Bank of Israel

Monetary Policy Report

Second Half of 2023

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According to the Bank of Israel Law, 5770–2010, the Bank of Israel has three objectives: (1) to maintain price stability, as its central goal. Price stability is defined as an annual inflation rate of between 1 percent and 3 percent; (2) to support other objectives of the government's economic policy, particularly growth, employment and reducing social gaps, provided that this support does not prejudice the attainment of price stability; and (3) to support the stability and orderly activity of the financial system.

Section 55(a) of the Bank of Israel Law, 5770–2010 regulates the publication of this report, which the Bank of Israel submits to the government and the Knesset Finance Committee twice a year. The report surveys the economic developments that took place during the period covered by the report. It also surveys the policy adopted in order to maintain the inflation rate within the range set by the government and to achieve the other objectives of the government's economic policy. The economy's financial stability is surveyed by the Bank of Israel in its Financial Stability Report.

In accordance with Section 55(b) of the Bank of Israel Law, 5770–2010, this Monetary Policy Report presents the reasons for the inflation rate's deviation from the target range set by the government for more than six consecutive months—from the publication of the Consumer Price Index for January 2022 (which was published on February 15, 2022) until the publication of the Consumer Price Index for November 2023, in the middle of December. The inflation rate during this period exceeded the upper bound of the target range, and the explanations for this are provided in Section 2 below ("Background Conditions from the Monetary Committee's Viewpoint).

The Monetary Policy Report for the second half of 2023 was prepared by economists in the Research Department, under guidance from the Monetary Committee. The report is based on data published up to the interest rate decision reached on January 1, 2024.

Abstract

Monetary policy: During the second half of 2023, the Bank of Israel kept the interest rate unchanged at a restrictive level of 4.75 percent. At the beginning of 2024, on January 1, the Monetary Committee decided to reduce the interest rate by 0.25 percentage points, to 4.5 percent. Until the outbreak of the war in early October, the policy had been operating in an environment of a depreciating trend of the shekel, against the background of increasing uncertainty regarding the impacts of the proposed legislative changes on the economy, alongside inflation that was above the target range. In the second part of the half-year, in view of the war that began on October 7, monetary policy focused first on stabilizing the financial markets, particularly the foreign exchange market, and in reducing the uncertainty, alongside maintaining price stability and supporting economic activity. Accordingly, the Committee implemented a program to sell foreign exchange, and pursuant to the Governor's decision, it also activated a plan to supply liquidity in the swap and repo markets. In addition, the Bank of Israel put into operation a focused program of monetary loans aimed at easing credit terms for small and micro businesses that were negatively impacted by the war. These steps came in addition to the broad framework promoted by the Banking Supervision Department to defer repayments on loans from banks and credit card companies to households.

Domestic real activity and the labor market: The third quarter of 2023 was characterized by some slowing of activity, while the labor market remained tight. At the beginning of the fourth quarter, the "Swords of Iron" War broke out, and its impacts were felt on both the supply and demand sides; a decline in current consumption, employee absences due to reserve duty and the closing of educational institutions; and a marked adverse impact on the construction and agriculture industries, as well as the tourism, entertainment, and leisure industries. Supply limitations alongside the marked decline of demand at the beginning of the war were reflected in a decrease of private expenditure and in a marked decline in the volume of business sector revenues. The most severe impact was on the food services and construction industries. There was some recovery in activity later in the quarter: Credit card expenditures returned to routine levels, and the level of mobility in the economy improved considerably. Flash surveys by the Central Bureau of Statistics also indicated a notable improvement in employment in all industries examined, particularly in view of the reopening of the education system. At the end of the half-year, some industries experienced a recovery in the job vacancy rate, which had declined significantly with the outbreak of the war.

The inflation environment: During the reviewed period, the year-over-year inflation rate moderated gradually, in both the tradable and nontradable components. At the time of the interest rate decision on January 1, 2024, the year-over-year inflation rate had declined to 3.3 percent (based on the CPI for November, which is what was known at the time), after having been 5.4 percent in January 2023. The annual growth rate of the core CPI (excluding fruit and vegetables and energy) declined to 2.9 percent. It appears that the war did not contribute to an increase in inflation in the immediate term. In contrast to previous security incidents, 1-year inflation expectations declined at the beginning of the war, but later returned to their prewar level. The interest rate path expected according to the Telbor curve declined during the reviewed period, and at the end of the period it indicated an interest rate of 3.4 percent in another year. This is in contrast to a level of 4.6 percent just before the war. After the decision that was reached at the beginning of January, the last decision covered by this report, the CPI for December 2023 was published, indicating that

the inflation rate was 3 percent in 2023. This means that the inflation rate entered the price-stability target range set in the Bank of Israel Law, against the background of the restrictive monetary policy as described in the report.

Exchange rate: With the eruption of the war, Israel's risk premium increased sharply, and the shekel depreciated markedly against the dollar and euro. In order to moderate the fluctuations in the exchange rate and to supply the liquidity required for the continued orderly activity of the markets, the Bank of Israel pre-empted the first trading day after the war broke out, and announced a program to sell up to $30 billion of foreign currency. Within the framework of that program, the Bank of Israel sold $8.2 billion in October and approximately $338 million in November. At the beginning of November, the trend reversed, and the shekel began to appreciate notably. This trend continued until the end of the reviewed period, so that at its end, the shekel was stronger than it was at the beginning of the period.

Fiscal policy: Against the background of the war, the deficit in the government budget increased in 2023, reaching 4.2 percent of GDP, compared to a surplus of 0.6 percent of GDP in 2022. The deficit in the updated 2024 budget is expected to be 6.6 percent of GDP, and the debt to GDP ratio is expected to increase to 66 percent at the end of 2024, from 60 percent of GDP just before the war. The war's costs on the defense and civilian expenditures side as well as the loss of revenues are estimated by the Research Department to be more than NIS 200 billion. On January 15, the government approved the updated government budget for 2024, which includes budget adjustments of NIS 17 billion for 2024 and 2025. However, the marked increase expected in expenditures, even after the adjustments, is liable to create inflation pressures in the short–medium term commitment to maintain price stability.

Financial stability: Equity indices in Israel increased in the third quarter of 2023, which was notable compared to the global trend. However, equity indices in Israel since the beginning of 2023 were characterized by significant underperformance compared to indices worldwide. The considerable uncertainty in the first days of the war were reflected in sharp declines in the prices of financial assets—stocks, corporate bonds, and government bonds—with increasing price volatility and a decline in liquidity levels. Most of the impacts dissipated after a short time, but market volatility remained high, as did the country's risk premium. In view of the war in Israel, two of leading ratings agencies announced that they are placing Israel's credit rating on a "negative outlook" and the S&P rating agency decided to downgrade its credit rating outlook. During the reviewed period, the credit balance increased slightly only for large and medium companies—further to the trend that began before the outbreak of the war. After the war broke out, the Monetary Committee announced a monetary program focused on easing the terms of credit for small and micro businesses that had been adversely impacted by the war. With regard to financial risks, the construction and real estate industry should be given particular emphasis, as even before the war it was dealing with rising financing costs and a marked decrease in demand, alongside a moderate trend of price declines. With the outbreak of the war, most construction sides closed due to the absence of Palestinian workers. Credit to the construction and real estate industry makes up approximately 38 percent of total bank credit and about 44 percent of the tradable corporate bond balance, so the construction companies' ability to deal with the high financing costs alongside a decline in their revenue has an important impact on the performance of the financial system.

The housing market: During the reviewed period, the increase in home prices halted, and they began to decline. For the first time since 2018, the annual rate of increase in home prices was negative, at -1.3 percent. This is in contrast to the parallel figure of 9.8 percent at the end of the previous half-year, and the peak of 20 percent that was reached in September 2022. The halting of the price increase was accompanied by a sharp decline in mortgage volume and in the number of transactions. There was a similar trend in the development of rent prices—with declines of 0.3 percent in October and 0.8 percent in November, for the first time in two-and-a-half years. However, in contrast to home prices, the annual rate of increase at the end of the period is still positive, although it moderated to 3.9 percent.

The global economy: In the second half of 2023, central banks slowed the pace of interest rate increases, and it currently appears that the cycle of interest rate increases has reached its end—partly in view of the continued moderation in inflation. The interest rate path expected by the markets declined markedly, and according to it, several interest rate reductions are expected during the course of 2024. However, even at the end of the reviewed period, inflation levels in major blocs remained higher than major central banks' targets, mainly because of the continued demand pressures in the services industries. Economic activity in the major economies moderated, and in the background, there was continued weakness in the global manufacturing sector and in world trade. Major equity indices worldwide increased sharply, led by big technology companies. With that, trading was volatile against the background of high uncertainty, partly due to the continuation of tight monetary policy and concern over its ramifications on real and financial activity.

The Research Department staff forecast: The Research Department published three scheduled forecasts during the reviewed period, alongside the interest rate announcements in July 2023, October 2023, and January 2024. In addition, another, unscheduled, forecast was published in November 2023, with some clarification of the uncertainty that prevailed when the October forecast was being compiled, which was only about 2 weeks after the outbreak of the war. Based on the forecast published at the beginning of January, GDP is expected to grow by 2 percent in each of 2023 and 2024, as in the November forecast, and by 5 percent in 2025—so that the output gap is expected to close during that year. The broad unemployment rate among the prime working ages (25–64) is expected to average 5.3 percent in 2024 and 3.2 percent in 2025. The annual inflation rate over the 4 quarters of 2024 is expected to be 2.4 percent, and during 2025 it is expected to be 2 percent.

