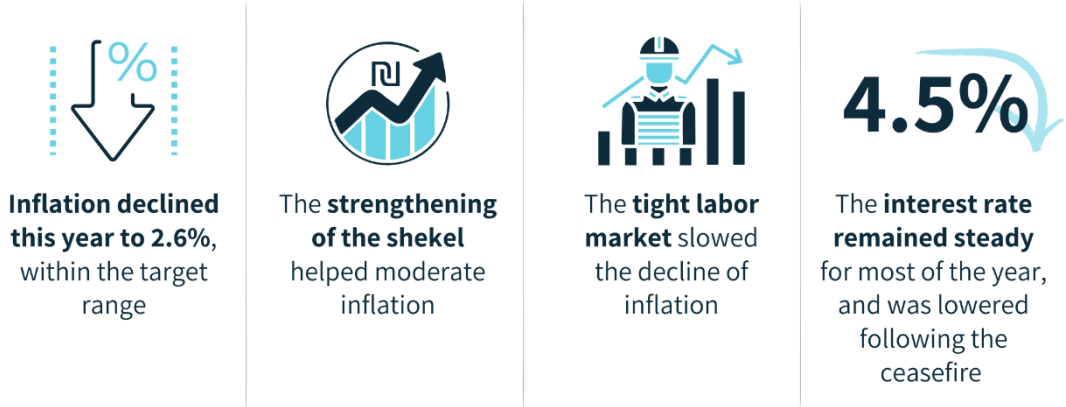
Chapter 3
Inflation and Monetary Policy

- The Consumer Price Index rose by 2.6 percent in 2025, remaining within the inflation target range, after inflation in 2024 was 3.2 percent—above the upper bound of the range. Excluding volatile components and one-off factors, the slowdown in inflation was even more pronounced. The moderation process was volatile, and during most of the year inflation remained above the upper bound of the target range.
- In view of inflation being above the upper bound of the target range for much of the year, supply constraints, and significant geopolitical uncertainty, the Monetary Committee kept the policy rate unchanged at 4.5 percent for most of the year. Given the supply constraints, a faster reduction in the policy rate would likely have contributed little, if at all, to growth while significantly increasing inflation.
- The stability of the policy interest rate during most of the year, alongside the decline in inflation expectations, was reflected in an increase in real yields, thereby contributing to the restraint of aggregate demand and to the easing of inflationary pressures. In November, following the moderation of inflation and inflation expectations and in the wake of the ceasefire agreement, the Monetary Committee reduced the policy rate to 4.25 percent. The appreciation of the shekel, the ongoing improvement in the security situation, and signs of easing in labor market tightness led to an additional rate cut in January 2026, to 4.0 percent.
- The appreciation of the shekel played a major role in moderating inflation. This appreciation was largely due to the decline in Israel's risk premium following geopolitical developments, and fiscal restraint measures that offset part of the war-related costs, as well as from the gradual pace of monetary easing. Part of the appreciation also reflected the global weakening of the US dollar.
- Inflation expectations converged during the year toward the midpoint of the target range, supporting the moderation of actual inflation.
- Supply constraints in the labor market—alongside the fiscal impulse that was mainly due to high defense expenditures—continued to exert upward pressure on inflation, offsetting part of the effect of the moderating factors. Although preliminary indicators toward year-end pointed to some easing, they still suggested that the labor market remained tight.



1. INTRODUCTION

In 2025, inflation returned to within the price stability target range, reaching 2.6 percent compared with 3.2 percent in 2024. A key factor behind this moderation was the significant appreciation of the shekel, which largely reflected the decline in Israel's risk premium following geopolitical developments and fiscal restraint measures, as well as the global weakening of the US dollar.

In face of the appreciation, there were strong inflationary forces—particularly excess demand amid supply constraints created by the war, especially in the still-tight labor market, and the fiscal impulse resulting from high defense spending.

In this environment, where the supply of production factors remained limited, a rapid reduction in the policy rate was expected to contribute little, if at all, to growth, while significantly increasing inflation. The Monetary Committee therefore maintained the interest rate at a restrictive level of 4.5 percent for most of the year. Keeping the rate unchanged, alongside the decline in inflation expectations, led to higher real yields, which helped restrain excess demand, supported the appreciation of the shekel, and prevented domestic demand pressures from translating into higher inflation. Only after inflation had firmly settled within the target range, the risk premium had declined, and the ceasefire agreement signaled a possible easing of supply constraints, did the Committee begin to gradually reduce the interest rate.

This chapter opens with a review of inflation developments and quantifies the contribution of the various forces that influenced it—namely, the exchange rate, excess demand, labor market tightness, and inflation expectations. It then discusses monetary policy: the considerations that led the Committee to keep the interest rate unchanged for most of the year, the way in which rising real yields contributed to restraining demand and moderating inflation, and the circumstances that prompted the rate reductions toward the end of 2025 and early 2026. The chapter concludes with an overview of developments in the monetary base and monetary aggregates.

2. INFLATION

a. Background

In 2025, inflation continued to be significantly influenced by the war that began in October 2023. The labor supply remained constrained, mainly due to the high level of reserve duty call-ups, which persisted until the ceasefire in the Gaza Strip in October 2025, and due to the continued stoppage in the entry of Palestinian workers, whose replacement by foreign workers was gradual and partial.

The war's impact on aggregate demand was less clear. Demand was likely dampened by the elevated risk premium, but there was also a sharp increase in defense expenditures, including extensive government transfers to reservists and domestic purchases by the government, which increased aggregate demand. (See Box 2.1 in Chapter 2.) In addition, the sharp rise in the stock market contributed demand through its effect on the public's assets ("the wealth effect").[1]

As the supply side was more severely affected, the labor market remained tight, and the economy was characterized by excess aggregate demand. The economy's risk premium declined during the year, reaching a level that was close to the prevailing level before the war. This development contributed to a sharp appreciation of the shekel, which was also supported by the general weakness of the US dollar globally.

Table 3.1 summarizes the main indicators related to inflation and monetary policy, with an emphasis on 2025.

[1] For evidence regarding the effect of changes in the public's financial asset values on private consumption, see Arnon Barak (2017), "The Private Consumption Function in Israel", Discussion Papers Series 2017.04, Bank of Israel Research Department.

Table 3.1 | Main indicators of inflation and monetary policy, 2021–2025

						2025			
	2021	2022	2023	2024	2025	Q1	Q2	Q3	Q4
Inflation (percent)									
Actual inflation[a]	2.8	5.3	3.0	3.2	2.6	4.4	2.8	1.6	1.9
Inflation excluding energy, fruits and vegetables	2.7	5.0	2.7	3.3	2.7	4.0	4.8	2.4	-0.4
One-year inflation expectations derived from the capital market[b]	1.9	3.1	2.8	2.9	1.8	2.0	1.8	1.7	1.6
Ten-year inflation expectations derived from the capital market[b]	2.0	2.3	3.0	2.9	2.5	2.6	2.5	2.6	2.5
Forecasters' one-year inflation projections[b]	1.2	2.8	2.8	2.9	2.3	2.6	2.4	2.3	2.0
Yields (percent)									
Bank of Israel declared interest rate	0.10	1.25	4.50	4.50	4.48	4.50	4.50	4.50	4.41
Real yield to maturity on one-year government bonds[b]	-1.9	-1.4	1.6	1.3	2.3	2.1	2.3	2.4	2.3
Nominal yield to maturity on ten-year government bonds[b]	1.2	2.6	3.9	4.7	4.3	4.4	4.4	4.2	4.0
Real yield to maturity on ten-year government bonds[b]	-0.8	0.1	1.2	2.0	2.0	2.0	2.2	2.0	1.8
Change in the shekel exchange rate (percent)[c]									
Nominal effective	-8.4	3.9	4.3	-5.1	-7.7	2.2	-2.0	-3.9	-4.1
Vis-à-vis the dollar	-3.6	10.2	6.4	-1.5	-11.1	1.0	-4.7	-4.0	-3.8
Vis-à-vis the euro	-10.4	3.2	9.6	-5.4	-0.7	4.2	1.6	-2.3	-4.0
Asset prices (percent)									
Overall yield on shares (general shares index, nominal)[d]	30.9	-15.5	4.9	30.7	47.0	-0.2	22.9	6.5	12.4
Rate of change in home prices	13.1	14.7	-1.0	7.7	-0.9	0.2	-0.9	-1.5	1.3
Additional background data (percent, quarterly data are seasonally adjusted)									
Unemployment in the primary working ages (25–64)	4.6	3.3	3.0	2.8	2.7	2.6	2.6	2.9	2.8
GDP growth[e]	9.3	6.4	2.1	1.0	2.9	5.8	-4.5	12.1	4.2
Additional background data (percent)									
S&P Index of commodities excluding energy[f]	22.5	1.3	-7.3	7.6	16.7	4.8	1.8	1.5	6.1
Brent crude oil price (per barrel)[f]	48.7	8.9	-4.9	-5.4	-15.7	1.3	-11.0	2.2	-7.5

[a] Change in CPI during the period. Quarterly figures are seasonally adjusted in annual terms as calculated by the Central Bureau of Statistics. Due to methodological changes the Central Bureau of Statistics made in recent years in how flight prices are measured, the quarterly inflation rates may not fully reflect updated seasonality patterns.

[b] Based on the zero coupon yield curve. Period average.

[c] Yearly figures are the December average compared with the December average of the previous year. Quarterly figures are the average in the final month of the quarter compared with the average in the final month of the previous quarter.

[d] Yearly figures are the last day of the year compared with the last day of the previous year. Quarterly figures are the last day of the quarter compared with the last day of the previous quarter.

[e] The average during the period compared with the average during the previous period, in annual terms.

[f] Yearly figures are the December average compared with the December average of the previous year. Quarterly figures are the quarterly average compared with the previous quarter.

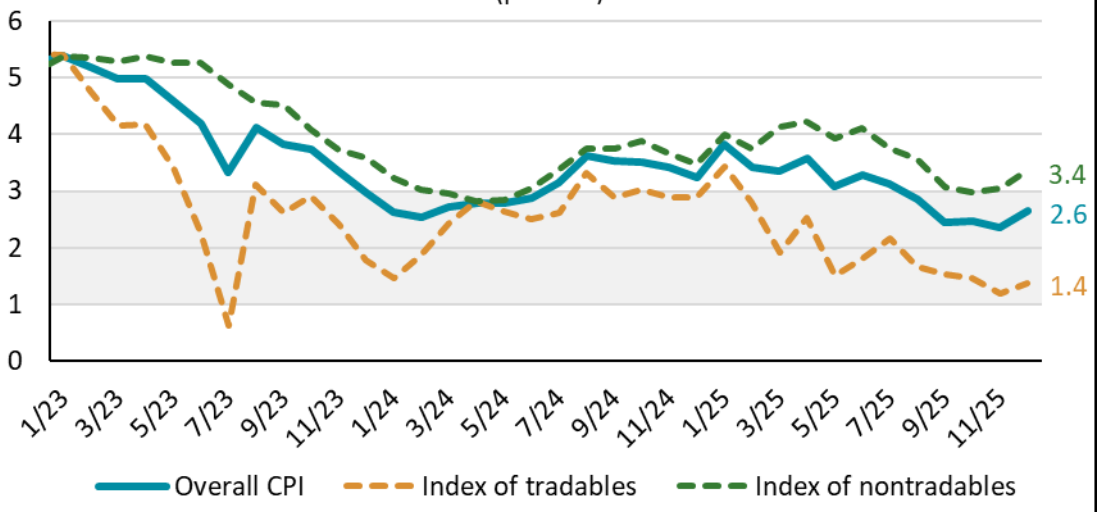
SOURCE: Bank of Israel, Ministry of Finance, Central Bureau of Statistics, and Bloomberg.

b. Survey of the development of inflation

In 2025, inflation totaled 2.6 percent, within the inflation target range (Figure 3.1), following an inflation rate of 3.2 percent in 2024. The moderation of inflation was driven mainly by the tradable component, which is particularly sensitive to the exchange rate and to the price of oil, and increased by just 1.4 percent this year, compared with 2.8 percent in 2024. In contrast, the nontradable component rose by 3.4 percent in 2025 compared with 3.5 percent in 2024.

