BANK OF ISRAEL

January 20, 2025

Report on the Bank of Israel's discussions prior to deciding on the interest rate

The discussions took place on January 5, 2025 and January 6, 2025.

General

The Monetary Committee sets the interest rate in a process that includes two discussions—the first in a broad forum, and the second in a narrower one.

In the broad-forum discussion, the relevant background economic conditions are presented, including the real and financial-monetary developments in Israel's economy and developments in the global economy. Participants in this discussion include the members of the Monetary Committee, senior representatives from the various departments of the Bank, and economists from the economic departments (Research and Markets), who prepare and present the material for discussion.

In the narrow forum—which consists of the Monetary Committee and a representative of the Markets Department—the Research and the Markets Departments present their views of the main considerations that should guide the setting of the monetary policy. An open discussion on monetary policy follows, which ends with a vote on the level of the interest rate. According to Section 18(c) of the Bank of Israel Law, 5770–2010, the decision on the interest rate is reached by majority vote of the members of the Monetary Committee who participate in the voting.

A summary view of the economic situation available at the time of the Committee's discussion is presented in the notice regarding the interest rate decision, which was published on January 6, 2025, and in the data file that accompanied the notice.

THE NARROW-FORUM DISCUSSION

The members of the Monetary Committee participating in the discussion decide on the appropriate rate of interest.

After the discussion, it was decided to keep the interest rate at 4.5 percent. All members of the Monetary Committee supported the decision.

The discussion focused on the impacts of the geopolitical environment on the economy and on economic developments: inflation and inflation expectations, the level of economic activity in view of the war, the labor market, fiscal developments, developments in the financial markets and in the foreign exchange market, the housing market, the Research Department's updated forecast, and global developments.

Main points of discussion

The Committee discussed the state of the economy in view of the Swords of Iron War, and the significant economic ramifications on Israel's economy, as the economic recovery continues at a moderate pace.

The Committee discussed the inflation environment. Inflation over the preceding 12 months remained stable and is at 3.4 percent, slightly above the upper bound of the target range. Based on forecasters' assessments, inflation is expected to increase during the first half of 2025, against the background as well of the expected tax changes, and in particular the increase in VAT, alongside continued supply constraints, together with excess demand, and is then expected to moderate toward the upper bound of the target range in the second half of the year. One-year inflation expectations, from the various sources, declined and are within the target range. Expectations for the second year and onward remain within the target range. In the Committee's assessment, there are several risks for a possible acceleration of inflation—the geopolitical developments and their impacts on economic activity, prolonged supply constraints, shekel volatility, and fiscal developments.

The recovery in economic activity continues at a moderate pace, against the background of geopolitical developments. The supply limitations in some industries continue to delay the contraction of the gap between actual GDP level and the level expected according to the long-term trend. A considerable portion of the gap is explained by supply constraints deriving mainly from a shortage of workers—a shortage of non-Israeli workers and the absence of workers due to military reserves service. Current indicators of economic activity in the fourth quarter of 2024 indicate some recovery; there was a marked increase in credit card expenditures and the aggregate balance of the Business Tendency Survey conducted by the Central Bureau of Statistics increased. However, it remains lower than its prewar level and some industries are not showing an improvement. The Committee members discussed possible developments for aligning supply and demand in the economy, and the possible ramifications of those processes on inflation.

The labor market remains tight, with slight improvement in the participation and employment rates, alongside a slight decline in broad unemployment and a moderate increase in wages. The job vacancy rate increased slightly in November, but it is slightly lower than its June–July level. The participation rate among ages 15+, and the employment rate, increased slightly in November. The share of those temporarily absent due to military reserves service was relatively high in November, at about 1.4 percent, but it is expected to decline in December due to the return of those serving in the reserves. The broad unemployment rate declined somewhat in November, and is 3.2 percent. The nominal wage increased at a moderate pace in recent months, and the real wage is higher than its prewar level, but there is still a gap compared with its long-term trend.

The Committee members discussed the Research Department's forecast. The forecast was compiled under the assumption that the direct economic impact of the war will continue until the end of the first quarter of 2025. This assumption reflects a moderate level of intensity of fighting in the beginning of 2025 as well. The Department assumes that during the forecast period, the existing limitations on the supply side will gradually recede, but that domestic demand will recover first at a slightly higher pace than supply. The forecast also incorporates the expected impact of the budget adjustments on economic activity. The geopolitical developments since the October forecast reduced, in the Department's view, the downside risks in the growth forecast. Based on the Department's assessment, GDP grew by 0.6 percent in 2024, and is expected to grow by 4.0 percent in 2025 and by 4.5 percent in 2026. According to the forecast, year over year inflation at the end of 2025 will be 2.6 percent, and at the end of 2026 will be 2.3 percent. The broad unemployment rate among the prime working ages (25–64) is expected to remain low and, in the assessment of the Department, will be 3.1 percent in 2025 and 2026, on average.