1. Policy measures

In its decision on the interest rate on January 1, 2024, the Monetary Committee decided unanimously to lower the interest rate by 0.25 percentage points to 4.5 percent. This came following the previous half-year in which the Bank of Israel left the interest rate unchanged at the restrictive level of 4.75 percent, with the aim of returning inflation to a price stability environment—in accordance with the target and taking into account the variety of policy objectives. This measure came after a reverse trend during the first half of 2023, in which the interest rate increased by 1.5 percentage points, completing a cumulative increase of 4.65 percentage points since April 2022. Looking forward, the Monetary Committee announced that the interest rate path would be determined in accordance with the continued convergence of inflation to the target, continued stability in the financial markets,

economic activity, and fiscal policy. The downward path of the interest rate as assessed by the Research Department is more moderate than the market's assessment, in view of the expected fiscal expansion (Figure 1).

During the first part of the reviewed period, the Monetary Committee operated in an environment of depreciation of the shekel, in view of the effects of legislative changes on the economy, alongside inflation that was above the target. The uncertainty that was created by proposed legislative changes was partly reflected in excess depreciation of the shekel and in underperformance of the Israeli equity market (Figure 9). The Research Department's forecasts during that period reflected the potential economic price of the changes, and an International Monetary Fund report also pointed to the damage from continued uncertainty over time.

During the second part of the period, in view of the war that broke out on October 7, the Monetary Committee operated first and foremost to prevent a negative impact on financial stability, and chose to use a combination of monetary tools to deal with the various challenges. On the very first trading day after the outbreak of the war, the Committee activated a program to sell foreign exchange, and the Governor decided to also activate a program to provide liquidity to the swap and repo markets. In addition, the Bank of Israel activated a targeted program of monetary loans in order to ease the terms of credit for small and micro businesses that were harmed as a result of the war. These measures came in addition to the broad program advanced by the Banking Supervision Department to defer household loan repayments to banks and credit card companies. In the November interest rate decision, the Monetary Committee announced that insofar as stability in the financial markets becomes entrenched and the inflation environment continues to moderate toward the target range, monetary policy would be able to focus more on supporting economic activity (Figure 1).

In the January 2024 interest rate decision, the Monetary Committee believed that the conditions had become right to lower the interest rate in accordance with its announcement in the November decision. Stability in the financial markets had become entrenched, and the inflation environment continued to moderate toward the target range. An analysis of the inflation dynamic, measured both quarterly and semiannually, showed that the pace of inflation had moderated, and inflation expectations from various sources were that inflation would enter the target range in the first quarter of the year. The financial markets were also recovering following the declines at the beginning of the war.

Monetary policy during the reviewed period, and particularly since the outbreak of the war in early October, focused on maintaining stability in the markets, with concern over price stability and supporting activity. The main concern during the period was a lack of stability in the financial markets, particularly the tremendous volatility in the foreign exchange market—depreciation of the shekel in view of the legislative changes, which intensified when the war broke out. Beyond that, the war's effects on activity, particularly on supply and demand, as well as on inflation, were an important consideration in determining policy. As such, the Committee reviewed the channels of the war's impact and the extent of the impact on supply alongside the decline in demand. In particular, the Committee examined the lack absence of workers due to the broad mobilization of reserve soldiers and due to the shutdown of the education system; the impact to physical capital and the ability to work in threatened areas; the impact to various industries, such as construction, agriculture, trade, and tourism and leisure services; the impact to labor productivity; and the impact of significant uncertainty and of the increased risk premium on investments in the economy. In addition to the depreciation, supply-side limitations due to the war may also lead to price increases. Against that, lower demand should moderate inflation in various industries. The Committee members' assessment was that the policy tools that were used during the reviewed period were consistent with the commitment to return inflation to the target, while considering all factors.

The Monetary Committee's policy decisions following the outbreak of the war took various considerations into account. The war's impact on GDP, the concern over business collapses, and the need to provide available credit at low interest in order to rehabilitate parts of the economy and assist businesses and households were considerations that supported lowering the interest rate. Against those, the main consideration—returning stability to the markets, particularly the foreign exchange market—and the inflation rate that had been higher than the target for a prolonged time, combined with the significant depreciation of the shekel that intensified at the beginning of the war and contributed to a further increase in inflation, supported leaving the interest rate in place. In weighing these considerations, the Monetary Committee decided on a number of steps. In July, September, October, and November, the Committee decided unanimously to leave there monetary interest rate unchanged in order to maintain stability and certainty in the markets. In the January 2024 decision, the Committee decided to lower the interest rate as stated (Figure 1). Following the outbreak of the war, the Committee also decided to activate targeted monetary tools to ease the liquidity difficulties of households and businesses by supporting the supply of inexpensive credit to small businesses and deferring loan repayments for households harmed by the war.

As a main step to maintain stability of the markets, on October 9, before the first trading day following the outbreak of the war, the Bank of Israel announced a program to sell foreign exchange totaling up to $30 billion, from the foreign exchange reserves that totaled about $200 billion (about 40 percent of GDP). This was in order to moderate the volatility in the shekel exchange rate and to provide the necessary liquidity for the continued orderly operation of the financial markets. In addition, the Bank of Israel announced the activation of swap mechanisms in the foreign exchange market totaling up to $15 billion as needed, as well as a program of repo transactions against government and corporate bonds, the aim of which was to provide shekel liquidity to institutional investors and mutual funds. This was in view of the sharp declines in the equity indices and the increases in long-term government bond yields and corporate bond spreads. By the end of October, in view of the Bank of Israel's activity in the foreign exchange market and assessments that the war would not expand to additional fronts, the shekel stabilized and even continued to strengthen significantly until the end of the period.

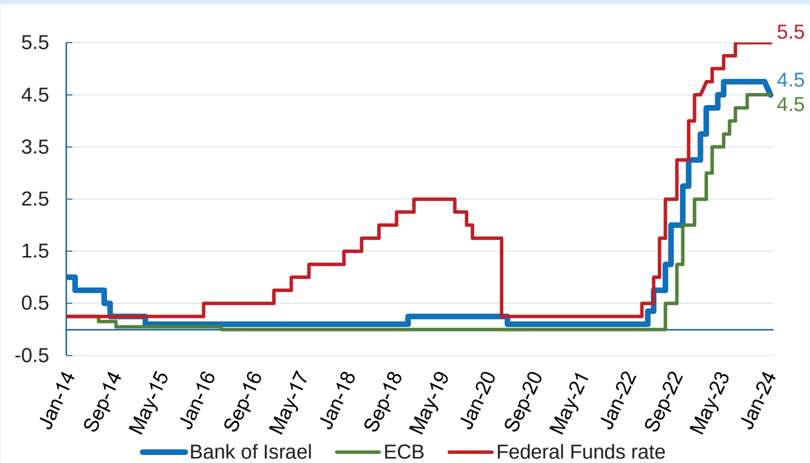
On October 15, the Banking Supervision Department published a broad program to defer loans for households.[1] The commercial banks adopted the program, and a large majority of them even expanded it. The broad program was intended to ease the burden of credit and fees for households and businesses

1 This is not the measure decided upon by the Monetary Committee, but the Banking Supervision Department is under the responsibility of the Governor, who is the Chairman of the Monetary Committee. The Monetary Committee took this measure into account when setting out its policy during the period, and it is one of the complementary measures adopted by the Bank of Israel. Among other things, these measures enabled the Monetary Committee to avoid lowering the interest rate in its October and November 2023 decisions, by providing targeted assistance to population groups impacted by the war.

located and operating within a range of 30 kilometers from the Gaza border, civilians who had been evacuated from their homes, those mobilized for emergency reserve duty, and those who are first-degree relatives of people killed, kidnapped, or missing during the war. It relates to the deferral of payments on loans in three activity segments (mortgages, consumer credit, and business credit), current account overdrafts, and fees. According to the program, loans for these groups will be deferred without interest or fees. Other bank customers will be given the option to defer loans for 3 months, with the deferred payments bearing interest that shall not exceed the interest rate in the loan contract, and those payments being added on to the end of the loan period. The deferral is to be done without fees. The Monetary Committee noted that the program will make it easier for households, and will reduce their financial uncertainty. On November 6, the program was expanded to include residents of the north of the country. Toward the end of the program's 3-month period, on December 17, it was extended for a further three months, and was expanded to include additional population groups that would now be eligible for the benefits.

On November 6, the Bank of Israel announced a targeted monetary program to ease the terms of credit for small and micro businesses that were harmed as a result of the war. The Monetary Committee decided to activate a program to support the supply of credit to small and micro businesses, totaling up to NIS 10 billion, which would be utilized in respect of credit to be issued until the end of January 2024. As part of the program, the Bank of Israel would provide the banking system with monetary loans for a period of two or three years at variable interest—the bank of Israel interest rate minus 1.5 percentage points. These loans would be provided against loans that the banks would provide to small and micro businesses whose turnover declined by at least 25 percent as a result of the war, and on condition that the average interest rate on loans to those businesses would not exceed the prime interest rate. On November 21, this measure was expanded to include nonbank credit providers in order to further ease the terms of credit for small and micro businesses. On November 19, measures were published to advance the payments market. These included raising the ceiling for depositing checks, and more.

Figure 1
Bank of Israel Interest Rate, Federal Funds Rate, and ECB Interest Rate
January 2014–January 2024 (percent)



SOURCE: Bank of Israel calculations.

