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**BANK OF ISRAEL**

Office of the Spokesperson and Economic Information

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**Press release:**

**Remarks by the Governor of the Bank of Israel at the press briefing on monetary policy held today at the Bank of Israel**

Good afternoon.

We are in the eighth week of the “Swords of Iron” War. Beyond the security issues, the war has marked economic ramifications, which impact on real activity and on the financial markets. We at the Bank of Israel and the Monetary Committee are utilizing a range of tools that are available to us in order to assist the economy and the public in Israel to get through this period and reach the optimal starting point for the day after. Obviously, the extent of economic uncertainty at this time is related to the security situation and to how the war will develop at the front. In view of these, and in accordance with the information that has been collected since the previous decision, the Research Department has updated its macroeconomic forecast.

I want to reiterate that Israel’s economy is robust and stable. It has known how to recover from more than a few difficult periods in the past and to return rapidly to prosperity. The economy’s growth drivers are able to adjust to various situations. Among these growth drivers are innovation and technology, in which we are global leaders.

We have been carrying out continuous assessments at the Bank on the war’s impact on various economic and financial aspects. Obviously, there has been a notable adverse economic impact on the economy in the first weeks of the war and costs to the State budget because of the war. However, there is also room to recognize that in several areas the economy is displaying abilities to adjust to the situation forced upon it. We see this particularly in the return to work in many industries, in the composition and volume of purchases by the public, and by the return of trade activity. The continuation of routine as much as possible on the home front, against the background of the war on the front, is very essential to the economy. A major component in that is the education system’s return to functioning. Beyond the basic importance of imparting an education, its activity enables other parts of the economy as well to function better.

The fiscal ramifications of the war are expected to be with us in the medium term as well. It is important that the government directs its policy with this view. Alongside the need to provide a budgetary response to needs created by the war, in emergency times as well there is considerable importance to maintaining a responsible fiscal framework. The markets look at the economy not just from a short-term perspective, but also from the medium and long term. Therefore, it is important that the government cut new expenditures of a prolonged nature. The expenditures on the fighting and the replenishing of the army’s stocks will end, and the civilian expenditures will wind down gradually with the recovery of the economy and the end of the massive rehabilitation of the communities that were destroyed. However, at the same time, it is likely that government expenditures will increase due to a permanent increase in security expenditures, and an increase in interest payments due to the public debt level increasing and becoming more expensive. These expenses are expected to be much smaller than the current costs of the fighting. However, as noted, they are significant, as they will continue for a long time. Therefore, it is important to make decisions soon regarding the budget adjustments that will support a continued reduction of the debt to GDP ratio from the level that it will reach at the end of the hostilities. Such a decline is important in order to maintain the credibility of fiscal policy in the view of the markets, and to prepare for additional crises that the State of Israel is liable to face in the coming years.

Let me switch now to discussing our decision today. The Monetary Committee discussions that were held over the past 2 days naturally focused on the economic impacts of the war. The Monetary Committee analyzed the various processes and their impact on economic activity and on inflation, and at the end of the discussions the Committee decided to leave the interest rate unchanged at 4.75 percent.

It is important to understand—despite some decline in the risk premium, it is still at a high level. This is against the background of the considerable uncertainty regarding how the war will develop. Inflation remains above the target range. Despite inflation expectations being anchored, the effects of the war on the inflation processes are still not clear. These will depend on the relative severity of the supply limitations and the decline in demand. As we noted in the interest rate decision, the Monetary Committee’s policy is focused on the stabilization of the markets and the reduction of the uncertainty, alongside price stability and support for economic activity. The interest rate path will be determined in accordance with the development of the war and the uncertainty derived from that. To the extent that the financial markets’ recent stability will become entrenched and the inflation environment will continue to moderate toward the target range, the more that monetary policy will be able to support economic activity.

With the eruption of the war, we took several steps with the goal of ensuring the full and orderly functioning of the markets. These programs succeeded in generating stability so far in the foreign exchange and financial markets. The high level of the Bank of Israel’s foreign exchange reserves, which was approximately $200 billion just before the war, gives us a range of activity for maintaining the stability in the markets, while reducing the uncertainty at this time.

In addition, with the agreement of the banking system, we expanded the assistance framework to banking system customers residing in the North as well as the South. Recall that the frameworks that were formulated enable populations that were adversely impacted directly by war damages as well as reserves soldiers to defer, without interest or fees, the repayments on loans or mortgages, and to be eligible for other benefits. In addition to these, since the previous monetary policy decision, we at the Bank adopted several policy measures with the goal of supporting the orderly supply of credit to small businesses. As part of that, we decided to implement a program of extending low-cost credit to small and micro companies at a scope of NIS 11 billion, through the banking system and through nonbank entities.

