

BANK OF ISRAEL

Office of the Spokesperson and Economic Information

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**New study from the forthcoming Research and Policy Analysis Notes:**

**Monetary Policy’s Effect on Private Consumption in Israel—**

**An examination using credit card expenditure data**

**• Monetary tightening through a one percentage point increase in the interest rate reduces private consumption expenditure (domestic; excluding housing) by up to approximately 5 percent in the first six months following the interest rate hike, and by about 2 percent on average during the year following the interest rate hike.**

**• Interest rate hikes affect different components of private consumption expenditure to varying degrees: They significantly reduce the consumption of leisure services, which have a higher weight in consumption by households in the upper quintile, but do not affect food consumption, which has a higher weight in expenditures by the lowest quintile.**

**• Interest rate hikes since April 2022 have moderated private consumption and can explain the relatively slow consumption growth in the following year.**

The primary goal of monetary policy is to maintain price stability. The main tool for this purpose is the interest rate set by the Bank of Israel. Raising the interest rate is expected to moderate private consumption and thus act to reduce pressure on prices and slow inflation. An analysis conducted by Dr. Sigal Ribon from the Bank of Israel Research Department examined the extent to which changes in the interest rate affect private consumption and its components, and found that an interest rate hike indeed works to reduce private consumption expenditure, with a relatively strong impact on the consumption of leisure services consumption, but no impact on food consumption.

The analysis is based on monthly data of real credit card expenditures from 2016 to mid-2023. The monthly frequency of these data, unlike the National Accounts data, which are only available quarterly, allows for examining and identifying the response of private consumption, particularly in the short term, to interest rate changes, while attributing the response to the exact timing of its occurrence. Additionally, the information available in the credit card data also allows for analyzing the different components of household expenditure, to examine not only the impact of the policy on total consumption but also on different components of consumption—such as consumption of goods versus consumption of services and particularly consumption of leisure services.

To isolate the response of private consumption to the policy, it was important to attribute the change in consumption only to the unexpected component of interest rate changes, since it is likely that households had already made the necessary adjustments in their consumption volume in relation to expected changes and did not wait for the decision itself. Therefore, the analysis used the change in the three-month Telbor yield on the day following the interest rate decision. This change reflects the unexpected part of the interest rate decision.

The relationship between monetary policy and private consumption has been extensively studied worldwide using macroeconomic aggregate data or, alternatively, using detailed information such as household expenditure surveys, as well as relying on high-frequency granular data of credit card payments or other financial information. Many studies have found that contractionary monetary policy (interest rate hikes) works to reduce consumption mainly by households that are liquidity-constrained or households directly affected by the interest rate change, such as those with mortgages, and that the main impact is on the consumption of durable goods.

The results of the current analysis indicate that monetary policy significantly affects private consumption expenditure, as reflected in credit card expenditure (excluding housing). A one percentage point increase in the short-term interest rate leads to a reduction of up to approximately 5 percent in expenditure within six months after the hike and an average decrease of about 2 percent in consumption in the year following the interest rate hike. The analysis also shows that not all consumption components respond equally to interest rate changes. The expenditure on leisure goods and services, for which demand elasticity relative to income is the highest, and which has a higher weight in consumption in the upper income quintile than in the other quintiles, is also the component that is most sensitive to interest rate changes. In contrast, food expenditures, which constitute a relatively large part of the expenditure of households in the lower quintile, hardly respond to interest rate changes.

The obtained estimates were used to assess the quantitative impact of the recent cycle of interest rate hikes on consumption. The analysis shows that the process of raising the interest rate from the low level of 0.1% before April 2022 to 4.75% in mid-2023 had a significant impact on consumption during this period, on the order of about 6%. This impact is consistent with the analysis presented in the Bank of Israel's 2023 Annual Report. According to the analysis in the Report, private consumption deviated by more than 5% from the pre-COVID trend in the first three quarters of 2023 (before the war). In particular, the deviation was relatively large in the entertainment and leisure sectors. The analysis presented here, particularly the strong response of expenditure on leisure services, can at least partially explain the deviation of consumption from the trend.