Figure 3.1 | Annual Inflation, Tradable and Nontradable Components, January 2023–December 2025

(percent)



The division into tradable and nontradable components is based on the component's exposure to the exchange rate and discretionary adjustments.

SOURCE: Based on Central Bureau of Statistics.

The development of annual inflation was also affected by government tax and regulatory measures, particularly the one percentage point increase in the VAT rate in January 2025. This increase led to a temporary acceleration in annual inflation in January, to 3.8 percent[2], but from that point until the end of the year, inflation moderated gradually. Excluding the effects of tax and regulatory measures, inflation totaled 2.2 percent in 2025, compared with 2.8 percent in 2024 (Figure 3.2).[3]

The moderation of inflation was also evident in indices that exclude volatile components—energy, fruit and vegetables, and airfares (a component that was particularly volatile during the year in view of restrictions on airlines' supply, and that influenced the volatility of the CPI as a whole).

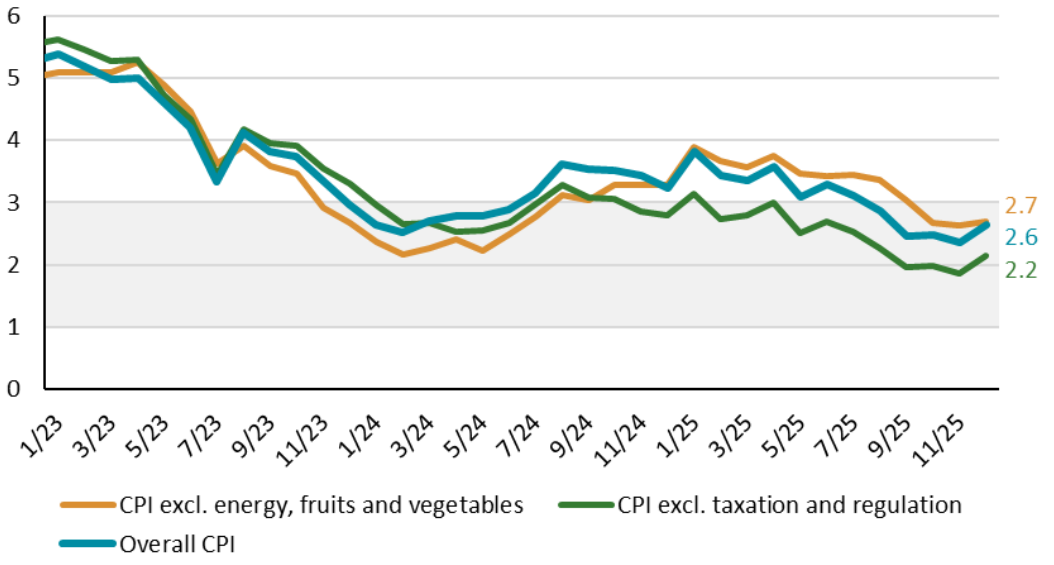
The moderation of inflation was apparent across almost all components of the Consumer Price Index. Figure 3.3 presents the annual change in annual inflation and the contributions of the main CPI components to that change. The figure illustrates the impact of the shekel's appreciation, which reduced import prices, on inflation this year. The main contributions to the slowdown in the annual inflation rate during 2025 came from components with a large tradable share—clothing and footwear, food, miscellaneous items, and furniture and household equipment. Among the nontradable components, the housing item—the largest in the index—also made a prominent contribution to the moderation of inflation, reflecting the increase in the ratio of the housing stock to the population. (For a discussion of the factors that

[2] According to the Bank's assessment, the VAT increase in January contributed about 0.4 percentage points to annual inflation.

[3] Monitoring the CPI excluding tax and regulatory measures makes it possible to distinguish between temporary regulatory effects on inflation and underlying inflationary processes in the economy. For further discussion, see Box 3.1 in the *Bank of Israel Annual Report* for 2024.

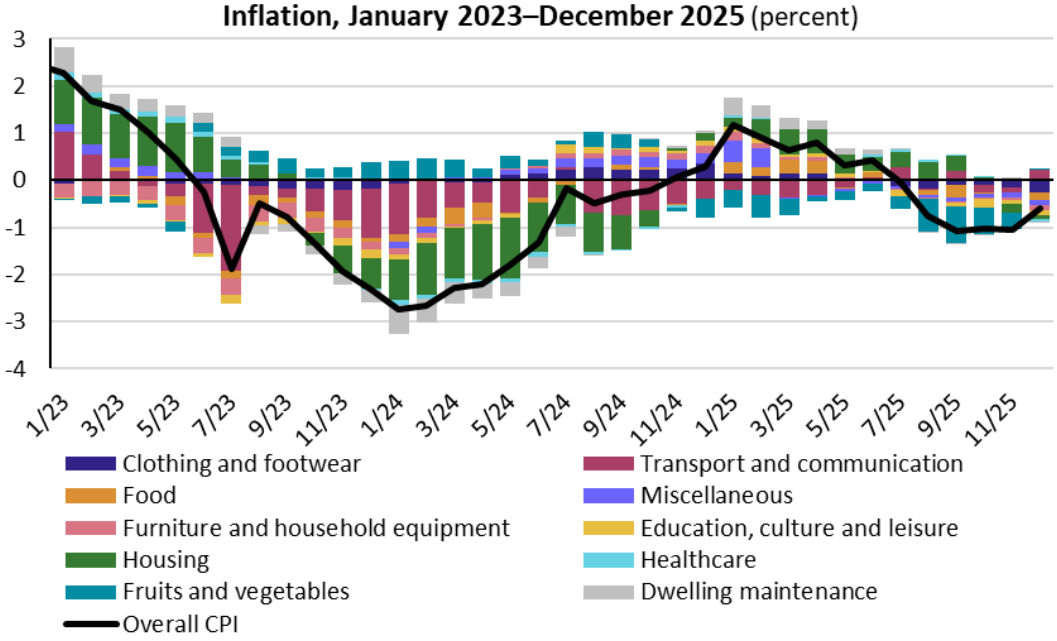
contributed to the moderation in rent increases, see Chapter 8 – The Housing Market.)[4]

Figure 3.2 | Annual Inflation and Partial Indices, January 2023–December 2025
(percent)



SOURCE: Based on Central Bureau of Statistics.

Figure 3.3 | Components' Contribution to the Annual Change in Annual Inflation, January 2023–December 2025 (percent)



The figure presents the change in annual inflation for each month relative to the annual inflation rate in the same month of the previous year (black line), and the contribution of each of the main CPI components to that change (colored columns).

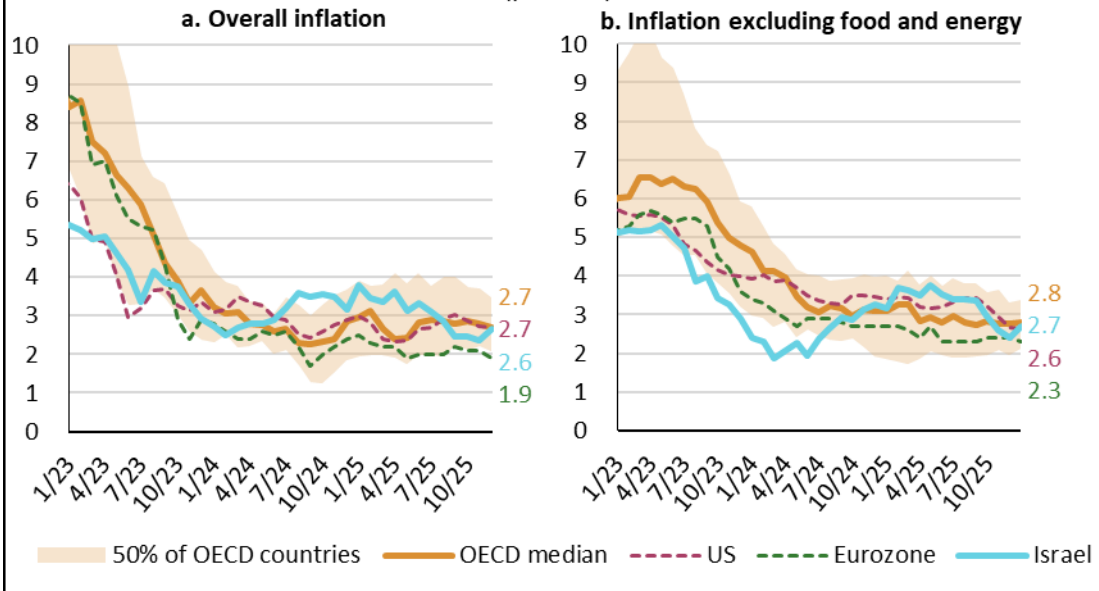
SOURCE: Based on Central Bureau of Statistics.

[4] While the fruit and vegetables component showed more moderate increases in many months relative to the same months in the previous year, it did not contribute to the moderation of inflation over the year as a whole, since its rate of increase during 2025 as a whole was slightly higher than in 2024 (as reflected in the column for December 20250.

The moderation of inflation during the year brought Israel's inflation rate, by year-end, close to the OECD median, and even slightly below it. This followed a period shortly after the outbreak of the war when inflation in Israel had risen above the OECD level (Figure 3.4a). A similar picture emerges when excluding the volatile food and energy components (Figure 3.4b).

Figure 3.4 | Annual Inflation in Israel and the OECD, January 2023–December 2025

(percent)



SOURCE: Based on OECD.

c. The forces that affected inflation

The war led to an increase in inflation in 2024 through three main channels: a rise in the economy's risk premium; supply constraints due to the decline in the number of available workers—mainly as a result of the large-scale reserve call-ups and the ban on the entry of Palestinian workers into Israel; and demand pressures due to a sharp increase in domestic defense and war-related expenditures.

The moderation of inflation in 2025 reflects a decline in the inflationary effects of the war, although some of these effects appear not to have fully dissipated. In particular, while the risk premium declined to a level close to that prevailing before the war, and the fiscal pressure was partly offset by tax increases, the labor market remained tight.

The following sections provide a detailed review of the main factors that influenced inflation during the year.

