December 7, 2023

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

The discussions took place on November 26 and 27, 2023.

General

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

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

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

A summary view of the economic situation available at the time of the Committee's discussion is presented in the notice regarding the interest rate decision, which was published on November 27, and in the data file that accompanied the notice.

THE NARROW-FORUM DISCUSSION

The members of the Monetary Committee participating in the discussion decide on the appropriate rate of interest. After the discussion, it was decided to keep the interest rate at 4.75 percent. All members of the Monetary Committee supported the decision.

The discussion focused on the economic developments resulting from the eruption of the "Swords of Iron" War on October 7, real activity, particularly in the major industries, inflation and expectations, and developments in the foreign exchange and financial markets. In addition, the Committee discussed the implementation of plans intended to assist the public in dealing with the economic difficulties resulting from the war.

Main points of discussion

The Committee discussed the economy's state after 8 weeks from when the Swords of Iron war broke out, and examined the developments since then. The war has significant economic ramifications, both on real activity and on the financial markets. Indicators of economic activity show a contraction in the economy's business activity with recent gradual recovery. The extent of uncertainty regarding the extent and duration of the fighting is high, and this has an effect on the extent of adverse impact on activity as well. Although market volatility moderated and financial markets are operating effectively, the economy's risk premium remains high.

The Committee discussed the effects of the war on economic activity, both on supply and demand. The indicators since the beginning of the war pointed to a decline in the economic activity. However, after several weeks of war, it appears that the economy is in a process of economic recovery in some components of activity. The Committee members noted that first, limitations deriving from the supply side were notable, resulting from the absence of workers and from supply chain disruptions. However, some were loosened, except in the construction and agriculture industries, and as this process advances, the slowdown in activity is expected to derive more from the impact on demand. The decline in demand is reflected in a decrease in private consumption, as seen in the scope of credit card purchases. The economy's process of gradual activity, and the variation among various industries, were emphasized.

The Committee discussed labor market developments. The data indicate a marked decline in the labor input in the economy in October. A flash survey by the Central Bureau of Statistics indicated in October that the absence of workers is the main constraint on activity in the business sector, but reports for November are already indicating an easing in this limitation. The most notable negative impact based on the survey is in the food services and the construction industries.

The Committee discussed the inflation environment and the war’s impact on it. The year over year inflation rate continues its trend of moderation and was 3.7 percent in October, above the target. The annual rate of increase of nontradable components in the CPI remains high, at 4.2 percent. The rate of increase of tradable components in the CPI is volatile, and was 2.9 percent. Since the beginning of the war, the path of 1-year inflation expectations declined slightly. According to forecasters’ projections, inflation is expected to enter the target range during the first half of 2024. The Committee members noted that several factors may support the continued moderation of inflation in Israel—the slowing of inflation worldwide, a decline in energy prices, the appreciation of the shekel in the past month, and the slowdown in domestic demand as a result of the war. Nonetheless, the Committee members noted that there is considerable uncertainty regarding the the development of inflation in the coming period. The Committee assesses that the current monetary policy supports the convergence of inflation to within its target. However, the risk of shekel deprecation, against the background of the volatility in the exchange rate in the recent period, is still a risk to inflation’s convergence to its target. In addition, there is uncertainty regarding the scope of government expenditures on the assistance plans and the developments in the State budget and their impact on inflation.

The Committee members discussed developments in the foreign exchange market. After a sharp deprecation in the first weeks of the war, there was a marked appreciation, and the shekel declined to below its level just before the war. In view of the impacts of the war and the need to stabilize the markets, the Bank of Israel announced, on October 9, 2023, a program to sell $30 billion in foreign currency.