All of these measures were intended to assist small and micro businesses, as well as households, in getting through this challenging period until they could return to normal activity.

At the time of the July 2023 interest rate decision, annual inflation had declined from 5 percent to 4.6 percent, and the CPI for May was lower than forecast.[2] In addition, there were increased signs pointing to a trend of moderating inflation. Activity remained high, and National Accounts data for the first quarter had been revised upward and pointed to a relatively high level of growth. The labor market remained tight, and the employment and labor force participation rates were at record high levels. With that, the most recent data of current indicators continued to point to moderation. There were also signs of moderation in the labor market. These included a downward trend in the job vacancy rate, particularly in the high-tech sector. The Monetary Committee discussed developments in the housing market, particularly the moderation of the volume of transactions and of new mortgage borrowing. The pace of increase in home prices in the past 12 months continued to decline, and from the beginning of the year, prices remained unchanged. In contrast, the owner-occupied housing services item in the Consumer Price Index continued to increase. The Committee also discussed the Research Department's macroeconomic forecast, and noted that the main risk to the forecast was the realization of a scenario in which legislative and institutional changes would be accompanied by an increase in the country's risk premium.

At the end of the discussion, four members of the Committee were of the view that the interest rate should be left at its level of 4.75 percent, and one member believed that it should be raised by 0.25 percentage points to 5 percent. The Committee members emphasized that there was a reasonable likelihood of further interest rate increases in the coming decisions, should the inflation environment not continue to moderate as expected.

At the time of the September 2023 interest rate decision, the annual inflation rate had continued to moderate, and had declined to 3.3 percent in the July CPI reading—the most recent figure to date. The Monetary Committee noted that the sharp decline in the annual rate of inflation also reflected the impact of the most recent figure from the July CPI, and that it was possible to assume that following the publication of the next CPI reading, the inflation rate in the coming months could be expected to be higher. The Committee's assessment was that the process of monetary tightening and moderation of demand in Israel and globally were acting to moderate inflation, and that inflation expectations and forecasts for one year and beyond were within the target range. The depreciation of the shekel remained a significant factor delaying the convergence of inflation back into the target range. The global inflation environment had moderated in many countries, but remained above the central bank targets. However, the core indices mostly remained "sticky". The Committee members discussed data on economic activity and the labor market. In the second quarter of 2023, the economy grew at an annual rate of 3 percent, the GDP level was higher than the trend line from before COVID-19, the labor market was in full employment, and real wages were increasing. However, at the time of this decision as well, there were signs of moderation in the labor market, including a downward trend in the job vacancy rate, mainly in the high-tech sector. The Committee discussed developments in the housing market, particularly the continued decline in home prices and the continued moderation in the volume of transactions and of new mortgage borrowing.

2 The decision was made on July 10. The most recent annual inflation figure available at that time was the figure for May.

At the end of the discussion, all of the Committee members were of the view that the interest rate should be left at its level of 4.75 percent. The Committee believed that economic activity in Israel was high and that it was accompanied by a tight labor market, despite some moderation in a number of indicators. Inflation was still broad and high, while in recent months there was an apparent slowing trend. The Committee therefore decided to leave the interest rate unchanged, but saw a reasonable likelihood of continued interest rate increases in its future decisions.

At the time of the October 2023 interest rate decision, which was made about two weeks after the outbreak of the Swords of Iron war, the Committee members agreed that in view of the war, policy at this stage must be focused on stabilizing the financial markets and reducing uncertainty. The Committee discussed the economic situation prior to the beginning of the war. The Israeli economy featured a low debt to GDP ratio, high foreign exchange reserves, and a current account surplus. Economic activity was strong, despite moderation in the pace of growth, and the labor market was tight an in a full employment environment, with a very low unemployment rate. The Committee members noted that these conditions at the start of the war improved the economy's ability to deal with the consequences of the war.

The Committee discussed the effects on the financial markets, particularly on the foreign exchange market, in view of the sharp depreciation of the shekel at the beginning of the war. In order to stabilize the markets, on October 9 the Bank of Israel announced a program to sell foreign exchange, as well as the activation of swap mechanisms in the foreign exchange market and a program of repo transactions against government and corporate bonds.

The expected effects of the war on economic activity, both on supply and on demand, were also discussed. The channels of the effect include the absence of workers, harm to physical capital and the ability to work in threatened areas, harm to various industries (due to mental effects as well), and the effect of significant uncertainty and of the increase in the risk premium on investments in the economy. The Committee noted that the intensity of the war's effect would increase if a greater part of the economy would be affected for a longer period of time, and that there was tremendous uncertainty regarding the duration and impact of the war.

The Committee also discussed the inflation environment and the war's impact on it. The annual inflation rate in September was 3.8 percent, which is higher than the target range. In addition, the Committee discussed the developments in the housing market prior to the war and the war's ramifications on the construction industry. They noted that activity in the construction industry was harmed as a result of the war, due to the lack of workers and the closure of building sites by local authorities. At the end of the discussion, all of the Committee members were of the view that the interest rate should be left unchanged at 4.75 percent.

At the time of the November 2023 interest rate decision, almost 8 weeks after the outbreak of the war, the Committee's assessment was that the war would have significant economic consequences, both on real activity and on the financial markets. The indicators of economic activity pointed at first toward contraction of business activity in the economy, but then showed a gradual recovery.

The Committee noted that there was a great amount of uncertainty with regard to the severity and duration of the war, and that this was affecting the extent of the impact on activity. The Committee discussed the fact that while the volatility in the markets had moderated and the financial markets were operating properly, the economy's risk premium remained high. Data regarding the labor market showed a significant decline in labor input in October. According to a flash survey by the Central Bureau of Statistics, which was conducted due to the war, the absence of workers was the main constraint on business sector activity in October, but reports for November were already indicating an easing of this constraint. The most significant impact according to the flash surveys was in the food services and construction industries. The Committee members also discussed developments in the inflation environment, as well as the significant volatility in the foreign exchange market. Following the sharp depreciation in the first weeks of the war, there was a significant appreciation, and the shekel exchange rate passed its prewar level. Following the discussion, all of the Committee members were of the view that the interest rate should be left unchanged at 4.75 percent, and noted that insofar as the recent stability in the financial markets becomes entrenched and the inflation environment continues to moderate toward the target range, monetary policy would be able to focus more on supporting economic activity.

At the time of the January 2024 interest rate decision, the Monetary Committee decided to lower the interest rate by 0.25 percentage points to 4.5 percent. The Committee noted that the is having significant economic consequences on real activity. There was a great amount of uncertainty regarding the expected severity and duration of the war, which was in turn affecting the extent of the impact on activity. In the January 2024 decision, the Committee believed that the conditions had become right to lower the interest rate in accordance with the Committee's announcement in November. The stability of the financial markets had become entrenched and the inflation environment continued to moderate toward the target range. The pace of inflation continued to decline, even when analyzing the inflation dynamics in quarterly and semiannual measurement. Expectations from various sources were that inflation would converge to the target range during the first quarter of the year. The financial markets had recovered following the declines at the beginning of the war.

The indicators of economic activity and the employment situation indicated a gradual recovery following the sharp declines at the outset of the war, but with a high level of variance between industries. It was noted in that in the previous 12 months, the Index of Home Prices declined by 1.3 percent. The volume of activity in the housing market continued to moderate, and there were difficulties in activity in the industry in view of the war. In the credit market, the slowing trend of bank credit to businesses and households continued, in parallel with the general slowdown in economic activity. Globally, economic activity and inflation in the major economies moderated. In the background world trade continued to show weakness, assessments were that central banks would start a process of monetary accommodation during 2024.

The Committee announced that in view of the war, the Monetary Committee's policy is focusing 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 continued convergence of inflation to its target, continued stability in the financial markets, economic activity, and fiscal policy.

2 Background conditions from the Monetary Committee's point of view

The beginning of the reviewed period was characterized by significant political instability, including widespread demonstrations in view of the legislative changes being advanced by the government. The second part of the period was significantly influenced by the Swords of Iron war, which began on October 7, 2023 with a surprise attack launched against civilians and security personnel in the Gaza proximity area, which led to a very large number of killed, wounded, and kidnapped, and to widespread damage to property. Following security incidents along the northern border, there was increasing concern of a further outbreak of war in that region. A very high number of reserve forces were mobilized to the south and north of the country, and residents of the confrontation areas in both regions were evacuated from their communities.

The Swords of Iron war continued at high intensity until the end of the reviewed period. The Gaza Strip was the main combat zone, but fighting continued at lower intensity along the northern border, with an escalation in attacks by Houthi rebels from Yemen against free shipping in the Red Sea. Communities in the Gaza proximity area and along the northern border remained empty throughout the entire fourth quarter of 2023, following the evacuation of about 126,000 residents. The IDF continued to maintain significant reserve forces. Until the end of the period, the war cost the lives of about 1,300 Israelis, about 460 of whom were IDF soldiers. Until the end of the period, 110 kidnapped victims were returned to Israel, and 11 bodies were extracted from Gaza. 129 kidnapped victims remain in Gaza, 21 of whom have been declared dead.

a. Real economic activity in Israel and the labor market

In the third quarter of the year, prior to the war, the macroeconomic picture showed some slowing of activity, and the labor market remained tight. GDP in the second quarter increased by 3.1 percent. The GDP level remained above the level derived from the pre-COVID trend, but the positive deviation narrowed. There were signs of continued weakness in exports and in imports in the third quarter (Table 1). Foreign trade data indicated a continued decline in goods exports and in imports in July and August, while services exports continued to increase, but at a lower rate than in May-June, and similar to the second quarter overall (Table 2). The labor market remained tight in the third quarter. Real wages in continued to converge with the trend in July, as the pace of increase in nominal wages of Israeli workers in the previous 12 months increased by about 6 percent. Flash estimates for August indicated a slight decline in the annual pace of nominal wage increases. At the beginning of the second half, there was a cooling in the surplus demand for workers (job vacancies) in all business sector industries. While employment continued to increase, the job vacancy rate declined, which showed a slow convergence toward the rates that were prominent before COVID-19 from the high rates that were prominent afterward, as well as a weakening of the surplus demand for workers as a factor pushing wages higher (Figure 2). With regard to the state of the economy prior to the war, revised National Accounts data showed that in the third quarter, the economy grew by 2.5 percent (a downward revision from 2.8 percent in the previous estimate), representing a slower-than-expected convergence of the GDP level to its trend (Table 1).

