

BANK OF ISRAEL

Office of the Spokesperson and Economic Information

August 9, 2023

Press release:

**Monetary Policy Report for the first half of 2023**

**Abstract**

This report surveys monetary policy during the first half of 2023.[[1]](#footnote-1) During this period, the inflation rate was above the upper bound of the target range, further to the trend that has lasted since January 2022. During the first half of the year, the increase in inflation was halted, and inflation in May was 4.6 percent.

Throughout the reviewed period, the shekel depreciated relative to the major currencies, a trend that supported high inflation, particularly in the prices of tradable goods. The housing component of the Consumer Price Index, which reflects rental prices, increased sharply throughout the period, and also made a considerable contribution to the inflation rate.

Despite the increase in inflation, forward expectations derived from the capital market for medium and long terms (more than two years) remained anchored within the target range. Inflation in Israel remained lower than in most advanced economies, and is in the lower quarter among OECD countries. Inflation excluding energy and food is also in the lower quarter among OECD countries.

Alongside this, economic activity during the period remained slightly higher than the long-term potential, with some slowdown in the most recent data. The labor market remained tight, and the employment rate remained at a level reflecting full employment. However, there appears to be a decline in demand for workers, particularly in the high-tech sector.

**Monetary policy:** The Monetary Committee continued its process of monetary tightening, with the aim of returning inflation to the target range, while examining the mix of economic developments in Israel and abroad. During the reviewed period, the Committee raised the interest rate from 3.25 percent to 4.75 percent in four increases: two increases of 0.5 percentage points and two additional increases of 0.25 percentage points. In July, the interest rate was left unchanged.

**The inflation environment:** The first half of 2023 featured a high inflation environment that exceeded the upper bound of the price stability target range. Annual inflation was 5.4 percent in January, and 4.6 percent in May. Over the past six months, and even more so over the past three months, the pace of inflation has moderated—particularly with regard to the prices of tradable goods. Inflation in Israel is lower than in most advanced economies, and is in the lowest quarter among OECD countries.

**Domestic real activity and the labor market:** The data and indicators presented to the Monetary Committee in the first half of 2023 continued to show high economic activity, around the trend that preceded the COVID-19 crisis. National Accounts data for the first quarter indicated growth around the potential rate, but some of the current indicators showed some apparent moderate in the most recent data. The labor market remained tight, and the employment rate remained at a level reflecting full employment. However, there are signs of a decline in the demand for workers, particularly in the high-tech sector.

**Exchange rates:** In the first half of this year, the shekel depreciated with higher volatility than in previous periods. At the beginning of the period, there was some appreciation of the shekel, but toward the end of January, a trend of depreciation began against the major currencies. This depreciation is not in line with the close connection that was typical of recent years between developments in the global equity markets and the exchange rate, and it seems that this development reflects an increase in the risk premium.

**The global economy:** During the reviewed half-year, global economic activity continued at a relatively moderate rate. Concern over a serious recession in Europe abated, and economic activity in China recovered, although at a more moderate pace than previous assessments. The global inflation environment remains high, but is in a moderating trend. An easing of the supply chain disruptions and lower shipping prices, as well as lower energy prices, contributed to this. In many countries, core inflation remained high. In parallel the process of monetary tightening on the part of central banks continued, but the pace of interest rate increases moderated.

**The credit market and developments in the domestic financial market:** The growth rate of credit among small and medium businesses moderated during the period, and credit to micro businesses declined. The flow of new mortgages narrowed during the period, and interest rates increased. During the half-year, the Israeli equity indices declined, reflecting underperformance relative to global equity markets.

**Financial stability:** During the reviewed period, the risk of firms in the real estate and construction industry increased to some extent, due to the continued tightening of monetary policy and the slowdown in demand in the industry. In addition, uncertainty regarding legislative changes related to the judicial system in Israel and their impact on the functioning of the economy increased volatility in the prices of financial assets.

**The housing market:** The moderation in activity in the housing market continued, alongside an acceleration of the increase in rental prices. There was a turnaround in home prices, as the price increases were halted during the reviewed period and there were sharp declines in the number of housing transactions and in mortgages. Building starts and building permits declined during the period.

**Fiscal policy:** In the reviewed half-year, the budget surplus declined due to a decline in tax revenue. The surplus during the first months of the year remained historically high due to relatively restrained public expenditure and revenues that were higher than the multiyear path. The decline in revenue mainly reflected declines in direct tax revenue and revenue from real estate taxes, but direct taxes remained higher than the pre-COVID-19 trend, while indirect taxes were slightly lower than it. The public sector wage agreement that was signed was relatively moderate.

**The Research Department staff forecast:** The Research Department published three forecasts during the reviewed period, alongside the interest rate announcements in January, April, and July 2023. The April forecast differed from the routine quarterly forecasts, in that it included two different forecasts based on two scenarios with regard to the legislative processes concerning the judicial system.

In the first scenario, the dispute surrounding legislative changes with regard to the judicial system is reconciled in a way that does not have an impact on economic activity moving forward. The second scenario presents an analysis of the potential economic implications should legislative and institutional changes be accompanied by an increase in the country’s risk premium, harm to exports, and declines in domestic investments and in demand for private consumption.

The July forecast relied on the assumption that the dispute surrounding the legislative changes concerning the judicial system would be resolved in a way that does not affect economic activity moving forward. According to this scenario, GDP is expected to grow by 3 percent in each of 2023 and 2024. The inflation rate is expected to be 3 percent in the next four quarters and 2.4 percent in 2024. According to the forecast, the interest rate in the second quarter of 2024 is expected to be 4.75–5 percent. According to Research Department assessments, the main risk to the forecast is the realization of a scenario in which legislative and institutional changes are accompanied by a further increase in Israel’s risk premium, depreciation of the shekel, harm to exports, and declines in domestic investment and in demand for private consumption.

1. In 2023, decisions were made on January 2, February 20, April 3, May 22, and July 10. Beginning in January, the Monetary Committee has been operating with only five members. [↑](#footnote-ref-1)