(1) The Exchange Rate

The exchange rate directly affects the shekel cost of imported goods and therefore has a direct impact on inflation—mainly on the prices of tradable goods (imports and import substitutes), but also on the nontradable component through the cost of

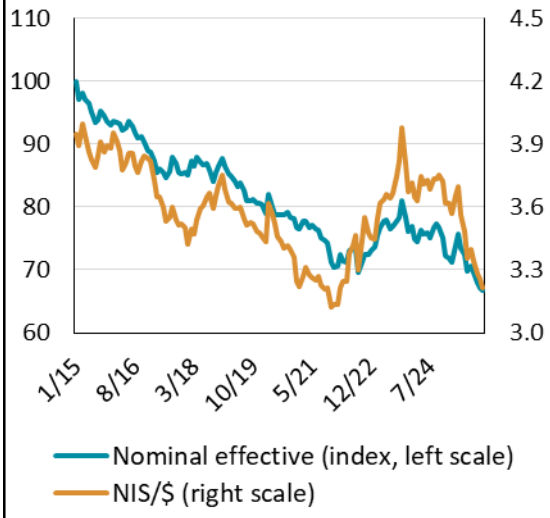
imported inputs such as oil. During the year, the shekel appreciated significantly (December 2025 average compared with December 2024 average)—by about 8 percent in terms of the nominal effective exchange rate; by about 11 percent against the US dollar (Figure 3.5); and by about 1 percent against the euro.

A common framework for analyzing exchange rate developments is the *Uncovered Interest Rate Parity* (UIP) equation. This equation explains exchange rate movements through changes in interest rate differentials between currencies and through changes in perceived currency risk. While in the mid-to-long term, the exchange rate is influenced mainly by real factors, in the short-to-medium term (a few years) it is affected primarily by factors such as the degree of monetary restraint adopted or expected by central banks, short-term changes in risk perception, and financial pressures arising from investors' hedging needs.

Box 3.1 empirically examines the short-term factors affecting the shekel-dollar exchange rate and their contribution to its development over the past three years. The appreciation of the shekel this year was stronger than that implied by the historical trend of the exchange rate. This trend reflects real factors such as the persistent current account surplus and the relative improvement in Israel's productivity. The box shows that about some of the appreciation this year can be attributed to global factors—the weakening of the US dollar worldwide and the rise in US equity prices—while some is attributed to domestic factors.

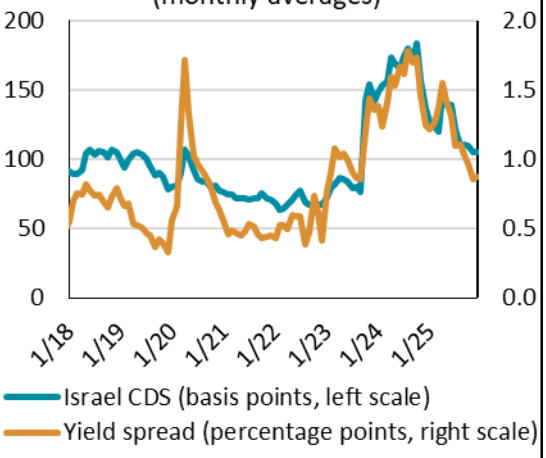
Among the domestic factors are the decline in the economy's risk premium, as measured by CDS contracts and by the dollar yield spread between Israel and the US (Figure 3.6). The current level of the risk premium is close to its prewar level. Monetary policy also contributed to the appreciation of the shekel. Despite the marked decline in the risk premium, which was reflected in the appreciation, the Bank of Israel's interest rate remained unchanged for most of the year and was reduced moderately only toward year-end. This increased the risk-adjusted interest rate differential vis-à-vis the Fed and the ECB (see Section 2 – Monetary Policy).

Figure 3.5 | Exchange Rates, 2015–2025
(monthly averages)



Nominal effective exchange rate: 01.01.2015 = 100.
SOURCE: Bank of Israel calculations.

Figure 3.6 | Nominal Yield Spread on Israeli Government and US Treasury 10-Year Dollar Bonds, and 10-Year CDS, 2018–2025
(monthly averages)



Bond yields are based on a calculation to a fixed term to maturity.
SOURCE: Based on Bloomberg.

BOX 1: THE LOCAL COMPONENT OF THE EXCHANGE RATE: TO WHAT EXTENT DID THE SHEKEL DEVIATE FROM THE GLOBAL CONDITIONS

- This box examines the extent to which recent fluctuations in the shekel–dollar exchange rate have been driven by global factors and to what degree they reflect unique domestic factors.
- From the beginning of 2023 through the first year of the war, the shekel depreciated beyond what would be expected based on global developments. This finding is consistent with a deterioration in sentiment toward Israel, against the backdrop of the political and social tensions during 2023 and the outbreak of the war toward the end of that year.
- Since Operation Northern Arrows at the end of 2024, the domestic component has contributed to the appreciation of the shekel, and the exchange rate has gradually converged to a level close to that implied by global factors.
- The estimated domestic component of the exchange rate is correlated with the sovereign credit risk of the Israeli government, as reflected in the CDS spread, and with long-term nominal interest rates in Israel, but it provides a broader measure of investor sentiment toward Israel.

Introduction

In recent years, the shekel–dollar exchange rate has exhibited considerable volatility. The shekel began to depreciate in early 2023, and with the outbreak of the war, the exchange rate reached a peak of more than 4 shekels per dollar. From late 2024 onward, the shekel appreciated, reaching approximately 3.2 shekels per dollar by the

end of 2025. During this period, there were significant changes in both the domestic and international spheres. Locally, these included legislative initiatives concerning the judicial system, the war, and significant military operations within it; and globally, there were changes in US interest rates and trade policy.

This box focuses on the domestic component in the pricing of the shekel, particularly short-term fluctuations in the exchange rate that cannot be explained by global factors. Although the methodology does not allow attribution of deviations from global developments to specific causal factors, it provides a simple and practical measure of the domestic component in the pricing of the shekel, which can serve as an indicator of investor sentiment toward Israel.

Estimating the Domestic Component of the Shekel–Dollar Exchange Rate

To assess the influence of global factors on the exchange rate, the following regression was estimated:

$$(1) \qquad \Delta ILS = \beta_0 + \beta_1 \Delta SP500 + \beta_2 \Delta EUR + \beta_3 \Delta TB10 + \beta_4 VIX + \varepsilon$$

where ΔILS denotes the rate of change in the shekel–dollar exchange rate. The explanatory variables represent the main global factors affecting the exchange rate.

$\Delta SP500$ is the return on the S&P 500 index, serving as a proxy for short-term capital flows, partly because it induces portfolio adjustments by institutional and other investors (Hau and Rey, 2004; Ben Zeev and Nathan, 2024).

ΔEUR is the rate of change in the euro-dollar exchange rate, reflecting the dollar's status as a safe-haven asset. An appreciation of the dollar against the euro is typically accompanied by depreciatory pressure on the shekel.

$\Delta TB10$ is the change in the US 10-year interest rate, which captures expectations regarding the risk-free rate in the US economy, which form the basis for the pricing of the exchange rate, and reflects global liquidity conditions that influence capital flows.

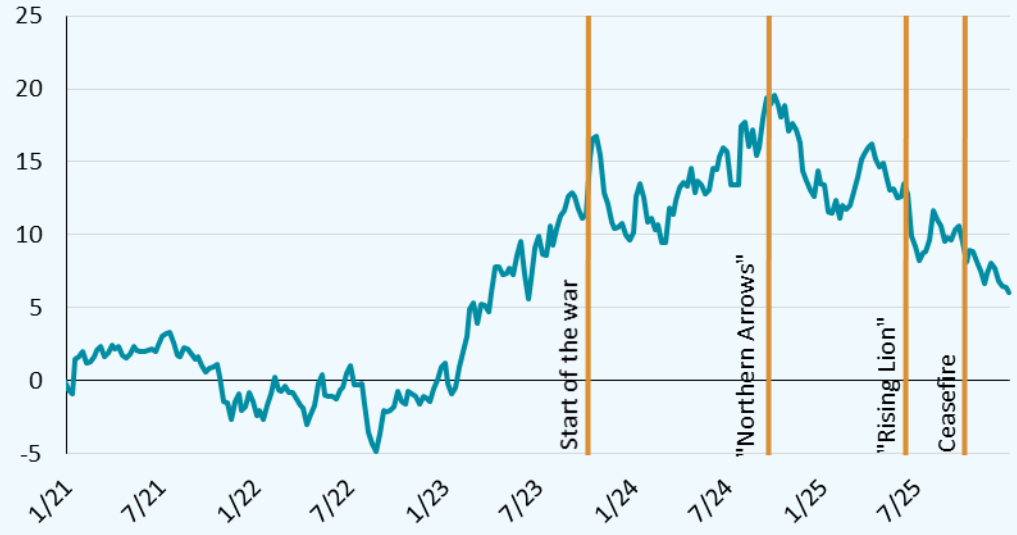
VIX is the implied volatility of options on the S&P 500 index, which serves as an estimate of market risk perception and volatility, which also affect capital flows (Rey, 2013).

The model is estimated using weekly data, and therefore captures short-term comovements of the variables rather than long-term common trends.[5]

[5] The estimate of the domestic component assumes stability in the relationship between the exchange rate and the explanatory variables. Sensitivity tests on samples including the forecast period confirm the stability of the estimated coefficients.

Figure 1 | Gap Between the NIS/$ Rate and the Conditional Forecast Based on Global Variables, January 2021–December 2025

(weekly data, percent)



SOURCE: Based on Bloomberg.

Using Equation (1), a conditional forecast of the exchange rate based on global variables was constructed. The forecast was derived from the coefficients estimated in a weekly sample between 2016–2020, together with the actual values of the explanatory variables for 2021–2025.[6] Figure 1 shows the deviation in percent between the actual exchange rate and this conditional forecast. It shows that until the end of 2022, the exchange rate closely followed global conditions, since the deviation from the conditional forecast is small and ranges around zero. However, between 2023 and 2025, the shekel was more depreciated than predicted by global factors.

The deviation from global factors was not uniform over time. From early 2023 until the outbreak of the war—a period characterized by social and political tensions surrounding legislative changes concerning the judicial system—the exchange rate increasingly diverged from global conditions. Following the outbreak of the war, the deviation widened further, reaching its peak on the eve of Operation Northern Arrows, when the shekel was approximately 20 percent weaker than implied by global factors. Since that operation, the deviation has gradually narrowed. These findings are consistent with the view that until the operation, domestic developments adversely affected investor sentiment toward the shekel and contributed to its depreciation, while from that point onward, the influence of these factors gradually diminished.

[6] The estimate in Figure 1 remains similar when Equation (1) includes lagged changes in the exchange rate and explanatory variables, or when the forecast begins from different starting points.

Explaining the Development of the Domestic Component

This section explores possible explanations for the exchange rate's deviation from global factors, focusing on the relationship between this deviation and developments in sovereign credit risk and domestic interest rates. To this end, the following regression was estimated for the period 2016–2025:

$$(2) \quad \Delta ILS = \alpha_0 + \vec{\beta} \cdot \overrightarrow{Global} + \alpha_1 \Delta CDS + \alpha_2 \Delta IL10Y + u$$

where $\overrightarrow{Global}$ includes the explanatory variables from Equation (1), ΔCDS denotes the change in the five-year sovereign CDS spread on Israeli government bonds, which serves as an estimate of the credit risk on Israeli government bonds, and $\Delta IL10Y$ represents the change in the interest rate on 10-year Israeli government bonds, which is influenced both by sovereign credit risk and by the short-term interest rate and expectations thereof.