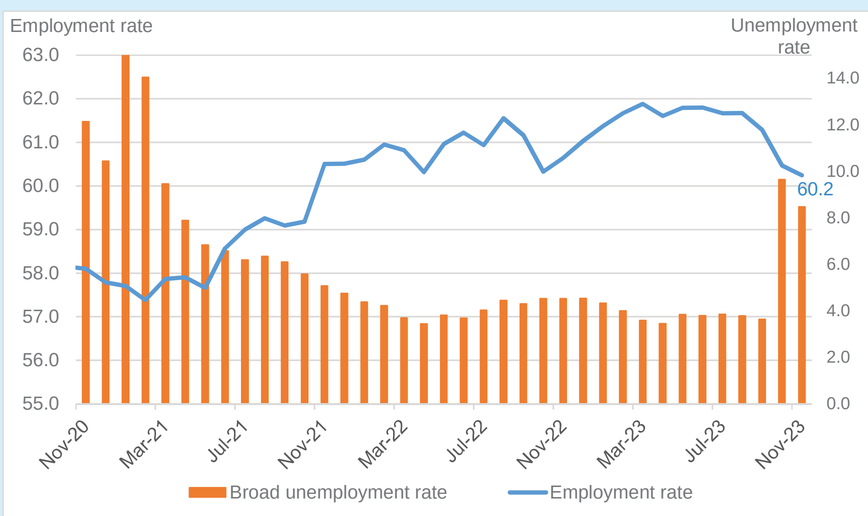
With the outbreak of the war in early October, these were the main channels of the war's direct economic impact:

- An impact on current consumption during the war – which was felt in a decline in credit card purchases.
- The absence of workers from their jobs due to mobilization of the reserves, as well as concern about leaving home and the closure of educational institutions.
- The destruction of buildings and infrastructure in localities that were hit by rocket fire or terrorist attacks.
- A continued impact to labor in the construction industry.
- A continued impact to the tourism, leisure, and recreation industries.
- A continued impact to labor in the agriculture industry due to the departure of foreign workers from Israel.

When the war began, there was a significant impact to economic activity as shown by various indicators. However, later on these indicators pointed to a clear recovery, although it was gradual and did not encompass all activity components. The indicators of economic activity in October pointed to a sharp contraction of business activity. The impact to the supply side was due to the absence of many workers due to their mobilization for reserve duty, the evacuation of residents from areas that had been hit or that were at risk, and the partial operation of the education system, which forced many parents to remain at home. (According to an emergency survey, about one-fifth of all employes in the economy were absent from work.) The decline in economic activity on the demand side was due to a high level of economic and security uncertainty and a negative impact to the incomes of some households. At the beginning of the war, the decline in demand was expressed in a decline in private consumption, as reflected in the volume of credit card purchases. In October, credit card purchases of most products declined, excluding the purchase of essential items, where there was a jump for a short period. In November, credit card purchases recovered in most industries, although they had not yet returned to the level that was prevalent prior to the outbreak of the war (with the exception of food). The decline in activity was reflected in a decline in the volume of business sector revenue—by an average of at least 16 percent compared with October of the previous year. The greatest impact was felt in the food services and construction industries, which, according to a Central Bureau of Statistics emergency survey, suffered from a serious shortage of workers due to the absence of Palestinian laborers and foreign workers. The uncertainty and risk of default were greatest in the construction industry. The Business Tendency Survey also showed that the strongest impact was felt in the construction industry, where activity declined to below the level of the first lockdown during the COVID-19 period. The supply of labor in the agriculture industry was also hit hard for the same reasons, as well as due to the fact that a considerable part of the country's agricultural land is within the threatened areas. The lowest impact to revenue was in the high-tech industry, where the decline in the number of workers was also minimal (since the ability to work from home is greater in high-tech than in other industries). However, a survey by the Innovation Authority, conducted at the beginning of October, shows that the security situation's impact on the high-tech industry was due not only to a shortage of workers, but also to an impact to the implementation of financing and investment agreements. This problem is more serious in companies that must now raise funds, due to the difficulty in meeting with investors. October data did not show significant changes, and are in line with the prewar trends—a decline in imports and stability in exports (Table 2).

As stated, the data that were available at the end of the period pointed to a gradual recovery of economic activity and of employment, following sharp declines at the beginning of the war. However, there is tremendous variance in the recovery between industries. Credit card expenditures returned to their normal levels. The level of mobility in the economy improved, and reached about 85 percent of its normal level on public transit, and a number of private transit indicators show a level that is very close to normal. The daily number of new applicants at the Employment Service remains high, after it jumped to about 10,000 at the beginning of the war, but it is in a downward trend. According to data available at the end of the period, the number averages about 2,000 per day. Analyses of the Central Bureau of Statistics flash surveys also pointed to a considerable improvement in employment in all industries that were examined, particularly in view of the reopening of the education system. In addition, the job vacancy rate recovered in November, after declining significantly in some industries at the beginning of the war. Fourth quarter data have not yet been published, but the comprehensive nowcast index signals a decline of about 16 percent in GDP (in annual terms) in the fourth quarter of the year.

Figure 2
Unemployment and Employment Rates, Age 15+
November 2020–November 2023 (percent)



SOURCE: Based on Central Bureau of Statistics.

Table 1

National Accounts data available at the time of the interest rate decision

(seasonally adjusted, quantitative rate of change from the previous period, annual terms)

		31/3/23	30/4/23	31/5/23	30/6/23	31/7/23
GDP	2022:Q3	2.1	1.7	1.8	1.8	1.8
	2022:Q4	5.8	5.6	5.3	5.3	5.3
	2023:Q1				2.5	3.1
Business output	2022:Q3	1.2	0.7	0.8	0.8	0.8
	2022:Q4	7.3	6.9	6.4	6.4	6.4
	2023:Q1				3.3	3.8
Private consumption	2022:Q3	-1.2	-1.3	-1.4	-1.4	-1.4
	2022:Q4	10.6	10.1	10.2	10.2	10.2
	2023:Q1				-1.7	-1.7
Fixed capital formation	2022:Q3	14.0	13.6	13.4	13.4	13.4
	2022:Q4	4.8	3.2	-0.9	-0.9	-0.9
	2023:Q1				14.7	15.3
Exports excl. diamonds and startups	2022:Q3	3.7	3.3	3.8	3.8	3.8
	2022:Q4	-7.9	-8.4	-6.5	-6.5	-6.5
	2023:Q1				0.4	3.1
Civilian imports excl. ships, aircraft and diamonds	2022:Q3	-4.1	-4.0	-3.9	-3.9	-3.9
	2022:Q4	0.8	0.0	0.3	0.3	0.3
	2023:Q1				-8.1	-9.9

SOURCE: Based on Central Bureau of Statistics.

Table 2

Development of GDP, imports, and uses

(seasonally adjusted, quantitative rate of change from the previous period, annual terms)

	2020	2021	2022	2021:Q4	2022:Q1	2022:Q2	2022:Q3	2022:Q4	2023:Q1
GDP	-1.9	8.6	6.5	19.4	-3.1	6.4	1.8	5.3	3.1
Business sector output	-2.4	10.3	7.8	22.9	-2.4	8.4	0.8	6.4	3.8
Civilian imports excl. ships, aircraft and diamonds	-7.2	18.2	12.1	28.3	14.0	9.9	-3.9	0.3	-9.9
Private consumption	-7.9	11.1	7.7	16.2	1.5	8.6	-1.4	10.2	-1.7
of which : excl. durables	-8.6	10.4	7.6	24.0	2.5	3.8	-0.2	7.4	0.3
Public consumption	2.8	4.2	0.7	9.6	-9.9	2.6	5.8	2.7	1.9
of which : excl. defense imports	2.6	3.7	1.1	12.6	-11.3	3.8	2.0	11.5	-3.2
Gross domestic investment	1.2	12.6	12.4	22.5	14.9	-3.4	19.6	2.9	-3.5
of which : fixed capital formation	-3.9	11.7	9.0	18.0	-0.1	7.1	13.4	-0.9	15.3
Exports excl. diamonds	-1.9	13.3	9.2	32.0	-6.0	16.8	2.4	-8.3	3.3
of which : excl. startups	0.2	11.8	9.2	25.7	0.6	13.5	3.8	-6.5	3.1

SOURCE: Based on Central Bureau of Statistics data.