When discussing the interest rate, the budget deficit for 2024 was estimated to be 7 percent, slightly lower than the October forecast. This was due to higher than expected tax revenues in the last quarter, among other things due to the bringing forward of vehicle purchases, and lower than expected performance of expenditures. The deficit target for 2025 in the current budget proposal is 4.4 percent of GDP. However, the Department assesses that the deficit is expected to be 4.7 percent of GDP. This is in view of the changes made in the adjustment measures since the government decision and the Research Department's assessments regarding the supplement to the defense budget within the framework of the Nagel Committee. In 2026, the deficit is expected to be 3.2 percent of GDP, mainly due to the end of the direct expenditures of the war. The debt to GDP ratio is expected to increase to a level of about 67 percent in 2024, to 69 percent in 2025, and to decline back to 67 percent in 2026.

The Committee members were of the view that the budget framework that was approved by the government with the adjustment measures approved in the Knesset, were significant steps that contributed to the markets' confidence in the Israeli economy and to moderation of the risk premium. However, during the budget discussions, several civilian expenditures of a permanent nature were added, and several adjustments of a permanent nature were removed or reduced. In the Committee discussions, it was noted that it is important that the budget framework for 2025 will be approved without additional changes, which will contribute to maintaining the markets' trust. Additionally, against every change in budget items that increases the deficit after 2025, it is important to adopt alternate measures that will prevent the growth of the expected deficits. In this way, the economy will be able to converge to a declining path of the debt to GDP ratio from 2026 and onward. In addition, it is important that to the extent the government approves an increase of the security budget from 2026 and onward on the basis of Nagel Committee recommendations, it will be accompanied by offsetting measures that ensure a marked and prolonged declining path of the debt to GDP ratio.

The Committee discussed the war's impacts on the foreign exchange market and on financial markets. In the reviewed period, the shekel appreciated by approximately 0.5 percent against the dollar and by 2.4 percent against the euro. The risk premium—as measured by CDS and government bond spreads—declined markedly, but remains at a level higher than its prewar level. Israel's capital market saw a positive year with increases in major equity indices, and was notably good compared to major markets worldwide.

The Committee members discussed housing market developments. Activity in the construction industry remains low relative to before the war, and is impacted primarily by workforce constraints, which are still significant. Central Bureau of Statistics third quarter data indicate that there was an increase relative to the previous quarter in building starts and building completions, but that compared to the corresponding quarter last year before the war—there has been a decline. In parallel, home prices increased by 6.7 percent in the past year, and new mortgage volume in November was high, at approximately NIS 8 billion, compared to NIS 7 billion in October. The Committee members reiterated the importance of maintaining a high supply of construction over time, beyond its current level, which will support the stabilization of housing prices.

The Committee members discussed global conditions. Economic activity worldwide continued to expand. The Global Purchasing Managers Index for November increased, and indicates continued expansion of economic activity. World trade in commodities grew at a moderate pace, and on annual basis expanded by approximately 1.6 percent in October. Economic growth data for the third quarter of the year pointed to an upward trend in the US and in the eurozone. In the US, the annual rate of change in the CPI was 2.7 percent in November. In the eurozone, the inflation rate increased to 2.2 percent in November. In line with expectations, the US Federal Reserve reduced the interest rate again, by 25 basis points, and the interest rate path priced in by the markets rose in the period reviewed, against the background of a higher interest rate forecast. The ECB continued its path of interest rate reductions, lowering it by 25 basis points, in line with forecasts, and it is expected to continue to reduce the interest rate by a relatively rapid rate.

All 5 Monetary Committee members supported the decision to keep the interest rate unchanged at a level of 4.5 percent.

In view of the continuing war, the Monetary Committee's policy is focused on stabilizing the markets and reducing uncertainty, alongside price stability and supporting economic activity. The interest rate path will be determined in accordance with the convergence of inflation to its target, continued stability in the financial markets, economic activity, and fiscal policy.

The next monetary policy decision will be published on Monday, February 24, 2025.

The dates of interest rate decisions for 2025:
https://www.boi.org.il/en/economic-roles/monetary-policy/interest-rate-announcement-dates-2024/

Participants in the narrow-forum discussion:

Members of the Monetary Committee:
Prof. Amir Yaron, Governor of the Bank and Monetary Committee Chairperson
Mr. Andrew Abir, Deputy Governor of the Bank of Israel
Dr. Adi Brender
Prof. Naomi Feldman
Prof. Zvi Hercowitz

Other participants in the narrow-forum discussion:
Mr. Uri Barazani, Outgoing Spokesperson of the Bank
Dr. Golan Benita, Director of the Markets Department
Dr. Oded Cohen, Chief of Staff to the Governor
Mr. Nadav Eshel, Assistant to the Governor
Ms. Nurit Felter-Eitan, Director of the Communications, Public Affairs & Community Relations Department
Ms. Liat Indig, Bank Spokesperson's office
Dr. Ziv Naor, Incoming Bank of Israel Spokesperson
Ms. Dana Orfaig, Research Department
Ms. Nava Ostrov, Monetary Committee Secretariat