I will shift now to expand on additional economic data, beginning with inflation. The return of inflation to its target remains a central goal, even at this time. We entered the war with inflation in Israel still above the upper bound of the target and encompassing a wide range of CPI components. The inflation rate in Israel has been above the upper bound of the target range for some time now, but according to the various expectations and forecasts, it is expected to moderate in the coming months and return in the first half of 2024 to the target range of 1–3 percent. We see in the recent data a decline in the inflation rate of nontradable goods, which are made up mostly of the housing component and the services industries. In contrast, the inflation rate for tradable goods is in fact lower, but it is more volatile. The recent marked appreciation, if it becomes entrenched, will reduce the inflation pressures and will help the inflation rate converge to the target. The policy tools that we have implemented so far are consistent with our commitment to returning the inflation rate to the target, and the Monetary Committee assesses that the current monetary policy supports the convergence of inflation to its target.

The housing market has considerable weight in economic activity. In recent months, we have seen moderation in this market, and the Home Price Index is declining, while alongside this we also see new difficulties emerging in the industry. The security situation has led to an adverse impact on activity on the construction industry, due to a lack of Palestinian workers and to some extent the departure of foreign workers from other countries. In addition, the closing of construction sites by some local authorities has limited the activity of the construction companies. The government is working to bring additional foreign workers into Israel soon, and it is important that it continue to act to minimize the various limitations in construction sites in order to maintain the activity in the industry. In addition to maintaining activity in the immediate term, activities that are required to maintain a high supply of construction over time should be taken. This is the key, as I have noted in the past, to continued moderation in housing prices.

In terms of the state of economic activity, the labor market just before the war was tight and at a full employment environment. Due to the war, the broad unemployment rate has jumped. This rate includes employed people who have been put on furlough by their employers. This is alongside a decline in the number of job vacancies to levels we saw just before the COVID-19 crisis. In contrast, we also see the economy’s ability to adjust to the situation. For example, the number of workplaces reporting minimal presence of workers declined from 20 percent in the first wave of the special survey to 11 percent in the second wave that was conducted approximately a week ago. In addition, consumption using credit cards, which declined notably in the first weeks of the war, is recovering. In the domestic capital market too, equity indices in Israel recently showed signs of recovery, as did bond spreads and yields.

The updated macroeconomic forecast published today by the Research Department takes these and other issues into account. The new forecast was built under the assumption that the war’s direct effect on the economy will continue into 2024, but at a decreasing intensity. This is in contrast to the assumption in the October forecast that the direct impact will be focused in the fourth quarter of 2023. Similar to the October forecast, the forecast assumes that the lion’s share of the war will be on one front, Gaza. There are industries, such as the construction and agriculture industries, in which the supply constraint (lack of workers and access) is relevant. There are other industries in which the dominant factor is a decline in demand. The Department’s forecast incorporates these industry limitations and their developments over time. Naturally, the forecast is characterized by a particularly high level of uncertainty regarding the duration, scope, and characteristics of the war. Clearly, a shorter or longer time and the spread of the war to other areas will change the estimates substantially. In accordance with these assumptions, the Department revised its growth forecast downward, and estimates that GDP will grow by 2 percent in each of 2023 and 2024. According to the forecast, the broad unemployment rate is expected to be 4.5 percent, on average, in 2024. The year over year inflation rate is expected to be 2.4 percent, on average, in the fourth quarter of 2024. The forecast estimates that the budgetary costs of the war (expenditures plus loss of income) are expected to total 10 percent of GDP. The debt to GDP ratio, one of the most significant fiscal indicators, is expected, according to the forecast, to be approximately 66 percent at the end of 2024.

This is the time to remember, again, that responsible fiscal policy brought the economy to a desired debt to GDP ratio of approximately 60 percent at the beginning of the war. This ratio supports us at this time when the economy is expected to face significant expenditures as a result of the war, whether for security or for support and assistance to businesses and households that were adversely impacted. It is important to continue conducting responsible fiscal policy, and to convey this to the markets, which today more than ever are following the activity in Israel. A new 2024 budget is only expected to be built in the first months of 2024. As such, it is important that already now the government demonstrate its commitment to fiscal responsibility by material decisions to reduce expenditures that have become less essential. The reduction should be via adjustments on items that have a permanent impact, and that make a lower contribution to economic growth. Thus, these will serve as sources for dealing with the expected increase in the defense budget in the years following the war as well, with the debt to GDP ratio liable to otherwise continue increasing without such adjustments.

Before concluding, there is no doubt that we are going through a challenging period. The Bank of Israel will continue to assist Israel’s economy to get through the challenges that we still face. As the Israeli economy has known how to recover from difficult periods in the past and to return rapidly to prosperity, I am confident and sure that Israel’s economy has all the necessary components to return to its tremendous potential growth.

I would also like to convey from here that the Bank of Israel and the Monetary Committee want to express our support for the soldiers on the front. We extend our condolences to the families of those killed, we wish for a full recovery to the injured, and we pray for the speedy return of the captives and the missing. Our thoughts and prayers are with you.

Thank you.