b. The inflation environment

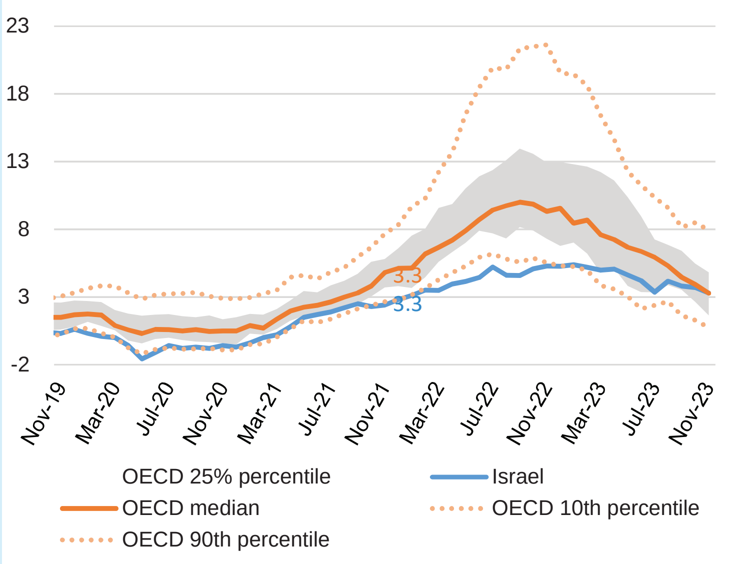
Annual inflation moderated gradually during the reviewed period, both the tradable and nontradable components, but remained higher than the upper bound of the target range. Following the decision reached at the beginning of January, the final decision reviewed in this report, the CPI reading for December 2023 was published. With that reading, the inflation rate for 2023 totaled 3 percent. This means that the inflation rate entered the price stability target range set in the Bank of Israel Law, in view of the restraining monetary policy as outlined in this report.

Following the outbreak of the war, there was further moderation in the general inflation rate, the core indices, and various partial indices. Inflation expectations to the various terms and from the various sources ranged within the inflation target, close to the upper bound. During the reviewed period, the pace of inflation moderated. Inflation in the past 6 months, and even more so in the past three months (in annual terms, seasonally adjusted), was lower than the annual pace, both in terms of the prices of tradable goods and in terms of the prices of nontradable goods. The moderating trend of inflation in Israel took place in parallel with the similar trend in many other countries (Figures 3a and 3b).

In the first part of the reviewed period, monetary tightening and moderation of demand in Israel and abroad worked to moderate inflation, while the interest rate was in a restraining environment. The depreciation of the shekel remained a significant factor delaying the convergence of inflation to within the target range, and contributed to an increase in the pace of inflation.

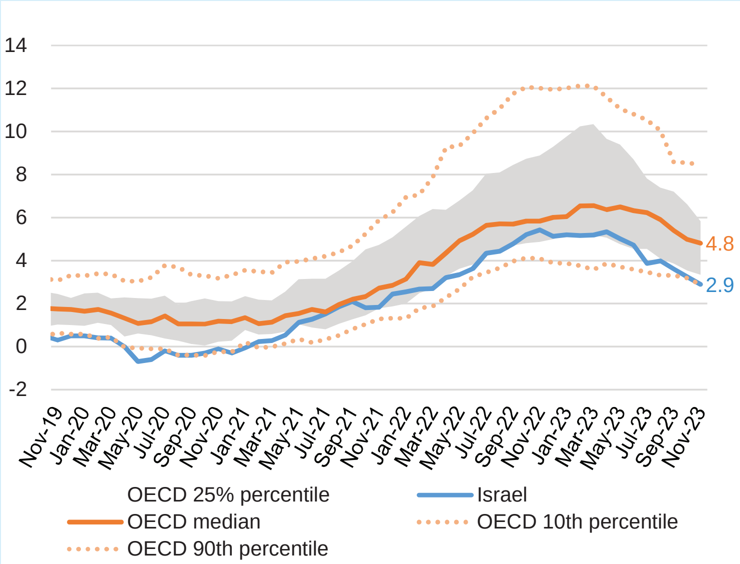
At the time of the decision reached at the beginning of January, the pace of annual inflation had fallen to 3.3 percent (according to the November CPI reading, which was the most recent reading available at the time), and it seems that the war has not led to an increase in inflation in the immediate term. After the annual inflation reading of January 2023 was 5.4 percent, it declined to 4.6 percent by May—the most recent figure available at the end of the previous half-year (Figure 3a). The annual pace of increase of the core index (excluding fruits and vegetables and energy) also declined, to 2.9 percent (Figure 4). The effect of the war on the different components of the Index varied. Thus, there were price declines in the rents component in October–November, after it had increased for a prolonged period, and there was a relatively anomalous decline in the transport component (led by flights) in November. In contrast, other components, such as food, showed a relatively anomalous increase in November (compared with November in previous years). The nontradable component led the CPI increase, but moderated gradually during the reviewed period, with a similar development of its components, reaching 3.8 percent in November. The tradable component featured a high level of volatility, and during the reviewed period, the pace of its annual increase continued to moderate, reaching 2.4 percent in November (Figure 5).

Figure 3a
Annual Inflation, Israel and the OECD
November 2019–November 2023 (percent)



SOURCE: Based on OECD.

Figure 3b
Inflation Excluding Food and Energy, Israel and the OECD
November 2019–November 2023 (percent)

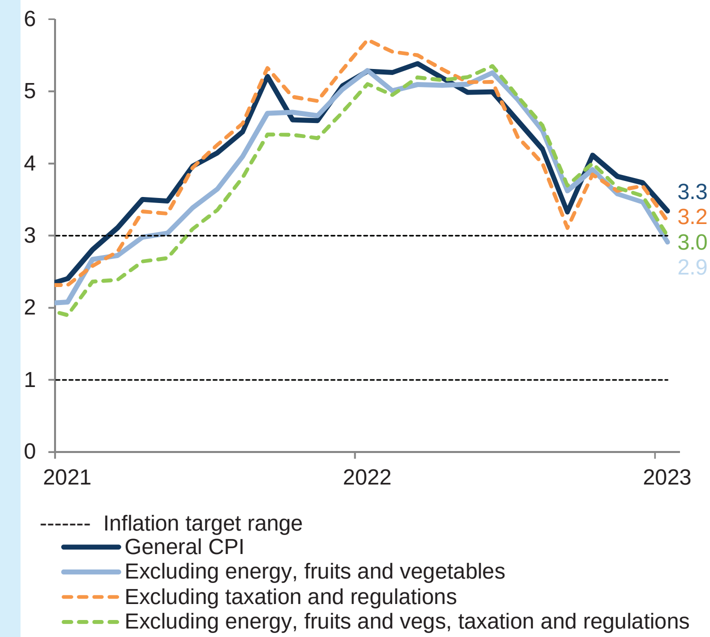


SOURCE: Based on OECD.

Figure 4

CPI - General, Excl. Fruits and Vegetables and Energy, and Excl. Taxation and Regulations

November 2021–November 2023 (percent)

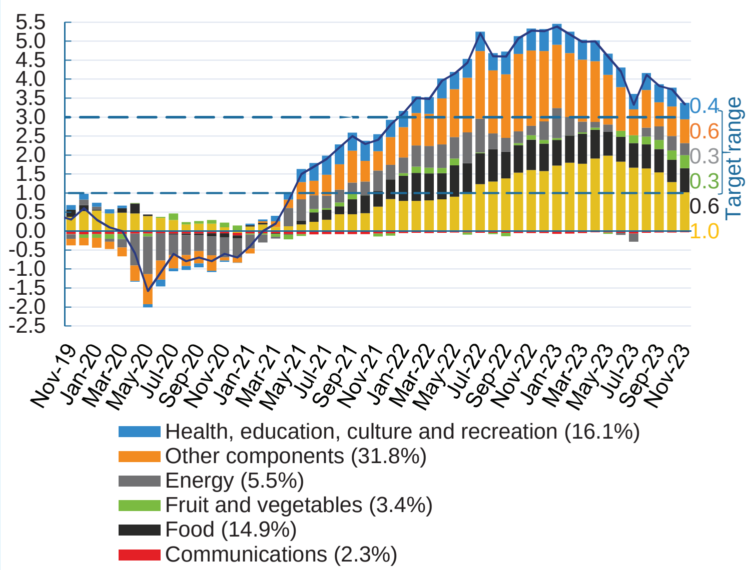


SOURCE: Based on Central Bureau of Statistics.

Figure 5

Main CPI Components' Contribution to Inflation[1,2]

November 2019–November 23 (percent)

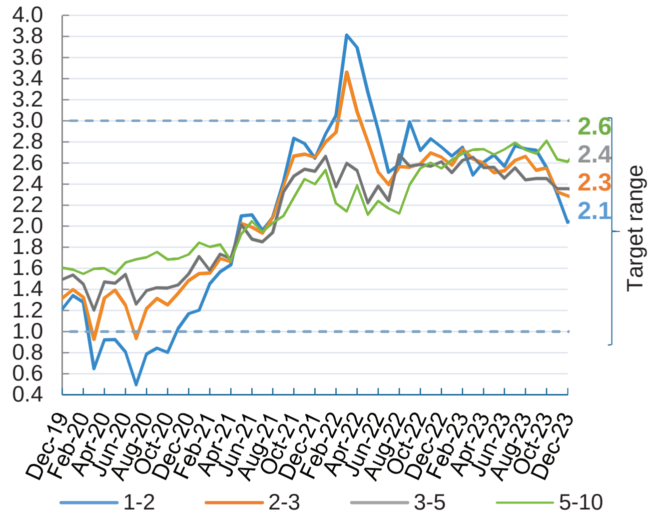


[1] The component's weight in the overall CPI (as of 2021) appears in parentheses.
[2] "Other components" includes furniture and household equipment, clothing and footwear, miscellaneous, household maintenance, and transportation - minus subcomponents having to do with energy prices.

