the debt to GDP ratio are rounded to the nearest half percentage point.  b According to the Central Bureau of Statistics definition, the broad unemployment rate includes the unemployed under the normal definition (someone who has not worked, wanted to work, was available to work, and searched for work), as well as employees who were temporarily absent from their jobs for economic reasons (including furloughed workers). Accordingly, the adjusted employment rate does not include those temporarily absent from their jobs for economic reasons.  c 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. | | | | | |

1. **Inflation and interest rates**

According to our assessment, **inflation in the coming four quarters (ending in the second quarter of 2025) is expected to be 3.2 percent** (Table 2)**.** Inflation in 2024 is expected to be 3.0 percent, compared with 2.7 percent in the April forecast, and inflation 2025 is expected to be 2.8 percent, compared with 2.3 percent in the April forecast (Table 1). There are a number of forces affecting inflation within the forecast range. First, increases in indirect taxes on consumption goods are expected to contribute to a temporary increase in measured inflation. These tax increases include the expected increase in VAT (from 17 to 18 percent) which was already passed by the Knesset, as well as additional increases in indirect taxes as part of the budget adjustments that we assume the government will implement. Net of the impact of indirect taxes, our assessment is that inflation in 2025 will be close to the midpoint of the target range.

Second, labor supply constraints, mainly due to the mobilization of reserve soldiers, are expected to increase costs for domestic manufacturers and to contribute to an increase in domestic prices. Relative to the April forecast, the current inflation forecast has been revised upward due to a revision in the working assumptions regarding the intensity and duration of the fighting, and regarding the increases in indirect taxes that the government will implement as part of its measures to stabilize the public debt.

**The interest rate is expected to be 4.25 percent in the first quarter of 2025** (Table 2). Due to the revised assumption regarding the duration of the fighting, our assessment is that the risk premium, which rose due to the war, will decline more gradually than we assumed in April, so that a higher interest rate will be necessary in order to stabilize inflation.

| **Table 2** | | | |
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| **Inflation forecast for the coming year and interest rate forecast for one year from now** | | | |
| (percent) | | | |
|  | Bank of Israel Research Department | Capital marketsa | Private forecastersb |
| Inflation ratec | 3.2 | 2.8 | 2.9 (2.2–3.3) |
| (range of forecasts) |  |  |  |
| Interest rated | 4.25 | 4.2 | 4.0 |
| (range of forecasts) |  |  | (3.50–4.25) |
| 1. Inflation expectations are seasonally adjusted (as of July 7, 2024). 2. Data as of July 7, 2024. 3. Research Department: the inflation rate during the four quarters ending in the second quarter of 2025. | | | |
| 1. Research Department: the average interest rate in the second quarter of 2025. Expectations derived from the capital market are based on the Telbor market (as of July 5, 2024).   SOURCE: Bank of Israel. | | | |

Table 2 shows that the Research Department’s inflation forecast is higher than expectations derived from the capital market and than the average projections of the private forecasters. Some of this gap may be due to different assessments regarding the taxation measures that the government will take within the forecast range. The Research Department’s interest rate forecast is similar to the forecasts derived from the capital market, and slightly higher than the average projections of the private forecasters.

1. **Main risks to the forecast**

The forecast is based on the assumption that the direct economic impact of the war will continue until the beginning of 2025. Various developments that may affect the duration and severity of the war may, of course, have a material impact on economic developments. In particular, a longer-than-expected war is expected to weigh down on economic activity. The channels of this potential impact include longer interruptions to the supply of labor, partly in view of the mobilization of reserve soldiers that will be required, a further increase in the risk premium, a decline in domestic demand for consumption and investments, and impaired sentiment toward Israel that will lead to a decline in demand for Israeli exports and in investments from abroad. If the fighting expands, these effects may be more serious and lead to a material negative macroeconomic impact. In particular, a broad war in the north, due to which activity in broad areas in Israel will be limited for a number of weeks with a likelihood of damage to infrastructure, is expected to materially worsen economic activity and delete a few percent from annual growth. Its cost will also necessitate a reassessment of the volume of adjustments needed in the budget and in taxes. All of these will also affect the development of inflation, the deficit, and government debt.

Another risk is that the government may only partially make the fiscal adjustments necessary to prevent an excess increase in the deficit, or that approval of the budget may be delayed into 2025, alongside a possible further increase in war expenses and in permanent expenses. These may lead to a further increase in Israel’s risk premium as a result of the markets’ perception and concern that the debt to GDP ratio is in a divergent path. Such a situation may lead to an impact to the economy’s growth path, a weakening of the shekel, and increasing inflationary pressure, which would also be reflected in higher interest rates.

In view of these risks, our assessment is that the balance of risks relating to the growth forecast tends downward, while in relation to the inflation and deficit forecasts, it tends upward.

1. The forecast was presented to the Bank of Israel Monetary Committee on July 7, 2024, prior to the decision on the interest rate made on July 8, 2024. [↑](#footnote-ref-1)
2. An explanation of the macroeconomic forecasts formulated by the bank of Israel Research Department, as well as a review of the models on which they are based, appear in the Bank of Israel’s Inflation Report 31 (second quarter of 2010), Section 3c. 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. [↑](#footnote-ref-2)
3. In addition to the unemployed, the broad unemployment rate includes those who were temporarily absent from their jobs for economic reasons (including furloughed workers). It does not include workers who were absent from their jobs due to reserve military service. [↑](#footnote-ref-3)