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To:
The Government and the Knesset Finance Committee

I am honored to hereby present the Bank of Israel Annual Report for 2023, pursuant to Section 54 of the Bank of Israel Law, 5770–2010.

The "Swords of Iron" War, which broke out on October 7th due to the deadly terror attack from the Gaza Strip, impacted the Israeli economy as well, and created a sharp distinction between economic developments and policy in the first three quarters of the year and those in the final quarter.

Israel's economy entered the war with good economic fundamentals, such as a low public debt to GDP ratio and high foreign exchange reserves. Until the war broke out, and after the implementation of policy tools for dealing with inflation, the economy was going through a "soft landing" process—it was in a full employment environment, and was growing at a pace that was slightly slower than the long-term pace, alongside the convergence of inflation to the target. This was after approximately 2 years of rapid growth and accelerating inflation, which occurred partly against the background of the economy's recovery from COVID-19 and global supply shocks. In this part of the year, consumption—influenced by the interest rate increases in the economy—and exports—affected by moderation in global demand—grew slowly. In contrast, investment increased relatively rapidly, together with capital stock in the business sector. High-tech services exports continued to increase but funds raised by the sector decreased. In the period preceding the war, Israel's economy and society were also affected by developments related to the legislative processes regarding the judicial system. The effects were felt in the financial markets, where they were mainly reflected in the weakening of the shekel and in the capital market's underperformance vis-à-vis other countries, and international institutions and credit rating agencies published warnings of long-term risks that may arise from those processes.

The war's adverse impact on the economy was seen on many levels. The negative impact was particularly severe at the beginning of the war, though in some areas—including the employment of Israeli workers—recovery was already seen later in the final quarter of the year. During that quarter, GDP contracted, private consumption, and particularly investment, declined sharply, and exports declined by a more moderate pace. The adverse impact was particularly acute in the construction and agriculture industries, which suffered from a severe shortage of non-Israeli workers, and in the tourism industry. At the beginning of the war, the shekel depreciated sharply, though later on it appreciated to beyond its prewar level. For the year overall, GDP grew by only 2 percent, meaning that GDP per capita did not grow at all. The surplus in the current account increased this year, due to its steep increase in the fourth quarter, when imports declined considerably.

The inflation rate, which peaked at 5.4 percent at the beginning of 2023, declined gradually over the course of the year, and its annual level reached 3 percent, the upper bound of the inflation target range. Inflation this year was broad-based—encompassing many goods and services, led by nontradables. Restrictive monetary policy, the decline in inflation worldwide, and the acyclical fiscal policy adopted by Israel during the period contributed to the decrease in inflation until the war. In contrast, the depreciation of the shekel delayed the convergence of inflation to its target.

Until the war broke out, monetary policy focused, as at many other central banks, on efforts to restrain inflation and to return it to its target range. Accordingly, the Bank of Israel increased the interest rate from the beginning of 2023 by 1.5 percentage points, to a level of 4.75 percent at the end of May, continuing the sharp increases from 2022. In the following months, the Bank kept the interest rate at that level, which was sufficiently restrictive to support the continued convergence of inflation to the target.

With the outbreak of the war, the Monetary Committee focused on stabilizing the markets and maintaining financial stability. To that end, the Bank rapidly implemented several tools—including a program to sell up to $30 billion in foreign exchange, swap transactions of up to $15 billion, and repo transactions vis-à-vis institutional investors and mutual funds. At the beginning of January 2024, the Monetary Committee decided to reduce the interest rate by 0.25 percentage points, in view of the entrenchment of stability in financial markets, the continuation of the decline in inflation, and the war's impacts on activity.

