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**BANK OF ISRAEL**

Office of the Spokesperson and Economic Information

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**Press release:**

**Remarks by the Governor of the Bank of Israel at the press briefing on monetary policy held today at the Bank of Israel**

Good afternoon.

After the Monetary Committee’s discussions to decide on monetary policy, the Monetary Committee decided to increase the interest rate by 0.25 percentage points to 4.5 percent.

In my remarks today, I will detail the background to reaching the decision. I will examine the issue of the continued path of monetary policy and the state of inflation in the economy, and will also touch upon additional economic developments in Israel and abroad. I will also discuss the recent developments regarding current events and the situation prevailing in the country, which are also taken into account in the macroeconomic forecast that the Research Department published a short while ago.

Inflation in Israel has been above the upper bound of the target range for some time, and according to the various expectations and forecasts, it is expected to moderate in the coming 12 months and to return close to the target range of 1–3 percent. The increase in prices is reflected in a wide range of CPI components. Alongside a decline that we have seen in recent data regarding the inflation rate for tradable products, among nontradable products, made up primarily of the housing component and service industries, there has not yet been a notable moderation. These components are apparently the “sticky inflation” components. The Monetary Committee assesses that the monetary tightening processes in Israel and abroad and the easing of demand are acting to moderate inflation.

We in the Monetary Committee are continuing the process intended to reduce the inflation rate and to return it to within the target range. We are aware that this is not a simple process, but are determined to do so, in order to ensure price stability, which is necessary for economic stability.

It is important to note that inflation in Israel is lower than inflation in most advanced economies. In addition, in a period of uncertainty worldwide, we see more significant deviations of inflation forecasts than in the past. We saw this, for example, in inflation data published in the eurozone, the UK, and the US. The inflation rate being above central bank targets, and in particular the continued increase of core inflation in most countries, are leading to monetary tightening worldwide continuing as well, even if the pace is moderating.

In terms of inflation expectations and forecasts for the various ranges, 1-year expectations from all sources are around the upper bound of the target range, and in some of the sources, the expectations even exceed the target range. However, there has not been a major change in expectations for longer terms and they are all within the target range. This is, among other things, important evidence of the confidence that the markets have in our determined and consistent monetary policy.

Israel’s economy entered 2023 after displaying impressive growth in 2021 and 2022. The Bank of Israel Annual Report that we published several days ago illustrates in depth the various strong points of economic activity in those years alongside the economic challenges facing the Israeli economy. The various indicators of current activity also point to a tight labor market and relatively vigorous economic activity, although there are some signs of moderation.

In addition, I would like to note the importance of conducting responsible fiscal policy, particularly at this time—and in fact, the government approved a proposed budget, the framework of which is in line with the contractionary monetary policy at this time. The public sector wage agreements that were recently signed also reduced the uncertainty in that sector and are consistent with restraining inflation and returning it to the target range.

Housing market developments are a focus of the Monetary Committee and we follow them closely. In recent months, we have seen a significant moderation in the pace of price increases, and almost their halt in the February data. Despite the decline in building starts in the last quarter of 2022, that year ended with a very high level of construction permits and building starts compared to the past. It is very important that the government and the other relevant factors continue increasing supply over time. This is the main path to a continued moderation of prices. Data on the number of transactions carried out and new mortgage volume in recent months also support the continued moderation of this market. Alongside all these, we are closely following developments of rents, the increase of which continues to impact on the inflation rate as well.

Alongside the developments in the real economy, we see significant developments in financial markets; while prices increased on capital markets worldwide for the year to date, equity indices in Israel have underperformed them and have declined over the year to date. Long-term Israeli government bond yields increased, in contrast to the worldwide trend that has been characterized by a decline in yields. In addition, corporate bond spreads in Israel widened.

In the foreign exchange market as well, there was high volatility in the shekel in recent weeks—which was also impacted by the recent events in the country. From the beginning of the year, there has been a marked depreciation of the shekel vis-à-vis the dollar and in terms of the nominal effective exchange rate, and even some separation from the strong connection that there was between the S&P 500 and the exchange rate. Depreciation of the shekel of course impacts on inflation in Israel, mainly in view of the pass-through mechanism of tradable products and imported production factors.