SOURCE: Based on Central Bureau of Statistics data.

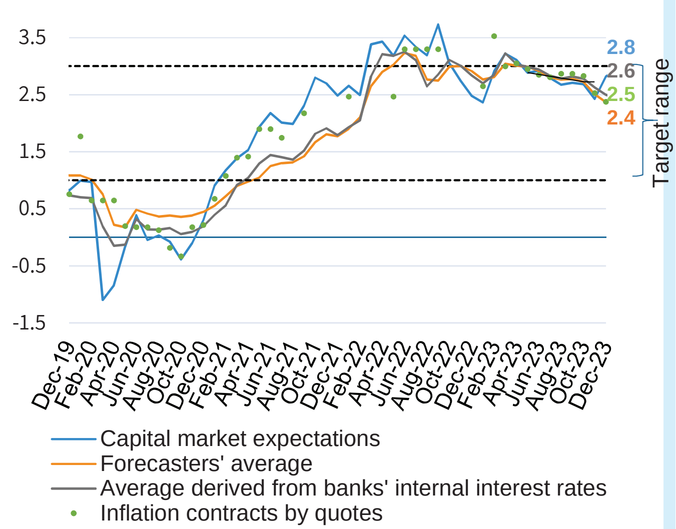
One-year inflation expectations derived from the capital market, which declined with the outbreak of the war, returned to their prewar levels, while one-year forward expectations remained lower than their prewar levels. The expected path of inflation according to the average of forecasters' projections for the coming 12 months also declined during the period, and even more so in the fourth quarter of 2023 (Figures 6 and 7).

Figure 6
Forward Inflation Expectations from the Capital Market[1]
December 2019–December 2023 (percent)



[1] Monthly averages, annual ranges.

Figure 7
One-Year Inflation Forecasts from Various Sources[1]
December 2019–December 2023 (percent)



[1] Monthly averages.
SOURCE: Based on Bloomberg.

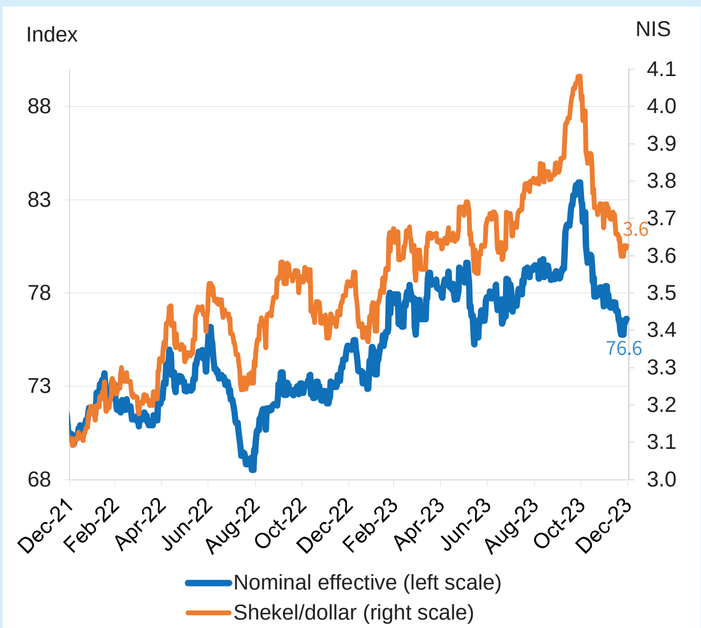
The expected interest rate path according to the Telbor curve declined during the reviewed period. At the end of the period, it indicated an interest rate of 3.4 percent in one year, compared with 4.75 percent prior to the war.

c. The exchange rate

With the outbreak of the war, Israel's risk premium increased sharply, and the shekel depreciated significantly against the US dollar and the euro. In order to moderate the volatility in the shekel exchange rate and provide the necessary liquidity for the continued proper functioning of the markets, the Bank of Israel announced a program—prior to the first trading day after the war began—to sell up to $30 billion in foreign exchange. As part of this program, the Bank of Israel sold $8.2 billion in October and about $338 million in November.

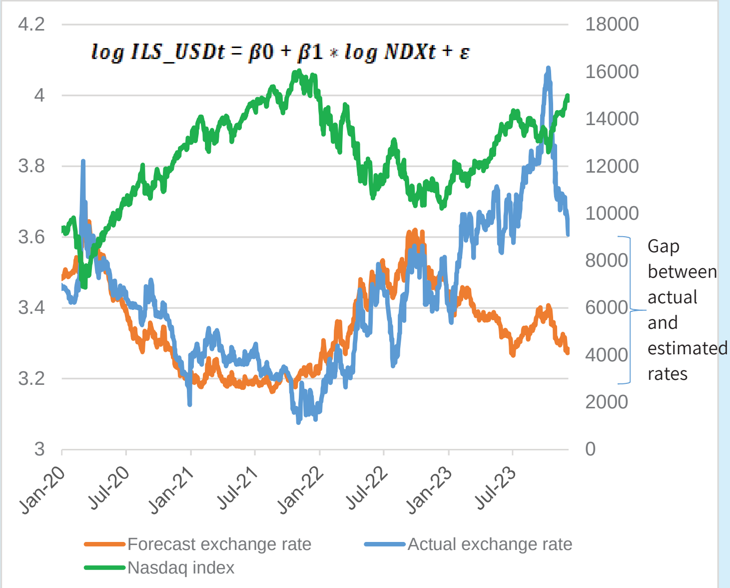
At the beginning of November, the trend reversed, and the shekel began appreciating significantly. This continued until the end of the reviewed period. The appreciation came against the background of apparent increased clarity regarding the state of the war, the likelihood of its spread to additional theaters, and assessments regarding future interest rate reductions by the Federal Reserve and the European Central Bank. The shekel was trading at a 5-month high against the US dollar at the end of the period—NIS 3.63 to the dollar. The shekel also appreciated against the euro and in terms of the nominal effective exchange rate relative to its position prior to the war (Figure 8).

Figure 8
Selected Exchange Rates, Monthly Average
December 2021–December 2023



SOURCE: Bank of Israel.

Figure 9
NIS/$ Exchange Rate and the Rate Estimated from a Regression of the Nasdaq on the Exchange Rate
January 2020–December 2023



SOURCE: Based on Central Bureau of Statistics and Bloomberg.

d. Fiscal policy

In view of the war, the deficit in the government budget increased in 2023, to 4.2 percent of GDP, compared with a surplus of 0.6 percent of GDP in 2022. The revised budget deficit for 2024 is expected to be 6.6 percent of GDP. As a result, the debt to GDP ratio is expected to increase significantly to about 66 percent in 2024. This is after fiscal policy brought the economy to a desirable debt to GDP ratio of about 60 percent prior to the war. The Bank of Israel Research Department estimates the costs of the war—defense and civilian (increased expenses and lost revenue)—at more than NIS 200 billion. On January 15, the government approved the revised state budget for 2024, which includes budgetary adjustments totaling NIS 17 billion in 2024 and in 2025. However, the significant expected increase in expenses, even after the adjustments, may create inflationary pressures in the short–medium term.

The increase in government expenditures in 2023 is mainly due to increased defense expenditures to cover the costs of the war, and increased civilian expenditures for dealing with evacuated residents, compensation for businesses that were harmed, and rehabilitation of the affected areas. Some of the expenses have been financed through the Compensation Fund and are therefore not recorded in the budget this year, but their significance in terms of the impact on the economy is the same as the costs that were recorded in the budget.

The additional expenditures included in respect of the direct effects of the war are expected to total about 10 percent of GDP. According to a Research Department assessment, government expenditures in respect of the war (gross, before adjusting for assistance from the US government and reducing other expenditures) plus the expected loss of revenue, will total more than NIS 200 billion. This assessment naturally comes with a very high level of uncertainty—partly in view of the uncertainty regarding the duration, severity, and nature of the war. The government deficit is expected to increase even more in 2024 due to increased defense expenditures to cover the costs of the war and restock military inventories, rehabilitation costs that are not covered by the Compensation Fund, and a decline in tax revenues due to the impact on economic activity. The costs of raising government debt are also expected to increase. Following the war, defense expenditures are expected to remain higher than they were prior to the war. A significant part of the increase in defense expenditures—mainly in purchasing—may be financed by assistance from the US government, but this is not certain, and in any case domestic defense expenditures are also expected to increase.

The second half of 2023 was characterized by an increasing budgetary deficit, which worsened with the outbreak of the Swords of Iron war. After about 5 months in which the government operated on a continuance budget, the Knesset passed the state budget for 2023–2024 at the end of May. This led to accelerated growth of ministry expenditures in the second half of 2023. At the same time, the decline in tax revenues continued, mainly due to the return of direct taxes (mainly corporate taxes and real estate taxes) to the long-term trend, and to some extent due to a decline in revenue from indirect taxes. These trends worsened with the outbreak of the war. In particular, the standstill in the activity of the construction industry—a significant source of direct taxes (betterment tax and purchase tax) and indirect taxes (VAT on new dwellings and land)—intensified the loss of revenue.