Based on this estimation, Figure 2 presents a decomposition of the cumulative change in the shekel-dollar exchange rate since the beginning of 2023. The sum of the colored bars (CDS, nominal 10-year interest rate, and residual) approximates the domestic component of the exchange rate.[7] The constant term in the regression captures a long-term trend in the exchange rate[8], which may be related to changes in the relative productivity of the Israeli economy or to its persistent current account surplus (Frish, 2016; Eckstein and Friedman, 2011).[9]

Figure 2 indicates that for most of the period, global factors supported an appreciation of the shekel. In contrast, the contribution of domestic factors varied over time. Until the outbreak of the war, the depreciation was domestically driven but not correlated with the CDS or the long-term nominal interest rate, and thus appears as a residual. It is likely that internal tensions during that period weakened investor sentiment toward Israel and the shekel, while their expected fiscal implications were moderate, resulting in only limited increases in the CDS and the long-term nominal interest rate.

With the outbreak of the war, government expenditures rose sharply, and since then, a significant portion of the domestic component of the exchange rate is explained by movements in the CDS and the long-term interest rate. Following Operation Rising Lion and, more markedly, after the ceasefire in Gaza, the shekel appreciated substantially, partly explained by declines in the CDS and the long-term, nominal interest rate. These developments were perceived by markets as reducing sovereign credit risk, thereby supporting the moderation of the CDS and the long-term interest

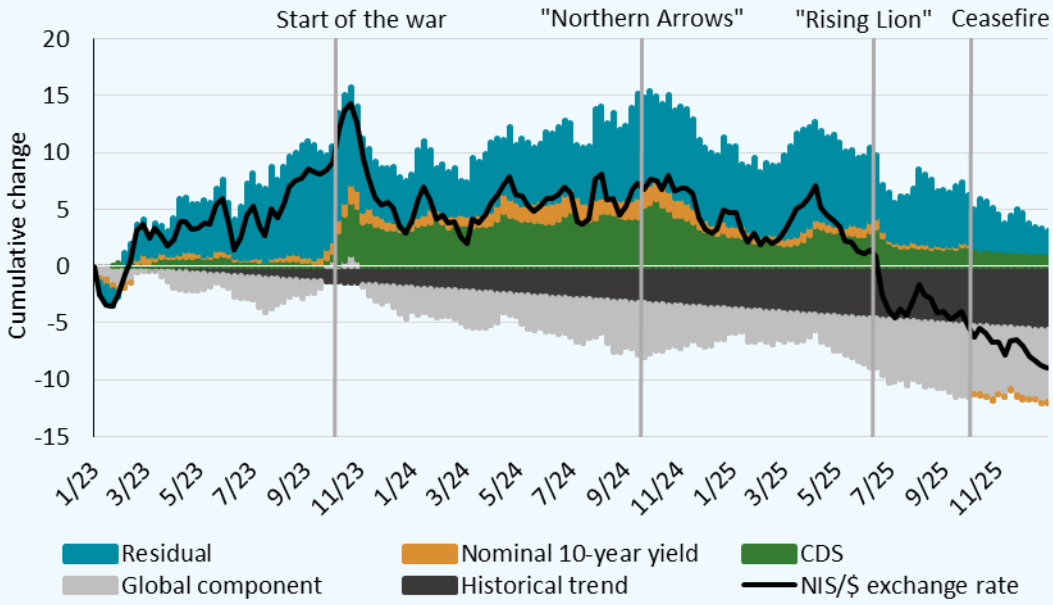
[7] This is only an approximation of the domestic component, as Equation (2) includes two additional explanatory variables that are correlated with global factors and therefore alter their explanatory power relative to Equation (1).

[8] All explanatory variables in Equation (2) are demeaned, so the constant term captures a long-term linear trend in the shekel–dollar exchange rate, unaffected by long-term trends in the explanatory variables.

[9] From 2016 until the outbreak of the war, Israel's per capita GDP grew by approximately 4 percent relative to that of the United States, and the current account surplus averaged about 3 percent of GDP. These trends support a real appreciation of the shekel.

rate and the appreciation of the shekel. Nevertheless, part of the appreciation during this period remains unexplained and likely reflects a general improvement in investor sentiment toward Israel.

Figure 2 | Decomposition of the Cumulative Change in the NIS/$ Exchange Rate, 2023–2025 (weekly data, percent)



SOURCE: Based on Bloomberg.

Conclusion

The analysis indicates that since early 2023, the shekel weakened against the dollar primarily due to domestic factors, while the government's credit risk increased only after the outbreak of the war at the end of that year. Since Operation Northern Arrows in late 2024, the shekel has strengthened against the dollar, supported by domestic factors including an improvement in sovereign credit risk.

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The impact of appreciation on inflation

The appreciation of the shekel had a significant moderating effect on inflation during the year. Bank of Israel Research Department estimates of the pass-through from the exchange rate to inflation vary depending on the model used and the sample period, but most fall within the range of 0.13–0.25.[10] Based on this range of coefficients and the change in the exchange rate (taking into account the relevant currency and timing for each model), the appreciation of the shekel contributed between 1.6 and 2.5 percentage points to the decline in inflation relative to a scenario in which the exchange rate had remained unchanged.[11]

This estimate reflects the combined impact of all factors that affected the economy through the exchange rate channel—whether their sole effect on inflation operates through the exchange rate (such as changes in demand for the shekel) or whether they also have additional effects on inflation beyond that channel (such as the Bank of Israel's interest rate, which influences inflation through its effect on aggregate demand; see discussion in the Monetary Policy section).

To quantify the contribution of the appreciation to the moderation of inflation relative to 2024, when the shekel also appreciated, a similar calculation was applied to the appreciation that occurred then. The difference between the estimated contribution of the appreciation to inflation this year and its estimated contribution in 2024 represents the estimated contribution of the appreciation to the moderation in inflation. Based on this calculation, the appreciation of the shekel contributed about 1.3 percentage points to the moderation in the inflation rate compared with 2024.[12]

[10] The analysis in this section is based on two types of tests: a structural (DSGE) model and empirical regressions. The structural model results are based on an update of the analysis presented in the *Monetary Policy Report* for the Second Half of 2019 ("How Does the Relationship Between the Exchange Rate and Inflation Depend on the Source of the Exchange Rate Change"), according to which a 1-percent appreciation against the currency basket lasting four quarters reduces inflation over that period by 0.25 percentage points. The empirical regressions are based on an update of the analysis published in *Policy Analysis and Research Notes*, December 2023 ("Pass-Through from the Exchange Rate to Prices"), which found that over the past decade, a 1-percent appreciation against the US dollar leads in subsequent months to a decline in inflation of about 0.13 percentage points. The empirical regressions indicate a somewhat weaker pass-through in cases of appreciation than in cases of depreciation (the value used here corresponds to appreciation). In the DSGE model, the pass-through is symmetric by definition.

[11] The relevant appreciation for the DSGE model (average effective exchange rate, 2025:Q4 vs. 2024:Q4) was about 10 percent. Assuming a pass-through of 0.25, this implies a contribution of -2.5 percentage points to inflation in 2025. The relevant appreciation for the empirical regressions (average exchange rate against the US dollar, November 2025 vs. November 2024) was about 12 percent. Assuming a pass-through of 0.13, this implies a contribution of -1.6 percentage points to inflation in 2025.

[12] The relevant appreciation for the DSGE model (average effective exchange rate, 2024:Q4 vs. 2023:Q4) was about 5 percent. Assuming a pass-through of 0.25, this implies a contribution of -1.2 percentage points to inflation in 2024. The relevant appreciation for the empirical regressions (average exchange

The later decline in the nontradable component relative to the tradable component is consistent with the estimated pass-through effects cited above. The impact of exchange rate changes on the tradable component is largely realized within about three months, while the effect on the nontradable component takes about six months to materialize. Quantitatively, these regressions yield a pass-through of about 0.1 for the nontradable component (compared with about 0.2 for the tradable component), implying an estimated contribution of about 0.5 percentage points to the moderation in nontradable inflation relative to last year. Offsetting this moderating factor, the tightness of the labor market contributed to an acceleration in the nontradable component (see discussion in the following section), thereby offsetting most of the moderating effect of the appreciation on this component.

(2) Excess demand

Due to its impact on reducing the labor supply and increasing demand for public defense consumption, the war led to the creation of excess demand. Excess demand tends to raise inflation through two channels. First, it may enable producers to charge higher price margins relative to production costs, particularly in industries where consumer demand is relatively inelastic. Second, it leads to higher wages—a key component of production costs for many goods and services. Rising production costs prompt producers to raise prices to the extent that demand allows.

A common measure in the literature for labor market tightness is the ratio of job vacancies to unemployed persons (V/U), which expresses the relationship between firms' demand for workers and the supply of available labor. This measure has been found in several studies to have explanatory power with respect to inflation.[13] Despite moderating during the year from its peak level in 2024, the V/U ratio remained high—an indication that the labor market is still tight. (For further discussion, see Chapter 5 in this Report.) Empirical analysis for Israel shows that the V/U ratio has considerable explanatory power for developments in the inflation of nontradable components.[14]

rate against the US dollar, November 2024 vs. November 2023) was about 2.3 percent. Assuming a pass-through of 0.13, this implies a contribution of -0.3 percentage points to inflation in 2024.

[13] For evidence on the superior performance of the V/U ratio relative to other measures of labor market tightness, see Régis Barnichon and Adam Hale Shapiro (2024), "Phillips Meets Beveridge," *Journal of Monetary Economics*, 148: 103660. For a discussion of the advantages of the V/U ratio as a measure of tightness relative to the unemployment rate and its application to the US, see Ben Bernanke and Olivier Blanchard (2025), "What Caused the US Pandemic-Era Inflation?," *American Economic Journal: Macroeconomics*, 17(3): 1–35.

[14] The analysis is based on the estimation of a New Keynesian Phillips curve of the following form:

$$\pi_t = \alpha + \beta_1 \pi_{t-1} + \beta_2 \pi_t^e + \beta_3 \mathrm{VU}_{t-1}^{low} + \beta_4 \mathrm{VU}_{t-1}^{high} + \beta_5 \Delta \mathrm{E}_t$$

where π_t is quarterly annualized inflation of the nontradable component excluding fruit and vegetables (seasonally adjusted); π_{t-1} is inflation with a one-quarter lag; π_t^e one-year-ahead inflation expectations from the capital market; VU_{t-1}^{low} is the deviation of the V/U ratio in the previous quarter from its average when negative and 0 otherwise; VU_{t-1}^{high} is the deviation of the V/U ration in the previous quarter from its average when positive and 0 otherwise; and $\Delta \mathrm{E}_t$ is the rate of change in the effective exchange rate (quarterly average vs. previous quarterly average).

An important finding from the analysis is that the effect of labor market tightness on inflation is nonlinear. It intensifies when the labor market is very tight.[15] Based on the estimation results, and taking into account the weight of the nontradable component in the overall index, labor market constraints contributed more than 0.9 percentage points to inflation in 2025. The estimated contribution in 2024 was 0.6 percentage points. It was lower than in 2025 because in the first half of 2024, the labor market had not yet reached the high levels of tightness that were characteristic of it in the second half of the year. Overall, labor market tightness accelerated inflation by about 0.3 percentage points this year.