The Committee discussed the effects of the war on the financial markets. Since the war erupted, financial risk indicators increased in most industries, but then there was some moderation, except in the construction industry. In the capital market, after sharp declines with the outbreak of the war, the trend changed in the past two weeks, and domestic equity indices increased sharply, similar to the global trend. Long-term government bond yields declined more moderately than the global trend, and corporate bond spreads, which widened with the eruption of the war, returned to close to their level before the war. The risk premium as measured by the CDS and the spread between dollar-denominated government bonds and US government bonds moderated slightly but is still at high levels.

The Committee discussed the various developments in the credit market, including the effects of the framework formulated by the Banking Supervision Department to defer loan repayments. This framework was adopted by the banks and credit card companies and is intended to assist households and businesses and to ease their cash flows in the coming period. In November, the agreed-upon framework was expanded to communities in the North as well. In addition, the Monetary Committee announced a targeted plan intended to assist the orderly granting of credit to small and micro businesses that were adversely impacted by the war.

The Committee discussed housing market developments and difficulties in the industry's activity in view of the war. The scope of housing market activity continues to moderate. In the past 12 months, home prices declined by 0.2 percent. In August-September 2023, the Home Price Index as well new home prices remained unchanged. The trend of decline in the scope of transactions and in new mortgage volume slowed, but this is not an indication going forward due to the lack of certainty created by the war. In October, new mortgage volume was NIS 4.5 billion. The owner occupied housing services component in the CPI declined by 0.3 percent and the year over year rate of increase continued to moderate, reaching 4.9 percent.

In addition, the Committee discussed the updated macroeconomic forecast compiled by the Research Department. The forecast is based on the assumption that the war's direct impact on the economy will continue into 2024 at a decreasing magnitude. This is in contrast to the assumption in the October forecast that the direct impact will be focused in the fourth quarter of 2023. The Research Department reduced its growth forecast, and in its assessment, GDP will grow by 2 percent in each of 2023 and 2024. Year over year inflation in the fourth quarter of 2024 is expected to be 2.4 percent, and the interest rate is expected to be 3.75 percent or 4 percent. The assessment regarding the budget for 2024 at the current time is still exposed to marked uncertainty regarding the impact of the war and of government decisions regarding the prioritization of dealing with the security and civilian needs deriving from it. In the Department's assessment, an increase is expected in the budget deficit, which is expected to total 3.7 percent of GDP in 2023 and 5 percent of GDP in 2024. In view of that, the debt to GDP ratio is expected to be 63 percent in 2023 and 66 percent in 2024.

The Committee discussed global conditions as well. The security incidents in Israel, which caused an increase in geopolitical tension in the Middle East, impacted moderately on global financial markets. Investment houses' growth forecasts for 2024 remained unchanged and their assessment is for global growth of 2.6 percent in 2024. The inflation environment moderated in a notable portion of countries, but remains above central bank targets. The Fed and the ECB kept the interest rate unchanged and emphasized in their forward guidance that the interest rate is expected to remain at a high level for a longer period of time, with markets not pricing in additional interest rate increases by them, and only pricing in an interest rate decrease during the second quarter of 2024.

After the discussion, all the Monetary Committee members were of the view that the interest rate should be kept unchanged at 4.75 percent.

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 developments in the war and the uncertainty derived from it. Insofar as the recent stability in the financial markets becomes entrenched and the inflation environment continues to moderate toward the target range, monetary policy will be able to focus more on supporting economic activity.

Participants in the narrow-forum discussion:

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

Other participants in the narrow-forum discussion:
Mr. Uri Barazani, Spokesperson of the Bank
Dr. Golan Benita, Director of the Markets Department
Dr. Oded Cohen, Chief of Staff to the Governor
Ms. Nurit Felter-Eitan, Director of the Communications, Public Affairs & Community Relations Department
Mr. Arie Knopf, Monetary Committee Secretariat
Ms. Shulamit Nir, Research Department
Ms. Dana Orfaig, Research Department
Ms. Esti Schwartz, Monetary Committee Secretariat
Mr. Daniel Shlomiuk, Bank spokesperson's office