At the end of November, the government approved the revised state budget for 2023, expanded the budget framework by about NIS 26 billion (an increase of about 6 percent relative to the original framework), and set a new deficit target of 3.7 percent of GDP instead of 0.8 percent of GDP in the original budget. To complete the macroeconomic picture, we must add extra-budgetary expenditures totaling about half a percent of GDP to the budget deficit in respect of direct and indirect compensation paid on account of the Compensation Fund. Among other things, this cost includes the full compensation paid for indirect damage to localities within a range of 40 km from the Gaza Strip, localities along the northern border and in the Golan Heights, and the business continuity grants throughout the country.

e. Financial stability – the credit market and developments in the financial markets

In the third quarter of 2023, the Israeli equity indices recorded price increases, and exceeded the global trend. However, the Israeli equity indices underperformed foreign indices since the beginning of 2023, in view of legislative changes in Israel. Long-term government bond yields increased slightly, and corporate bond spreads remained virtually unchanged. There was a slowing trend in bank and nonbank credit to all activity segments and in all industries. According to the Central Bureau of Statistics Business Tendency Survey for July, the difficulty in obtaining credit as reported by various segments remained relatively low. Alongside this, there were indications of a slight increase in the credit risk indices for medium, small, and micro businesses. There was a significant decline relative to recent years in the amounts raised in the high-tech sector, which was in line with the global trend.

The beginning of the Swords of Iron war had a negative impact on all risk channels, and a significant impact on the financial system. Similar to previous serious security incidents, the high level of uncertainty in the first days of the war was reflected in sharp declines of financial asset prices—equities, corporate bonds, and government bonds—as well as increased price volatility and a decline in the level of liquidity (Table 3). Most of these effects dissipated after a short period, but the volatility in the markets remained high, as did the country's risk premium. The impact to economic activity in the immediate term—due to the decline on the demand side (a high level of uncertainty and a potential decline in income) and on the supply side (shortage of workers)—and the sharp increase in government expenditures were reflected in the country's various risk indices, including the yield gap on government bonds vis-a-vis the US and the CDS price. In view of the war in Israel, two of the leading ratings agencies announced that they were putting Israel's credit rating into "negative watch", and the S&P ratings agency decided to lower its ratings outlook.

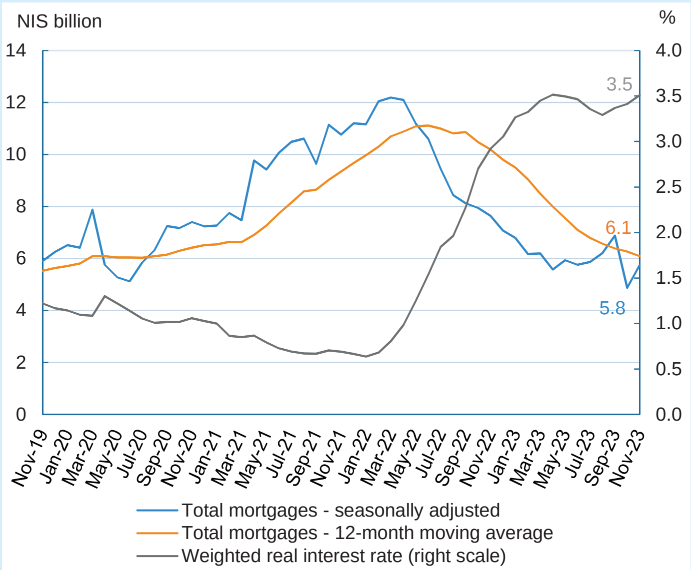
During the reviewed period, the balance of credit increased slightly for large and medium businesses, further to the trend that began before the war. Following the outbreak of the war, the Monetary Committee announced a targeted monetary program to ease the terms of credit for small and micro businesses that were harmed as a result of the war. The household debt to GDP ratio continued its downward trend, reaching 42.5 percent in October. Outstanding housing debt increased slightly, while outstanding nonhousing debt continued its downward trend. There was no significant change in the business debt to GDP ratio.

In the context of the financial risks, households and businesses dealt with increasing financing costs prior to the war, which was reflected in an increase in the rate of credit in arrears. Among the segments in which credit risk increased, it is worth placing particular emphasis on the construction and real estate industry. Companies in this industry—particularly construction companies, which are generally highly leveraged—had to deal with increasing financing costs and a significant decline in demand even before the war, alongside a moderate trend of declining prices. With the outbreak of the war, most building sites were closed due to the absence of Palestinian laborers, which account for a high and very prominent share of projects that are starting out. The freeze in construction may have a significant impact on the pace of the projects' progress, the companies' expected flow of income, and as a result on their ability to pay down their debts to lenders. Credit to the construction and real estate industry accounts for about 38 percent of total bank credit and about 44 percent of outstanding tradable corporate bonds. Therefore, construction companies' ability to withstand the high costs of financing alongside the decline in income will have an important effect on the performance of the financial system.

The balance of outstanding mortgages increased by about NIS 1 billion in December—the lowest figure since 2018. The slowdown in the growth rate of outstanding credit—which began with the start of monetary tightening—continued. The growth rate of business sector and household debt during the reviewed period was lower than during the same period in the previous year.

The stability of the financial system is not determined only by the risk levels in the various vulnerability channels, but also by its resilience and ability to absorb shocks, as we as by any policy measures taken to minimize the implications of the realization of risks on the system. As such, the financial system's resilience and policy measures adopted in response to events enable the system to deal with the realization of risks and maintain its stability. Prior to the war, the banking system had capital buffers and liquidity ratios that were higher than the Banking Supervision Department's minimum requirements, and credit loss allowances that were already made reflected a conservative assessment of the various segments' abilities to repay their debts. Similarly, the insurance companies had a repayment capacity that was significantly higher than the Capital Market, Insurance and Savings Authority's requirements. With the outbreak of the war, the government took a number of steps to that slightly moderated the economic uncertainty that had been created, and that enabled the smoothing of the temporary impact to revenue and its debt servicing capability. The Bank of Israel assisted in moderating the depreciation of the shekel through the sale of foreign exchange, the formulation of a program to defer debt repayments for those directly affected by the war, and the provision of low-interest monetary loans to the banks in order to provide credit to small businesses. These policy measures on the part of the government and the Bank of Israel were made possible, in part, thanks to the macroeconomic security buffers that were put in place over recent years, including a low government debt to GDP ratio and high foreign exchange reserves. All of these factors enabled the financial system to maintain its stability even during the realization of risks.

Figure 10
Total New Mortgages and Weighted Real Interest Rate on Mortgages
November 2019–November 2023



SOURCE: Bank of Israel, Banking Supervision Department.

Table 3
Developments in the domestic asset markets

	01/23	02/23	03/23	04/23	05/23	06/23
Yield to maturity (monthly avg., percent)						
3-month *Makam*	3.6	3.9	4.2	4.3	4.4	4.6
1-year *Makam*	3.9	4.2	4.7	4.6	4.6	4.8
5-year unindexed bonds	3.4	3.7	3.9	3.8	3.8	3.8
10-year unindexed bonds	3.4	3.6	3.9	3.9	3.8	3.8
20-year unindexed bonds	3.5	3.7	4.1	4.2	4.2	4.1
1-year indexed bonds	1.4	1.2	1.3	1.4	1.6	1.7
5-year indexed bonds	0.8	0.9	1.2	1.1	1.1	1.2
10-year indexed bonds	0.8	0.8	1.1	1.1	1.1	1.1
Yield gap between government bonds and AA-rated corporate bonds (percentage points)[a]	1.5	1.7	1.8	1.7	1.6	1.5
Equity market (rate of change during the month)						
General shares index	0.6	-5.6	-0.3	2.0	0.1	2.6
Tel Aviv 35	0.0	-3.5	0.3	1.6	-1.2	0.2
Foreign exchange market (rate of change during the month)						
Dollar/shekel	-1.3	5.6	-1.4	0.7	2.0	-0.4
Euro/shekel	0.3	3.4	1.1	1.8	-0.9	1.3
Nominal effective exchange rate	-0.1	3.9	-0.4	0.8	0.5	-1.1

[a] The calculation is for fixed-rate indexed bonds, excluding convertible and structured bonds, with a yield of up to 100 percent and a term to maturity of more than 6 months.

SOURCE: Bank of Israel.

f. The housing market

During the reviewed period, the increase in home prices was halted, and they even began to decline. For the first time since 2018, the annual pace of increase in home prices became negative, and according to the most recent figure at the end of the period (September–October), the figure was -1.3 percent. This is compared with the figure at the end of the previous half-year, 9.8 percent, and with the record high rate of increase of 20 percent in September 2022. Home prices did not increase in the index readings published during the period, while the downward trend in the number of housing transactions continued.