While in 2024 inflation rose even though production costs did not increase, in 2025 production costs began to rise. A common measure of production costs is the GDP labor share, calculated as the ratio of total wage expenditures to nominal GDP (which approximates total wages and profits). After several years of decline in the GDP labor share in the business sector (a more accurate indicator for supply constraints relevant to inflation than the economy-wide ratio), the ratio began to rise this year—consistent with the effects of supply constraints in the labor market. (For further discussion, see Chapter 5 in this Report.) As noted, inflation began to rise already in 2024, before production costs increased. This development may reflect wage rigidity relative to prices or producers' ability to charge higher margins above production costs under conditions of excess demand.

(3) Inflation Expectations

Inflation expectations influence the pricing decisions of firms and workers, who take into account the expected rise in prices when negotiating wages. Therefore, an important role of central banks is to ensure that economic shocks do not feed too strongly into inflation expectations, thereby generating a stronger and more persistent response in actual inflation ("second-round effects"). This role became particularly important under the conditions experienced by the Israeli economy following the war: first, supply constraints that created inflationary pressures up to and beyond the upper bound of the inflation target; and second, a significant increase in the government's financing needs—a development that tends to raise public inflation expectations, both due to the expected increase in excess demand and, potentially, due to concerns about fiscal sustainability or expectations of future tax increases.[16] All this followed a prolonged period of inflation above the target during the post-COVID recovery.

In view of this, the moderation of inflation expectations across all horizons this year was a positive development, reflecting the decline in the intensity of the security conflict and the fading of the war's inflationary effects, alongside monetary policy that

[15] Nonlinearity may arise, among other reasons, because as the pool of available workers shrinks, firms are forced to hire less suitable workers, thereby increasing production costs at an accelerating pace. Evidence of nonlinearity in the relationship between the V/U ratio and inflation appears in Pierpaolo Benigno and Gauti B. Eggertsson (2024), "Slanted-L Phillips Curve," *AEA Papers and Proceedings*, 114: 84–89, among other sources.

[16] For example, Box 3.3 in the *Bank of Israel Annual Report* for 2024 found that the increase in the deficit in 2024 contributed between 0.5 and 1 percentage point to one-year inflation expectations.

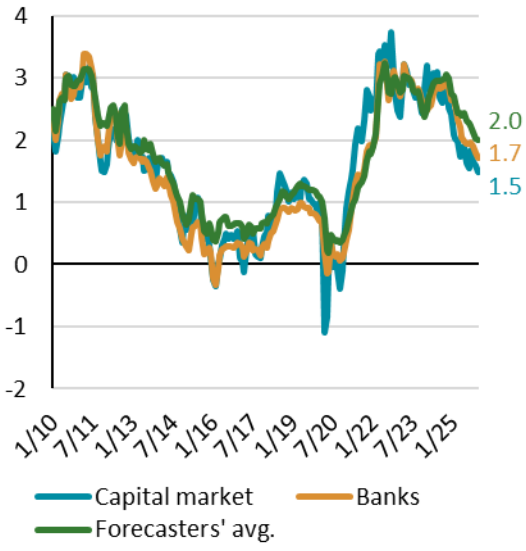
maintained the credibility of the inflation target. One-year expectations, which in 2024 hovered around the upper bound of the target range, moderated significantly this year to around the midpoint of the target range (Figure 3.7). Since producers' pricing decisions are influenced by their inflation expectations, it is likely that the moderate rise in expectations during the war and their rapid decline this year contributed to tempering the increase in actual inflation and shortening the period during which inflation remained above the target range. The decline in inflation expectations also contributed to moderating inflation through its effect on the rise in real yields—a factor that dampens consumption and investment demand. (See further discussion in the Monetary Policy section.)

Long-term (forward) inflation expectations also declined markedly (Figure 3.8).[17] The figure shows that after historically high expectation levels during 2024 (continuing the increase that began in late 2022), expectations moderated during 2025 to 2.3 percent at year-end—close to the long-term average. The figure also presents a comparison with expectations for corresponding horizons in the US. As shown, there is a positive correlation between expectations in Israel and in the US (and the average level in the sample is very similar). This correlation may be due to the influence of US inflation on Israeli inflation through imports, as well as from common economic forces in both economies. In any case, periods in which one country experienced inflationary pressures not shared by the other are reflected in gaps between the series. Following the decline in expectations in Israel, they stood at a level similar to that in the US at the end of 2025.

[17] Inflation expectations are calculated as the difference between nominal and real yields and may include liquidity and risk premia.

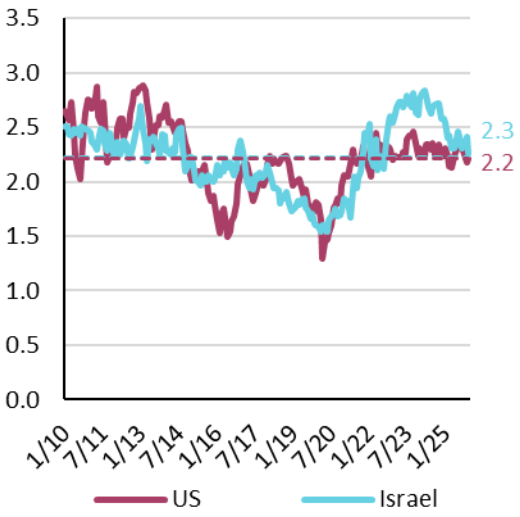
Historically, long-term inflation expectations in Israel have been well anchored.[18] This characteristic, reflecting the credibility that the public ascribes to monetary policy, is an asset that helps moderate inflation's response to macroeconomic shocks—as indeed occurred over the past two years.

Figure 3.7 | One-Year Inflation Expectations from Various Sources, January 2010–December 2025
(monthly averages, percent)



SOURCE: Bank of Israel calculations.

Figure 3.8 | 5-10 Year Forward Inflation Expectations from the Capital Market, January 2010–December 2025
(monthly averages, percent)



SOURCE: Based on FRED.

Summary of the contributions of the moderation of inflation

Inflation in 2025 totaled 2.6 percent—a decline of 0.6 percentage points relative to the previous year. A summary of the estimated contributions presented above indicates that a principal factor behind the moderation in inflation was the appreciation of the shekel, which largely reflected the decline in the economy's risk premium. This appreciation contributed an estimated 1.3 percentage points to the reduction in inflation. Conversely, labor market tightness is estimated to have contributed approximately 0.3 percentage points to the increase in inflation.[19]

As described in the section on monetary policy below, some of these effects were due to the Bank of Israel's policy stance. The fact that the Bank of Israel's policy rate remained unchanged for most of the year contributed to the moderation of inflation,

[18] See Box 3.1 in the *Bank of Israel Annual Report* for 2021.

[19] The price of oil declined by approximately 15 percent during the year (Table 3.1), compared with a decline of about 5 percent in 2024. According to our assessment, this contributed roughly 0.2 percentage points to the moderation of inflation. Fiscal and regulatory measures contributed only about 0.1 percentage points to the acceleration of inflation, as their impact was already significant in 2024 (an estimated 0.4 percentage points), stemming from the increase in cigarette taxes, the elimination of the fuel excise discount, and the reduction in subsidies for afternoon childcare programs. For further details, see Box 3.1 in the Bank of Israel *Annual Report* for 2024.

through its contribution to the appreciation of the shekel, its anchoring of inflation expectations, and its dampening impact on domestic demand, thereby preventing an increase in inflation due to a further tightening of the labor market.[20]

3. MONETARY POLICY

a. Policy measures and the Monetary Committee's considerations

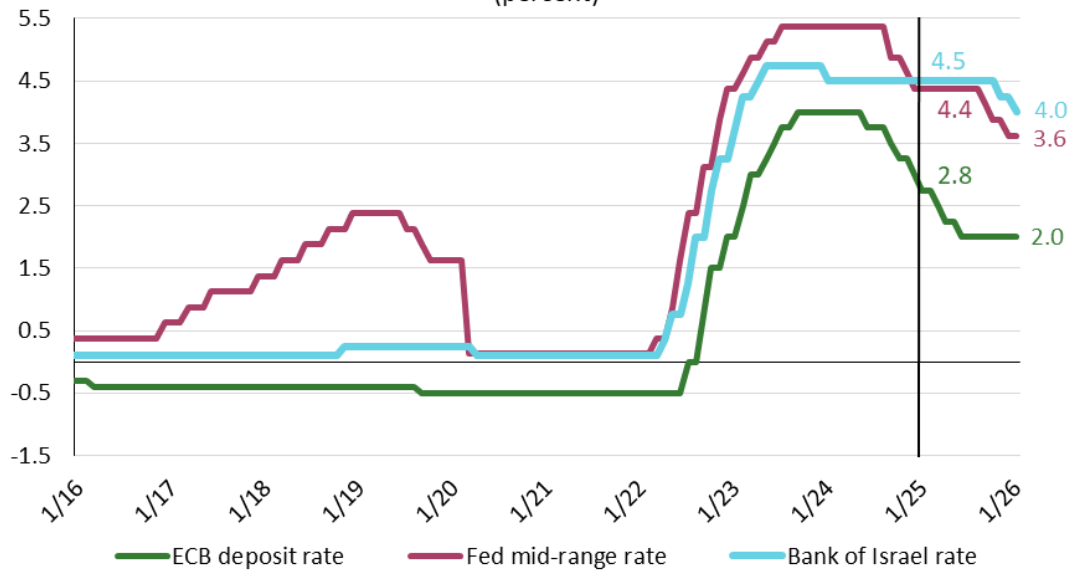
The Bank of Israel's policy rate remained unchanged for most of the year, at 4.5 percent (Figure 3.9). In November, after the annual inflation environment had stabilized within the target range and after the risk premium in financial markets declined against the backdrop of geopolitical developments—including the ceasefire agreement in Gaza in October—the Monetary Committee reduced the interest rate to 4.25 percent. This was the first rate cut since January 2024.

In January 2026, in view of the continuation of these trends and signs of a slight easing in labor market tightness, the Committee further reduced the rate to 4.0 percent.

The moderate decline in the Bank of Israel's policy rate was slower than the declines in the eurozone, which meant that the interest rate differential vis-à-vis the eurozone widened. The differential vis-à-vis the Federal Reserve increased only slightly, as the pace of rate reductions in the United States was also very gradual (Figure 3.9).

Figure 3.9 | Bank of Israel, Federal Reserve, and ECB Interest Rates, January 2016–January 2026

(percent)



SOURCE: Bank of Israel calculations.

[20] The aggregation of the estimated contributions implies a larger decline in inflation than was actually observed. It is important to note that these estimates are subject to a wide range of uncertainty. Moreover, in any given year, inflation may also be affected by idiosyncratic factors that are not captured in the analysis presented here.

The decision to leave the policy rate unchanged for most of the year reflected both the need to preserve a sufficiently restrictive monetary stance—aimed at aligning demand with the constrained supply and thereby moderating inflationary pressures—and considerations related to risk management. Until midyear, the pace of inflation exceeded the upper bound of the target range, with volatility, while economic activity remained moderate due to supply constraints. In other words, it reflected excess demand that required monetary restraint in order to bring demand in line with limited supply. In such circumstances, a rate reduction would have been expected to yield only a modest increase, if any, in activity but a significant rise in inflation.