The macroeconomic forecast that the Bank of Israel’s Research Department published today incorporates the various developments and their impact on the economy. The forecast is of course impacted by the uncertainty deriving from the legislative processes related to the judicial system. These could impact substantially on the economic and financial developments in the short term and in the longer term, and therefore on the monetary policy that will be required in the forecast period. In this regard, it is important to emphasize that there is a constant and structural difficulty in generating economic forecasts. It is no secret that at this time of great uncertainty, in Israel and abroad, compiling a forecast is more complicated than ever.

As the results of the legislative process and their economic impacts are not known at the time the forecast was compiled, the Research Department presented its assessments based on two scenarios:

1. A scenario in which the disagreement about legislative changes regarding the judicial system is settled in a manner that does not further impact on economic activity going forward.

2. A scenario that presents an analysis of the possible economic ramifications if legislative and institutional changes are accompanied by an increase in Israel's risk premium, an adverse impact on exports, and a decline in domestic investment and in demand for private consumption.

In the first scenario, the Department carries out the current analysis as in every quarter. In this scenario, GDP will grow by 2.5 percent in 2023, down from 2.8 percent in the previous forecast in January. In 2024, the forecast is for a higher growth rate of 3.5 percent, similar to the economy’s long-term potential growth. According to the forecast, the labor market will remain tight, but will return gradually to the levels that characterized it before the COVID-19 crisis. The unemployment rate among the prime working ages is expected to be 4 percent in 2024. According to the forecast, the inflation rate is expected to continue to be slightly below 4 percent in the final quarter of 2023, and to return toward the target range during 2024, and in the final quarter of the year it will be 2.3 percent on average.

Additional risks to this forecast include the global developments including a moderation of the inflation rate worldwide that is slower than assessed, and the difficulties in the global banking system, to which I will refer in a bit as well. Alongside all these, additional risk derives from the possible impacts of the various developments in the war in Ukraine.

The second scenario in the Research Department’s forecast presents an analysis of the possible economic ramifications if legislative and institutional changes will be accompanied by an increase in Israel’s risk premium, an adverse impact on exports, and a decline in domestic investments and in demand for private consumption. Indications of the directions of the possible effects of these processes can be learnt from the markets’ response to the developments that occurred in the recent period. This scenario is accompanied by high uncertainty compared to the first scenario, as there is great uncertainty regarding the pace of the materialization of the legislative processes related to the judicial system, their magnitude, their ramifications, and their persistence. The scenario presents a broad range of possibilities and analyzes the economic ramifications over the next 3 years, which the Research Department refers to as one bloc.

In this scenario, in a case in which the effect of the changes dissipates relatively rapidly, the cumulative impact of the three channels will be an average negative impact of 0.8 percent of GDP each year over the upcoming three years. In the scenario characterized by higher persistence of the shocks, the adverse impact is approximately 2.8 percent of GDP each year, on average, for the coming 3 years. Most of the decline in GDP, in this case, derives from a marked adverse impact on investment in the economy, due to an increase in uncertainty and the risk premium.

As noted, the uncertainty regarding the extent of the impact of the legislative process on the economic variables makes it difficult to quantify the various effects. As such, these model outputs should be viewed as an indication of the possible directions of the impact and their size, based on empirical links from the past.

Before I conclude, I will refer in short to the global banking situation and to the various developments of recent weeks. These include the collapse of banks in the US, led by SVB, which served as a significant bank for the high-tech industry, and the sale of the second largest bank in Switzerland, Credit Suisse, to UBS after encountering difficulties. It is important to me to emphasize that all these illustrate the importance of tight financial supervision, as is carried out by the Bank of Israel. This supervision places a consistent emphasis on the stability of the banking system, in which the public’s funds are deposited, and that has successfully withstood significant global crises. This all exists alongside a series of processes that we promoted in recent years, which are intended to improve competition and innovation in the banking system, and to increase customers’ negotiating power vis-à-vis the banks.

With your permission, I would like to conclude my remarks and refer briefly to the recent developments around the issue of the legislation related to the judicial system, which are currently being discussed in the President’s office. The uncertainty and the events we witnessed in recent weeks have naturally also had an impact on the Israeli economy. I am of the opinion that to the extent a decision will be reached that reflects a broad agreement through dialogue and collaboration, the economy will also be better off for it.

Thank you all, and happy holidays.