The halt in the price increases was accompanied by sharp declines in new mortgage borrowing and in the number of transactions (Figure 10). At the same time, there was an increase in the stock of unsold homes held by contractors. Building starts and building permits declined during the first quarter of 2023, after peaking in mid-2022, but their levels remained higher than in the past. There was a similar trend in the development of rental prices. They declined by 0.3 percent in October and by 0.8 percent in November, for the first time in two-and-a-half years. However, as opposed to home prices, the annual rate of increase at the end of the period remained positive, although it moderated to 3.9 percent. This is reflected in the owner-occupied housing services component in the Consumer Price Index, which is measured using new and renewing rental contracts. The monthly decline in the index can be explained by a solidarity effect among landlords, who may have avoided raising rends during the war.

g. The global economy

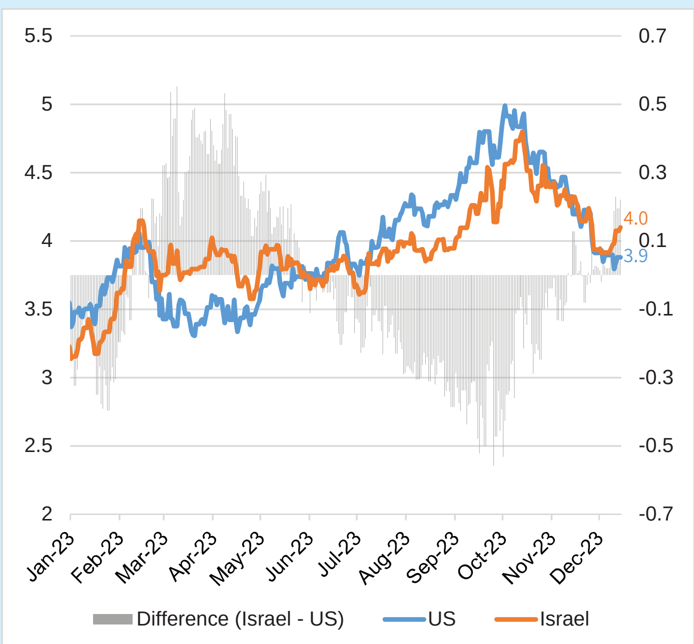
During the second half of the year, the central banks slowed the pace of interest rate increases, and it now seems that the cycle of interest rate increases has come to an end. This is partly due to the continued moderation of inflation. The expected interest rate path according to the markets declined

significantly, and according to it, the markets expect a number of interest rate reductions in 2024. In many advanced economies, the real interest rate level is positive, following a prolonged period of negative levels. The main factors affecting the markets and the various channels during the period were: interest rate increases, volatility in commodity prices, changes in the supply chains, and geopolitical developments—chiefly the continued war between Russia and Ukraine, the war in the Middle Eastern theater, and tensions between the US and China.

During the second half of 2023, the moderation of inflation worldwide continued. Core inflation, which adjusts for the effects of price changes in volatile components such as energy and food, also moderated. However, at the end of the reviewed period, the inflation level in the main blocs remained higher than the central bank targets, mainly due to the continuation of demand pressures in the service industries.

In the markets, the leading global equity indices recorded sharp gains, led by the large technology stocks. However, trading was volatile in view of the high level of uncertainty that was partly due to the continuation of monetary tightening and concern over its implications for real and financial activity. Government bond yields declined in view of a change in the interest rate forecast by the Federal Reserve and other signals from other central banks regarding the end of the cycle of interest rate increases, partly in view of the perception that interest rates are sufficiently tight (Figure 11).

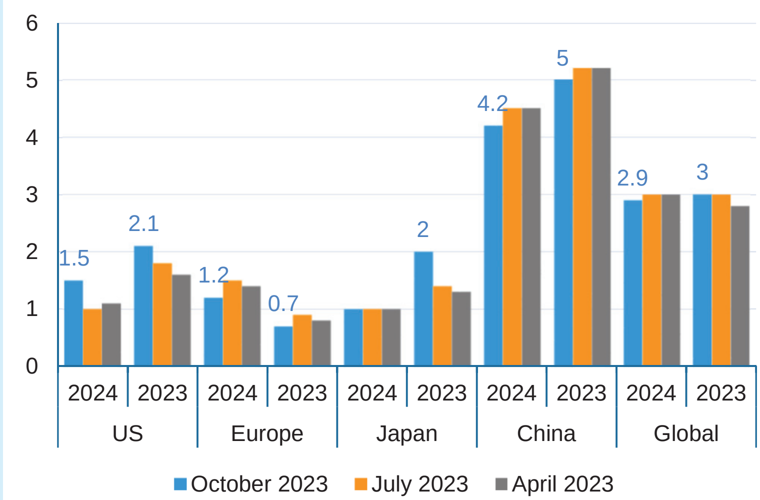
Figure 11
Yields on US and Israel Dollar Government Bonds, Daily Data
January–December 2023



SOURCE: Based on Bloomberg.

Economic activity in the leading economies moderated during the reviewed period. In the background, the global manufacturing sector and world trade continued to indicate weakness. Economic activity in the US was surprisingly good, supported by households' surplus savings, tight labor markets, and an increase in the wealth effect. In the eurozone, in view of weakness in the production and foreign trade segments, mainly in Germany, the pace of economic activity slowed. In China, a weaker-than-expected recovery from the COVID-19 crisis and structural problems such as high debt levels, an increase in household savings, and a significant crisis in the real estate sector, weighed down on activity in the world's second-largest economy (Figure 12).

Figure 12
IMF Annual Growth Forecasts for 2023 and 2024
percent



SOURCE: International Monetary Fund.

3. The macroeconomic forecast and the Monetary Committee's assessment regarding the expected path

a. The Research Department's macroeconomic forecast

The Bank of Israel Research Department published three normally scheduled forecasts, alongside the July 2023, October 2023, and January 2024 interest rate decisions. In addition, it published an unscheduled forecast alongside the November 2023 interest rate decision, providing some clarity to the uncertainty that was prevalent when the October forecast was being compiled, which was about two weeks into the war. The January 2024 forecast was built assuming that the direct economic impact of the war would peak in the fourth quarter of 2023, and that the war would last until the end of 2024, but with declining intensity. Similar to the previous forecasts from October and November, the January forecast is based on the working assumption that the war would be fought mainly on the southern front. According to the forecast, GDP is expected to grow by 2 percent in each of 2023 and 2024, as in the November forecast, and by 5 percent in 2025—so that the output gap is expected to close in that year. The broad unemployment rate among the prime working ages (25–64) is expected to average 5.3 percent in 2024 and 3.2 percent in 2025. The annual inflation rate over the 4 quarters of 2024 is expected to be 2.4 percent, and during 2025 it is expected to be 2 percent. The forecast features a particularly high level of uncertainty, partly in view of the uncertainty regarding the duration and severity of the war. The assessment regarding the 2024 state budget at this time is still exposed to uncertainty with regard to the decisions the government will make regarding how the budget will deal with the defense and civilian needs arising from the war. In view of the war's impact, the effect on economic activity is expected to lead to a decline in tax revenue, while the government's expenditures on defense and on civilian assistance programs will increase. In the Research Department's assessment, all these are expected to be reflected in a marked increase in the government's budget deficit, as detailed in Chapter b, Section 4 of this Report, which deals with fiscal policy (Table 4).

Table 4
Research Department forecasts

(percent rate of change unless noted otherwise)

Forecast for the year	2022			2023				2024
Forecast date	**07/22**	**10/22**	**01/23**	**07/22**	**10/22**	**01/23**	**04/23**	**04/23**
GDP	5.0	6.0	6.3	3.5	3.0	2.8	2.5	3.5
Private consumption	7.5	8.0	7.0	4.5	3.5	4.0	3.5	4.5
Fixed capital formation (excl. ships and aircraft)	5.0	8.0	9.0	3.0	3.0	3.0	1.5	4.5
Public consumption (excl. defense imports)	4.0	4.0	1.0	3.0	4.0	3.5	2.0	3.0
Exports (excl. diamonds and startups)	3.0	8.0	10.5	2.5	2.5	2.0	2.0	3.0
Civilian imports (excl. diamonds, ships and aircraft)	7.5	12.5	11.5	3.0	3.5	4.0	3.0	6.0
Unemploument rate - annual average (ages 25–64)	3.3	3.1	3.2	3.5	3.5	4.0	4.1	4.0
Government deficit (percent of GDP)	0.7	0.3	-0.3	1.2	1.0	1.8	0.9	0.9
Debt to GDP ratio	66.0	65.0	62.0	63.9	63.0	62.0	59.0	58.0
Inflation[a]	4.5	4.6	5.2	2.4	2.5	3.0	3.9	2.3
Forecast date	**07/22**	**10/22**	**01/23**	**04/23**				
Inflation in the coming year[b]	3.3	2.7	3.0	3.4				
Interest rate in one year[c]	2.75	3.5	4.0	4.75				

[a] The average of the Consumer Price Index in the fourth quarter of the year compared with the average in the fourth quarter of the previous year.

[b] In the four quarters ending in the same quarter in the following year.

[c] In the same quarter in the following year.

SOURCE: Bank of Israel.

b. The expected paths of inflation and growth

The war is having significant economic impacts on real activity. There is a very high level of uncertainty regarding the expected duration and severity of the war, which is also affecting the extent of the impact to activity. Similar to the Research Department, the Monetary Committee's assessment is that the economic effect of the war will be reflected in a moderate growth rate in 2024, and in recovery and convergence to the growth trend that was typical of the pre-COVID years only in 2025. This assessment also contains a high level of uncertainty due to uncertainty with regard to the decisions the government will make regarding how the budget will deal with the defense and civilian needs arising from the war.

Similar to the Research Department's forecast, the Monetary Committee's assessment is that annual inflation will converge to within the inflation target during the coming year, and will reach the midpoint of the target range—2 percent—during 2025.

The volatility in the markets, particularly in the foreign exchange market, during the reviewed period, and particularly after the outbreak of the war in early October, was a main consideration in the Committee's decision not to lower the interest rate and to leave it at 4.75 percent. Toward the end of the period, it seemed that stability was returning to the markets, which enabled the Committee to lower the interest rate to 4.5 percent in January 2024, against the background of the slowdown in inflation and the impairment of activity due to the war. The future path of the interest rate will be determined in accordance with the continued convergence of inflation to its target, continued stability in the financial markets, economic activity, and fiscal policy. However, the path of lowering the interest rate in the Committee's assessment is lower than the path in the market's assessment.