Although the Research Department had already assessed at the beginning of the year that inflation would moderate to within the target range during the course of the year, there was considerable uncertainty surrounding this forecast. This uncertainty was mainly due to the inability to predict the evolution of the war and its implications for the risk premium and the exchange rate, the labor market, and government expenditures—and, to a lesser extent, to uncertainty regarding the impact of tariff increases in the United States and their spillover effects.

Even after inflation entered the target range (in the August CPI, which was published in mid-September), the Monetary Committee decided to wait in order to ensure that the moderation in inflation was firmly established and that the security situation did not deteriorate.[21] This caution was intended to avoid an overly early rate reduction that might later have required a reversal in policy to respond to a renewed rise in inflation. A resurgence of inflation after a period of moderation could also have undermined the anchoring of inflation expectations. Moreover, frequent policy reversals tend to generate excessive volatility in financial markets and may weaken the effectiveness of monetary policy over time.[22]

A significant moderation of the inflation environment was an important precondition for lowering the policy rate, since even under a scenario of improved security conditions there remained a risk of renewed inflationary pressures if demand were to recover faster than supply. The combination of inflation moderating to within the target range and remaining there, the decline in the risk premium following Operation Rising Lion (the Israeli operation against Iran in June 2025) and the associated appreciation of the shekel and decline in inflation expectations, as well as the ceasefire agreement reached in October and its potential implications for the labor market, led the Monetary Committee to reduce the policy rate to 4.25 percent in November. In addition to these factors, there were initial indications leading up to the January 2026 decision that the supply constraints in the labor market were easing, which led the Monetary Committee to again lower the rate, to 4.0 percent.

[21] When the interest rate decision was made at the beginning of October, it was highly likely that the "Chariots of Gideon 2" military offensive in Gaza, which began in August 2025, would be expanded, with implications for reserve mobilization, government expenditures, international sentiment toward Israel, and more.

[22] For a discussion of the value of gradual interest rate adjustments, see for example: Michael Woodford (2003), "Optimal Interest-Rate Smoothing", *The Review of Economic Studies*, 70(4): 861–886.

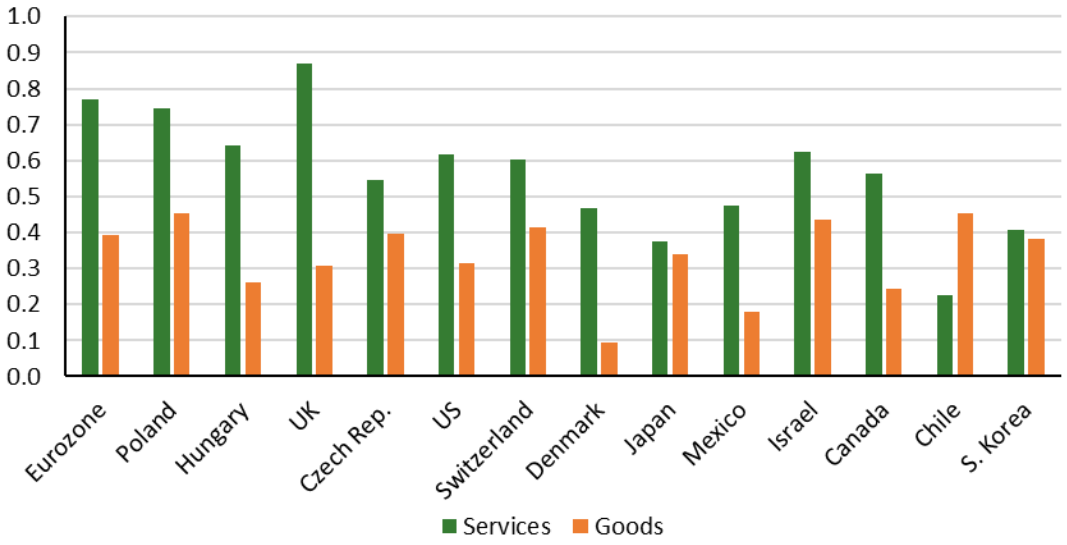
The assessment that the economy was characterized by excess demand was supported by several real indicators, as well as by the composition of inflation, particularly during the first half of the year. The inflation rate of the tradable component moderated—reflecting the impact of the shekel's appreciation—while inflation in the nontradable component, which is more strongly influenced by domestic demand pressures, remained high and even accelerated. The rapid increase in the prices of nontradables, although partly reflecting the effect of the VAT increase at the beginning of the year, supported the assessment that supply constraints in the labor market continued to manifest as excess demand pressures that were driving price increases.

The rapid rise in the nontradable component was also a reason for delaying rate reductions for another consideration: This component tends to exhibit greater persistence ("stickiness") than the tradable component. In other words, an increase in inflation of the nontradable component tends to last longer. This difference may reflect variations in the persistence of the underlying forces driving each component (for example, the tradable component is more affected by the exchange rate, which is inherently volatile), or it may stem from structural differences in the markets in which these goods and services are traded. In any case, the factors described above—the indication provided by the nontradable component regarding excess demand in the economy, and its higher persistence—justify a more restrictive monetary policy response to an increase in inflation of the nontradable component than to an increase originating in the tradable component.

In keeping with this, Figure 3.10 illustrates that in Israel, as in many other countries, the services component of inflation—which constitutes a major part of the nontradable segment—exhibits greater persistence than the goods component. Figure 3.11 provides evidence that central banks indeed tend to respond more strongly to changes in services inflation than to changes in goods inflation.[23]

[23] The figure focuses on the period from 2022 onward, since in the preceding decade policy rates in many countries were constrained by the zero lower bound. Consequently, changes in inflation—whether in goods or services—did not lead to changes in policy rates, which biases the regression slopes. Nevertheless, the qualitative result remains valid even when that period is included. In addition, the positive gap between the coefficient of the policy rate response to services inflation and that of the response to goods inflation is statistically significant.

Figure 3.10 | Persistence of Inflation in the Prices of Goods and Services, Select OECD Countries, 2011–2025

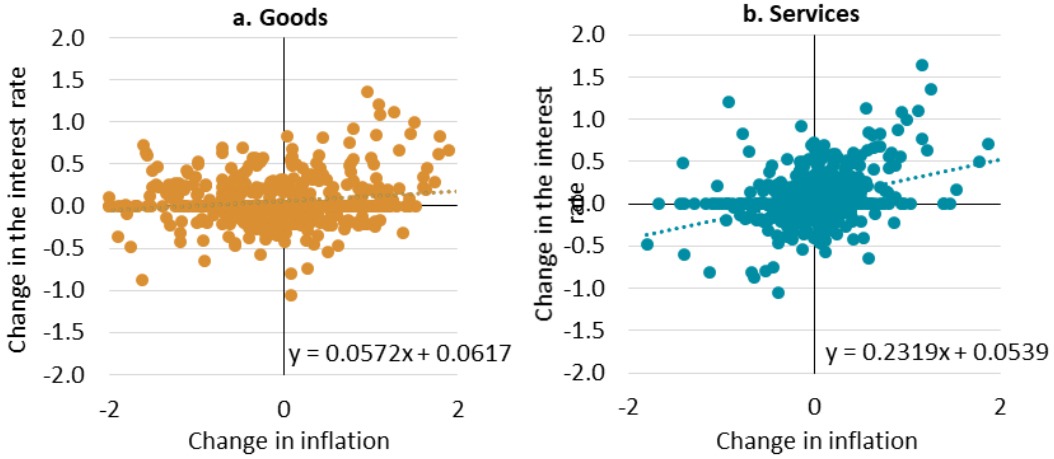


The figure presents the serial correlation coefficients for inflation in the prices of goods and services between annual inflation in month *t* and annual inflation in month *t-12*.

SOURCE: Based on OECD.

Figure 3.11 | The Interest Rate's Reaction to Goods and Services Inflation in Select OECD Countries, 2022–2025

(percentage points)



The figures present the monthly change in the central bank interest rate in each of the sample countries, as a function of the monthly change in annual inflation in the previous month in the goods and services components. The countries included in the sample are those presented in Figure 3.10. Each figure presents a regression of the change in the interest rate as an explanatory variable using an intercept and using the inflation rate relevant to the figure.

SOURCE: Based on OECD and ECB.

b. The real interest rate and the extent of monetary restraint

The short-term real interest rate

Monetary policy's effect on the economy operates largely through real yields, which influence aggregate demand—particularly private consumption and investment. To assess the effect of monetary policy, it is customary to focus mainly on short- to medium-term real yields, as these are the ones most directly affected by monetary policy: directly, through nominal yields; and indirectly, through the public's inflation expectations.

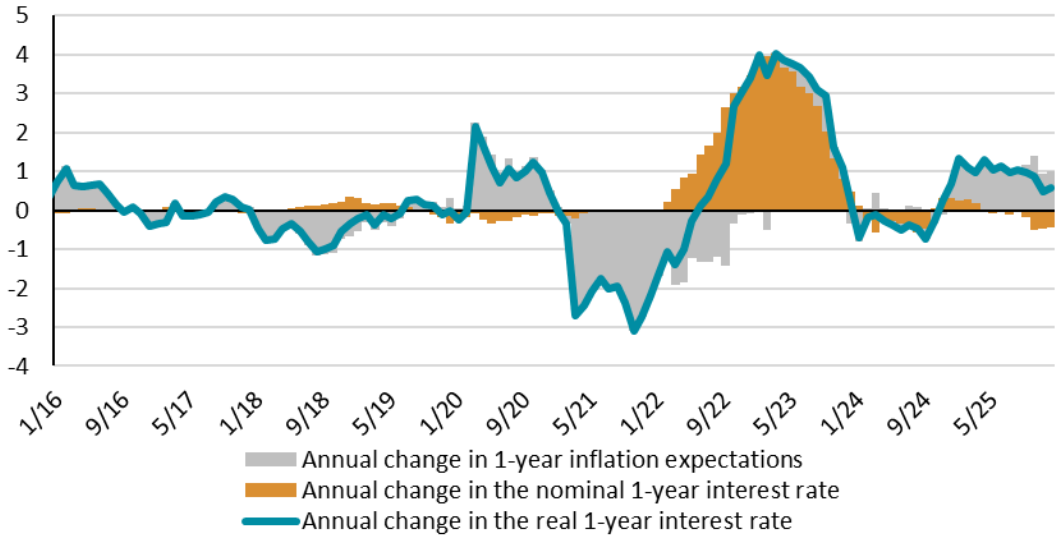
To examine policy's effect on real yields, Figure 3.12 presents a decomposition of the annual change in the one-year real interest rate (each month compared with the corresponding month in the previous year) into two components: the change in the one-year nominal yield and the change in one-year inflation expectations.[24] The figure shows that at the beginning of the year there was a significant increase—of about one percentage point—in the one-year real yield, so that for most of the year the real interest rate was higher than in the corresponding months of 2024. The figure indicates that the decline in inflation expectations, together with the Bank of Israel's decision to maintain the same policy rate (and its implications for the expected path of rates), led to an increase in the real interest rate. Toward the end of the year, there was a decline in the real yield, reflecting the reduction in the Bank of Israel's policy rate.