As expected, the process of raising the Bank of Israel interest rate increased the financing costs in the economy. Accordingly, the growth rate of business credit moderated this year—although it remained high until the war. The balance of credit to small businesses began to decline in the third quarter, and for micro businesses the decline began already in the second quarter. The growth rate of credit to households also moderated due to the interest rate increases. The pace of growth in housing credit was markedly lower than in previous years, and nonhousing credit contracted. Alongside these, households' savings increased, and funds were shifted from current accounts to deposits and *Makam*. After the war broke out, the government and the Bank of Israel took several steps to ease the terms of credit for businesses and households. The Bank of Israel's steps in this regard included a framework adopted by the banking system to provide relief from the credit and fees burden, a targeted monetary plan to ease terms of credit for small and micro businesses, repo transactions with supervised nonbank credit providers, and steps taken by the Banking Supervision Department to assist banking system customers who were adversely impacted by the war.

The fiscal policy adopted in 2023 and the fiscal frameworks determined by the government helped to stabilize the macroeconomic environment. Before the war, this was done by acyclical policy, which provided a response mainly to past price increases, without increasing demand in a period of inflationary pressures. During the war, the government implemented an expansionary policy, which included marked increases in expenditures related to the fighting, programs supporting households from the conflict areas, and assistance for workers and businesses across the country depending on the extent of the impact they endured. The government budget deficit soared this year to 4.1 percent of GDP, compared with a small surplus in 2022. This was mainly a result of the winding down of anomalous tax revenues that were collected in the past 2 years, in view of the recovery of the economy from the COVID-19 crisis and the strong real estate market, and due to the high expenditures and the slowdown in activity during the period of the war. The ratio of public debt to GDP increased from 60.5 percent last year to 61.9 percent this year.

The low debt to GDP ratio in Israel is a strategic asset, and the level of this ratio just before the war facilitated the economy's dealing with the immediate fiscal ramifications of the war and illustrated once again its importance in the economy's resilience to shocks.

The slowdown in demand for homes, in view of the interest rate increases, alongside the high volume of construction, led to an increase in the stock of unsold new homes and to a decline in home prices. The number of transactions declined sharply with the outbreak of the war, but recovered rapidly. However, the problem of a severe shortage of workers in the construction industry has not yet been solved, mainly because of the prohibition on employing Palestinian workers since the beginning of the war, alongside the span of time required to bring in foreign workers who will be able to replace them.

Looking ahead, the economy is facing significant challenges deriving from the war, in addition to structural challenges related to its fundamental problems that have existed for some time already. In order to establish the size of the defense budget in an informed manner, a committee should be established soon, with the participation of defense and civilian functions. It should delineate Israel's defense needs in the coming years and formulate an appropriate multiyear budget program that will take into account all the ramifications on the economy. It is important that if there is an additional increase in that budget, beyond what was already decided, it should be accompanied by fiscal adjustments that will at least prevent an enduring increase in the public debt to GDP ratio.

The fundamental challenges to the economy are reflected in low labor productivity and in low basic skills of weaker population groups compared to the general situation in advanced economies, and in a much higher poverty rate than in those economies. The employment rates of Arab women and *Haredi* (ultra-Orthodox) men are particularly low and the lack of core curriculum studies in schools in the *Haredi* sector withholds knowledge from *Haredi* men that is required for integrating into the labor market. A substantial upgrade is required in the scope and quality of infrastructures in the economy, particularly mass transit infrastructures. The rapid increase of the country's population magnifies the challenges related to the scope of infrastructures and to the supply of public services, chiefly high-quality education. The Bank of Israel has in recent years submitted to the government several reports that include detailed recommendations for dealing with these challenges. Their implementation will assist in increasing labor productivity and the standard of living in the economy over time and for the entire population. The cost of implementing these recommendations underlines even more the need for establishing appropriate priorities in the State budget.

In conclusion, the Israeli economy has known how to recover from more than a few difficult periods in the past and to return rapidly to prosperity. It is based on robust and solid economic foundations that have been built over years, which provide strength and stability. The implementation of responsible economic policy while dealing with current challenges, concurrently with handling the fundamental challenges to the economy and encouragement of its growth drivers, will help achieve sustainable growth.

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