BANK OF ISRAEL
Office of the Spokesperson and Economic Information

November 6, 2023

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

The discussions took place on October 22 and 23, 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 October 23, 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 ramifications on real economic activity, inflation, and financial markets of the “Swords of Iron” War, which erupted on October 7.

Main points of discussion

The Committee discussed the economy’s state just before the war broke out. The Israeli economy had a low debt to GDP ratio, high foreign exchange reserves, and a Current Account surplus. Economic activity was at a high level, despite moderation in the growth rate in the preceding months, and the labor market was tight, at a full employment environment, with a very low unemployment rate. The Monetary Committee members noted that these opening conditions improve the economy’s ability to deal with the effects of the war. Israel’s economy is robust, stable, rests on strong foundations, and has known in the past to recover from difficult periods.

The Committee dealt with the expected ramifications of the war on economic activity, both on supply and on demand. The impact channels in the coming period include lack of workers due to a broad call-up of the reserves and due to the closure of the education system, an adverse impact on physical capital and the ability to work in certain areas, a negative impact on various industries such as construction, agriculture, trade, tourism and entertainment services, an adverse impact on labor productivity, and the effect of the significant uncertainty and an increase in the risk premium on investments in the economy. The most recent data on credit card purchases indicate a decline in consumption since the war began, except for the food industry. Until now, a marked portion of the economic activity is continuing, but of course, there is still a lot of uncertainty regarding the continuation of the war and its ramifications. The magnitude of the war’s impact will increase the more that a larger part of the economy will be impacted for a longer time.

The Committee discussed the inflation environment and the war’s impacts on it. The year over year inflation rate in September was 3.8 percent, above the target. The year over year inflation rate of nontradables in the CPI, which include mainly housing services and the services industries, declined, but remained high at 4.6 percent. The growth rate of the tradable components in the CPI is volatile and was 2.6 percent. The Committee members noted that in the months preceding the war, inflation had been on a moderating trend, and according to forecasters’ projections, it had been expected to converge to the target range in the first quarter of 2024.

The Committee members noted that the shekel's depreciation, which accelerated since the war broke out, was a main risk to the convergence of inflation to the target even in the months before the eruption of the war. In addition to depreciation, supply-side constraints due to the war can impact on prices. In contrast, an adverse impact on demand can moderate the inflation rate in various industries. The expectations and forecasts of the inflation rate one year ahead remained relatively stable and are within the target range, around its upper bound. Expectations derived from the capital market for the second year and onward are also stable and are within the target range. The Committee members assessed that the policy tools implemented by the Committee are consistent with the commitment to return inflation to the target.

The Committee discussed the impacts on the financial markets. In the capital market, since the outbreak of the war, equity indices declined sharply, and the shekel depreciated notably. Long-term government bond yields and corporate bond spreads have increased. Since the previous interest rate decision, the shekel weakened by 6.3 percent against the dollar, by 4 percent against the euro, and by 4.8 percent in terms of the nominal effective exchange rate. To stabilize the markets, in view of the war, on October 9 the Bank of Israel announced a program to sell $30 billion of foreign exchange, out of foreign exchange reserves of around $200 billion (approximately 40 percent of GDP). This is in order to moderate the fluctuations in the value of the shekel and to supply the liquidity required for the continued orderly activity of financial markets. In addition, the Bank announced the implementation of up to $15 billion in Swap transactions in the foreign exchange market, as needed, and government-bond and corporate-bond Repo programs, the goal of which is to supply shekel liquidity to institutional entities and to mutual funds. The Committee members agreed that in view of the war, the policy at this stage has to focus on stabilizing the financial markets and reducing uncertainty.

The Committee also noted that the framework formulated by the Bank of Israel's Banking Supervision Department for deferring loan payments, which was adopted by the banks and expanded to the credit card companies, will provide relief for households and will reduce their financial uncertainty in the coming months.

The Committee discussed developments in the housing market before the war, and the impacts of the war on the construction industry. Home prices declined in recent months alongside moderation in the volume of transactions, and the pace of increase in home prices over the past 12 months moderated to 0.8 percent. The increase in the owner occupied housing services component of the CPI is moderating and was 5.5 percent in the past year. Activity in the construction industry was negatively impacted by the war due to a lack of workers and the closing of construction sites by local authorities.

The Committee discussed global conditions as well. The inflation environment moderated in a notable portion of countries, but the inflation rate is still above central bank targets. As such, the monetary policy in most countries remains restrictive and market expectations reflect a high interest rate environment for a longer period of time than previously assessed.

The Committee discussed the updated macroeconomic forecast formulated by the Research Department in the midst of the war. The forecast is based on a scenario of a war in which the lion's share occurs on the Southern front during the fourth quarter of 2023. Clearly, a longer duration or developments of the war to additional arenas will change the estimates significantly. In accordance with the above, the assessment of the Research Department is that the adverse impact of the war will reduce GDP growth between 0.5 and 1.0 percentage points in each of 2023 and 2024. Accordingly, and in view of the upward revision of activity data through the third quarter of 2023, GDP is expected to grow by 2.3 percent in 2023 and by 2.8 percent in 2024. The year over year inflation rate is expected to be 2.9 percent in the third quarter of 2024 and 2.5 percent at the end of 2024. According to the forecast, the interest rate in the third quarter of 2024 is expected to be 4.0 percent or 4.25 percent. The Department assessed that the costs of the war will lead to growth in the government deficit to about 2.3 percent of GDP in 2023 and about 3.5 percent of GDP in 2024. These will lead to the debt to GDP ratio at the end of 2024 being about 65 percent.

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, and it has activated a program to sell foreign exchange and to provide liquidity in the swap and repo markets. The interest rate path, and the use of additional monetary policy tools, will be determined in accordance with this purpose and with developments in the war, as well as with data on economic activity and the inflation dynamics, in order to continue supporting the markets' stability and achieving the policy objectives and the needs of the economy.

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
Mr. Arad May, Monetary Committee Secretariat
Ms. Dana Orfaig, Research Department
Ms. Irit Rozenshtrom, Research Department
Mr. Daniel Shlomiuk, Bank spokesperson's office