The increase in real yields was also evident at the two-year horizon (Figure 3.13) and led to a rise in the real spot yield curve along its entire length (not shown). The increase in real yields acted to moderate aggregate demand—a development consistent with the need to align aggregate demand with the constrained supply.[25]

[24] From a technical perspective, one-year inflation expectations are calculated as the difference between the one-year nominal yield and the one-year real yield. The decomposition presented here reflects an economic interpretation whereby, in the short term, the nominal interest rate is set by the central bank, inflation expectations are determined according to the public's assessments, and the real yield is derived from these two components.

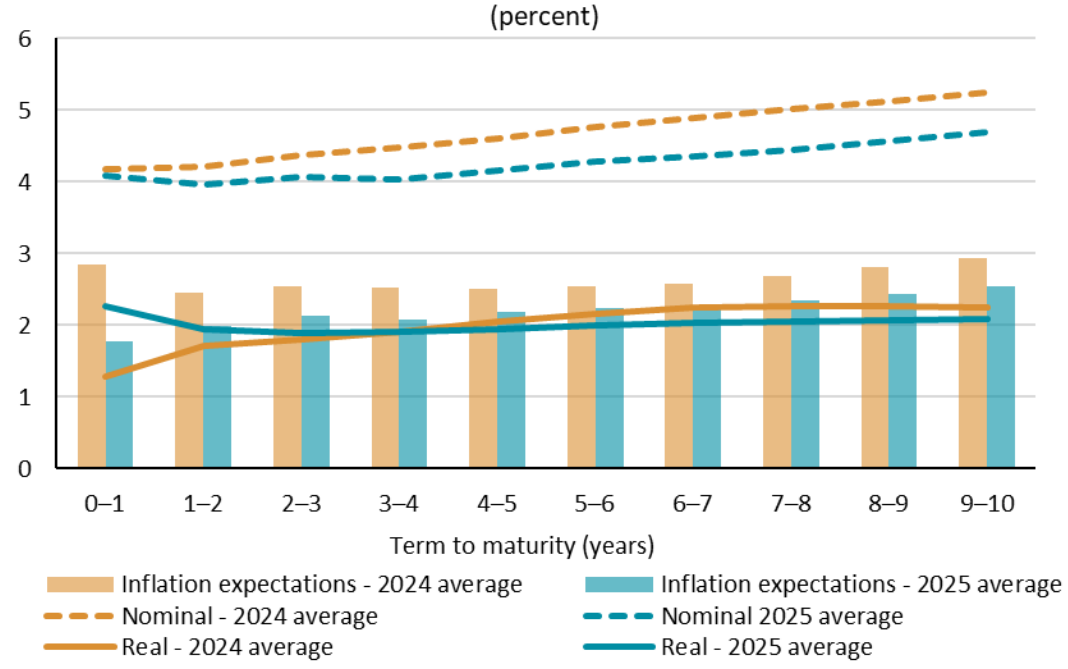
[25] Even when monetary policy is restrictive, financing conditions in the market may change simultaneously due to other factors, such as risk premia and credit spreads. In 2025, these components eased, particularly in the capital market. For further discussion, see Chapter 4 – Developments in the Financing Sources of the Nonfinancial Private Sector.

Figure 3.12 | Change in the Real 1-Year Interest Rate Decomposed into Components, January 2016–December 2025
(monthly average, annual rate of change, percent)



The annual change in the 1-year real interest rate (each month relative to the same month in the previous year) divided into the change in the nominal 1-year yield and the change in 1-year inflation expectations.
SOURCE: Bank of Israel calculations.

Figure 3.13 | Forward Real and Nominal Yield Curves and Inflation Expectations
(percent)



SOURCE: Bank of Israel calculations.

The long-term real interest rate and the extent of monetary restraint

The discussion above highlighted the increase in real yields during the year as a restraining factor on excess demand. This section shows that, given the supply constraints created by the war and the need to restrain the excess demand that resulted from them, a relatively high real interest rate was required.

To describe the extent to which monetary policy is restrictive or accommodative, it is customary to refer to the gap between the actual real interest rate and a benchmark rate known as the neutral interest rate.[26]

In practice, since the neutral rate is a theoretical concept that cannot be directly observed, its level is difficult to estimate. Under the conditions prevailing in the economy this year, it is reasonable to assume that the neutral rate was relatively high—a situation that required maintaining a high real interest rate. To illustrate this, the neutral rate can be represented as consisting of two components: a structural component, reflecting long-term structural forces; and a cyclical component, influenced mainly by short-term developments (up to about five years). Formally[27]:

$$(1)\quad \underbrace{rn}_{Neutral\ interest\ rate} = \underbrace{rn_{long\ run}}_{\text{Long-term factors}} + \underbrace{rn_{cyclical}}_{\text{Cyclical factors}}$$

Using this decomposition, the short-term real interest rate set by the central bank can be described as consisting of three elements: the degree of monetary restraint that the central bank seeks to achieve; short-term cyclical factors that affect the neutral rate; and long-term structural factors that also affect it. Formally:

$$(2)\quad \underbrace{r}_{\substack{\text{Short-term real}\\ \text{interest rate}}} = \underbrace{\underbrace{\underbrace{r-rn}_{\substack{\text{Desired monetay}\\ \text{restraint}}} + \underbrace{rn_{cyclical}}_{\text{Cyclical factors}}}_{\text{Slope of the real curve (short minus long)}} + \underbrace{rn_{long\ run}}_{\text{Long-term factors}}}$$

Equation (2) implies that if the central bank wishes to maintain the same degree of monetary restraint—or to increase it—it must act to raise the real interest rate in a way that offsets both the long-term structural forces and the short-term cyclical forces that push the neutral rate upward. Under the conditions prevailing in the Israeli

[26] According to the neo-Keynesian framework, the neutral interest rate is the real interest rate that would prevail in an economy where prices are fully flexible, such that monetary policy would be neutral in its effect on economic activity. In practice, since prices are not fully flexible, central banks can influence short- and medium-term real interest rates and thereby steer the economy in the desired direction—restraining demand when it is excessive, or stimulating it when it is weak. In the literature, the neutral rate is sometimes referred to as the *natural rate of interest*.

[27] For a similar decomposition of Equation (1) and a discussion of methods for measuring the monetary policy stance, see: Olamide Harrison and Vina Nguyen (2025). "How to Measure the Monetary Policy Stance," *IMF How To Notes*, https://doi.org/10.5089/9798400298882.061.

economy in recent years, it is likely that cyclical factors—namely, excess demand—acted to raise the neutral rate, since excess demand reduces aggregate savings and thereby exerts upward pressure on the interest rate level that balances the demand for savings with its supply.

As for long-term factors, in the years following the COVID-19 crisis, long-term interest rates rose in many countries, and the literature and recent policy measures offer several explanations for this.[28] The rise in long-term rates indicates the presence of economic forces that require maintaining a higher short-term rate in order to achieve the same degree of monetary restraint. Accordingly, both short-term and long-term factors likely contributed to the need for a high real interest rate relative to what was common in the previous decade in order to maintain the degree of monetary restraint that is consistent with market conditions.

Figure 3.14 indeed shows that this was the case. The figure presents a decomposition of the short-term interest rate into two components. The first is the forward real yield between the fifth and tenth years, representing the long-term factors in Equation (2). This yield reflects market participants' expectations regarding the level of the short-term real interest rate that will prevail in the future.[29] The second component is the gap between the short-term rate and the forward yield. In accordance with Equation (2), this component captures the degree of monetary restraint, $r - rn$, together with cyclical factors, $rn_{cyclical}$, that affect the neutral rate in the short term.[30]

The figure shows that over the past year, the one-year real interest rate reached a high level compared with the past decade—in fact, the highest level since 2008—and that this reflected contributions from both components: a high forward yield and a large gap between the short-term rate and the forward yield.

It is worth emphasizing that because changes in the short-term real interest rate are also due to the response to the development of the neutral interest rate and not just changes in the extent of monetary tightening, it is impossible to determine how the extent of monetary tightening changed this year based solely on the figure. However, in view of the evidence of excess demand, tightness in the labor market, and supply constraints presented in the chapter it is likely that a significant part, and perhaps even

[28] In the decade preceding the COVID-19 crisis, many central banks purchased bonds—a measure that worked to lower yields, while the banks' exits from the bond markets contributed to increased yields. Another factor was the deficits, which grew in many countries due to the COVID-19 crisis and are expected to remain high in many countries, partly due to an expected increase in their defense expenditures in view of increased geopolitical tensions. For a review of this topic, see: Gianluca Benigno, Boris Hofmann, Galo Nuño, and Damiano Sandri (2024). "Quo Vadis, r*? The Natural Rate of Interest After the Pandemic," *BIS Quarterly Review*, December 2024, pp. 17–30.

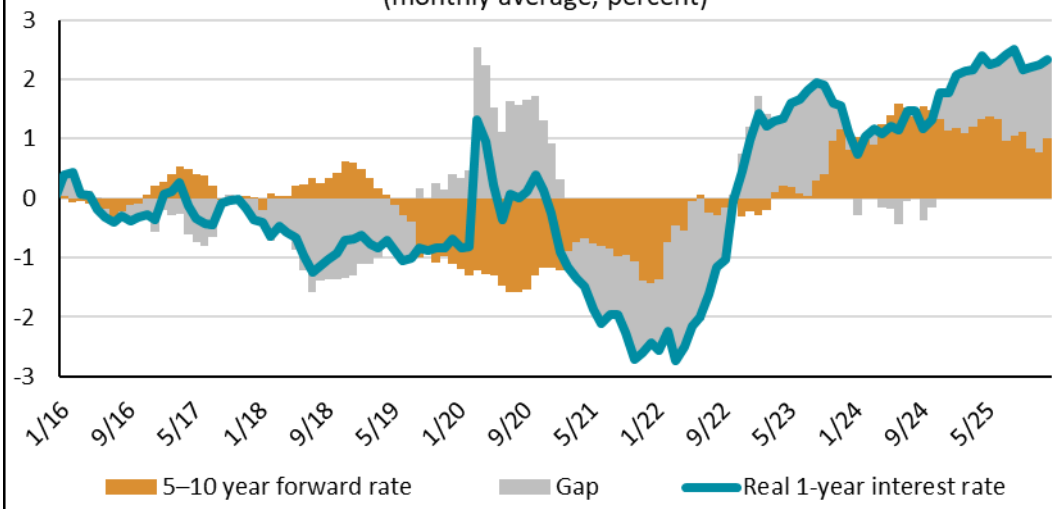
[29] The measured forward real yields include a term premium, which ideally should be deducted to obtain a more accurate estimate of the short-term real interest rate expected to prevail in the future. The implicit assumption in the analysis presented here is that the term premium is relatively stable over time.

[30] Figure 3.14 shows each variable in terms of its deviation from its historical average. This view is intended to focus the analysis on factors that were markedly different this year by historical comparison, and that led to the fact that the real interest rate was higher this year than in the past.

most, of the increase in the real interest rate reflected an increase in the cyclical component of the neutral interest rate and not just a tightening of policy.

Figure 3.14 | Real 1-Year Interest Rate, Real Forward Interest Rate, and the Gap Between Them (Deviation from Mean), January 2016–December 2025

(monthly average, percent)



The figure presents the deviation from the long-term average (January 2016 to December 2025) of each variable. The average values: 1-year real interest rate – 0.01%; 5-10 year forward real rate – 0.95%; Gap between them – -0.94%.

SOURCE: Bank of Israel calculations.

Monetary policy's contribution to the moderation of inflation

As described above, the Monetary Committee adopted a policy aimed at ensuring that inflation would moderate to within the target range and become entrenched within it. In retrospect, inflation at the end of the year actually was within the target range, and in January 2026 it declined to around the midpoint of the range. This policy was reflected in the decision to maintain the policy rate at its existing level for most of the year, against the background of volatility in inflation, geopolitical uncertainty, and fluctuations in the risk premium. As a direct result, and in view of the decline in inflation expectations, the real interest rate increased—a factor that acts to moderate demand for consumption and investment. The rise in the real interest rate also contributes to a real appreciation, and, given price rigidity, to a nominal appreciation as well. All of these factors work to reduce inflation.

Monetary policy's contribution to the moderation of inflation can be assessed using an estimate derived from the Research Department's DSGE model.[31] According to the model, a one percentage point increase in the expected one-year real yield leads to a

[31] The working paper describing the DSGE model is available on the Bank of Israel website: "MOISE: A DSGE Model for the Israeli Economy", Discussion Paper No. 2012.06.

decline of about 0.6 percentage points in inflation in the same year.[32] To translate this relationship into an estimate of the policy's impact, two calculations are presented. The first compares the actual development of the real yield with a counterfactual scenario in which the Committee had reduced the policy rate so that the real interest rate would have remained at its 2024 level. The second compares the actual development of the real yield with the path that was priced into the market in 2024.

For the first calculation, we rely on Figure 3.12, which shows that the one-year real interest rate was about one percentage point higher, on average, than in 2024. From this, we can infer that had the Bank of Israel reduced the policy rate so that the real interest rate had remained similar to its 2024 level, inflation would have been about 0.6 percentage points higher, and would have exceeded the target range at the end of the year.

For the second calculation, we rely on Figure 3.13, which indicates that already in 2024 the market expected the real yield to rise by about 0.4 percentage points in 2025. This expectation reflected the assessment that the Bank of Israel would maintain a similar policy rate to that of 2024, despite a projected decline in inflation expectations (which in practice declined even further).[33] In other words, roughly half of the increase in the real yield was already priced into the market in 2024, and may therefore have affected inflation even before 2025. Applying the model's transmission coefficients to only the unexpected component of the increase in the real yield generates an estimate of about 0.4 percentage points for monetary policy's contribution to the moderation of inflation.

Under both calculations, the conclusion is that keeping the policy rate unchanged for most of the year contributed significantly to bringing inflation back into the target range. In practice, the contribution was likely even greater. The DSGE model estimate is based on average historical relationships, whereas the economy this year faced supply constraints. In such an environment, the ability to expand production factors in response to rising demand is limited. It is therefore reasonable to assume that a monetary expansion would have resulted in a sharper increase in inflation.

4. THE MONETARY BASE AND MONETARY AGGREGATES

The interest rate is the price of money—the opportunity cost of holding liquidity. Changes in the interest rate, in addition to changes in economic activity, therefore affect the demand for liquidity. When the nominal interest rate serves as the policy instrument, the central bank supplies money elastically at the interest rate it announces, and the monetary base—that is, the total amount of currency in

[32] The assumption is that at the beginning of the year a contractionary monetary shock occurs, leading to a one percentage point increase in the expected one-year real yield. Roughly half of the increase in the real yield is directly due to the rise in the nominal interest rate, and half is due to an endogenous decline in inflation expectations.

[33] It is assumed here that the term premium for horizons of one to two years ahead is relatively small.

circulation and the commercial banks' demand deposits at the Bank of Israel[34]—is determined according to the demand for liquidity at the central bank's policy rate.[35]

The quantity of money, as measured by the M1 aggregate, consists of currency held by the public and the public's demand deposits in the banking system. It too is influenced by the Bank of Israel's policy rate.

In recent decades, the importance of monetary aggregates for the conduct of monetary policy has declined. In the 1970s and 1980s, the quantity of money served as a central anchor for monetary policy and was the main instrument through which central banks operated. Since then, the way monetary policy is conducted has changed. Today, the main policy instrument is the policy interest rate, and its level is not determined by reference to the growth rate of the money supply but is primarily based on an assessment of the level required to achieve the central bank's objectives.

Nevertheless, some economists argue that the importance of monetary aggregates has not disappeared entirely, and that during periods of unusual developments in these aggregates—for example, around episodes in which the central bank purchases assets, particularly in a zero-interest-rate environment—they may contain useful information for policymakers. As shown below, no unusual developments occurred in these aggregates during the year.

Developments in 2025 and in previous years

During 2025, the monetary base increased slightly (Table 3.2, Column 0), similar to 2024. The M1 aggregate rose in 2025 (Table 3.2, Column 3), following the very moderate pace of increase observed in 2024. In nominal GDP terms, in the past two years the quantity of money has remained relatively stable, following a period of rapid expansion during the COVID-19 crisis and a subsequent sharp decline as the economy emerged from the crisis (Figure 3.15).

Figure 3.16 suggests the reason for the stability in the quantity of money this year. The figure presents the annual change in the Bank of Israel's policy rate (in logarithmic terms) and the annual change in the ratio of M1 to GDP (also in logarithmic terms). This ratio reflects the public's demand for liquidity. As expected, the figure shows a strong negative correlation between the rate of change in the policy rate and the rate of change in the M1-to-GDP ratio. In periods when the interest rate rises, the opportunity cost of holding cash and demand deposits also rises, and therefore the demand for them declines.

[34] Banks must maintain demand deposits at the Bank of Israel as part of their liquidity requirements.

[35] The monetary base is affected both by flows outside the Bank of Israel's control—such as government operations (since government accounts are held at the Bank of Israel)—and by flows under its control, such as foreign exchange and government bond purchases and the issuance of MAKAM (short-term Bank of Israel bills). The Bank absorbs or injects liquidity to meet the demand for the monetary base at the policy rate, adjusting the base in view of other liquidity flows through interest-bearing deposits offered to banks via auction (which are not included in the monetary base) and through MAKAM issuance.

For example, during the COVID-19 crisis, the interest rate fell to near zero and the demand for money increased sharply.[36] As the economy exited the crisis, the interest rate rose to 4.75 percent and the demand for money contracted accordingly. From then until the end of 2025, the interest rate declined only slightly, and therefore the demand for money remained relatively stable. The figure illustrates that, at business-cycle frequencies, developments in the quantity of money (in terms of GDP) mainly reflect the effect of the Bank of Israel's policy rate.

In parallel with the stability in M1, there was again this year—similar to the previous three years—a rapid increase in term deposits of up to three months (Table 3.2, Column 4). This development may reflect the public's growing awareness of the possibility of earning returns on interest-bearing deposits, including through money market funds, in view of the gap between the Bank of Israel's policy rate and the interest paid on demand deposits.[37]

Table 3.2 | Rate of change in the monetary aggregates, 2021–2025

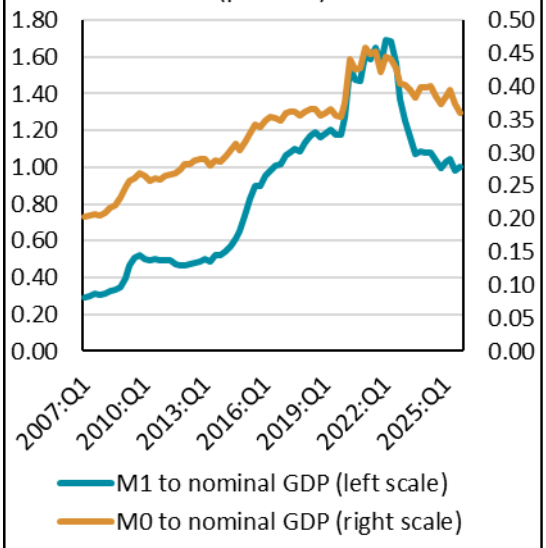
	0	1	2	1+2=3	4	5	6	3+4+5+6=7
	Monetary base[a]	Cash held by the public	Demand deposits	M1[b]	Term deposits up to 3 months	deposits of 3 months to 1 year	SRO[c]	Total[d]
	(Average in December compared with the average in the previous December)							
2021	12.6	6.9	25.2	22.0	-3.6	12.6	23.8	17.5
2022	3.0	6.0	-12.9	-10.0	34.6	85.0	-7.9	4.9
2023	1.6	8.8	-19.8	-14.6	24.9	17.3	-15.5	-3.1
2024	2.4	1.6	0.1	0.4	29.0	-6.3	7.1	6.6
2025	2.3	1.9	6.4	5.4	23.2	4.1	-13.2	6.2
	(Quarterly average compared with the average of the previous quarter)							
2025								
Q1	-1.7	-1.5	-1.1	-1.2	3.8	-1.3	-2.6	-0.2
Q2	2.4	2.2	0.7	1.0	4.0	0.3	1.0	1.7
Q3	0.5	-0.1	0.6	0.5	9.3	-0.1	0.5	2.8
Q4	0.1	0.1	6.7	5.2	5.7	0.4	-11.5	1.5

[a] Total banknotes and coins in circulation and demand deposits by the commercial banks with the Bank
[b] M1 = cash and demand deposits.
[c] Self-renewing overnight deposit - a liquid daily deposit.
[d] M1+SRO+unindexed deposits of up to one year.
SOURCE: Bank of Israel and Central Bureau of Statistics data.

[36] The demand for money tends to increase nonlinearly as the nominal interest rate—the opportunity cost of holding cash—approaches zero.
[37] For details on the public's shift from short-term deposits to money market funds and on the assets in which these funds invest, see Chapter 4.

Figure 3.15 | Ratio of M1 to the Monetary Base (M0) and to Nominal GDP, 2007:Q1–2025:Q4

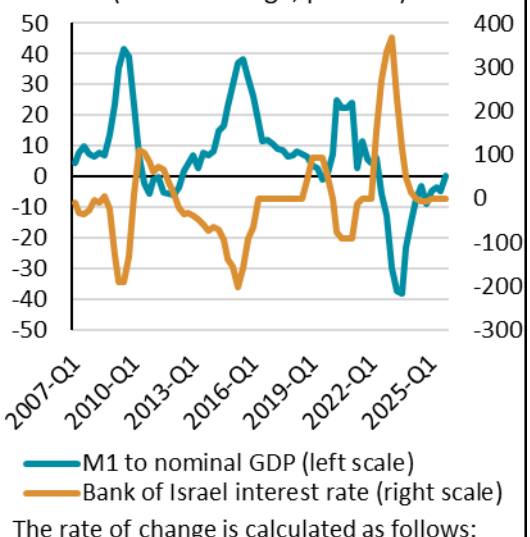
(percent)



SOURCE: Bank of Israel calculations.

Figure 3.16 | Ratio of M1 to Quarterly GDP and the Bank of Israel Interest Rate, 2007:Q1–2025:Q4

(rate of change, percent)



The rate of change is calculated as follows:

$100 \cdot (\ln(t) - \ln(t-4))$

SOURCE: Bank of Israel calculations.