Bank of Israel

Monetary Policy Report

First Half of 2023

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According to the Bank of Israel Law, 5770–2010, the Bank of Israel has three objectives: (1) to maintain price stability, as its central goal. Price stability is defined as an annual inflation rate of between 1 percent and 3 percent; (2) to support other objectives of the government's economic policy, particularly growth, employment and reducing social gaps, provided that this support does not prejudice the attainment of price stability; and (3) to support the stability and orderly activity of the financial system.

Section 55(a) of the Bank of Israel Law, 5770–2010 regulates the publication of this report, which the Bank of Israel submits to the government and the Knesset Finance Committee twice a year. The report surveys the economic developments that took place during the period covered by the report. It also surveys the policy adopted in order to maintain the inflation rate within the range set by the government and to achieve the other objectives of the government's economic policy. The economy's financial stability is surveyed by the Bank of Israel in its Financial Stability Report.

In accordance with Section 55(b) of the Bank of Israel Law, 5770–2010, this Monetary Policy Report presents the reasons for the inflation rate's deviation from the target range set by the government for more than six consecutive months—from the publication of the Consumer Price Index for January 2022 (which was published on February 15, 2022) until the publication of the Consumer Price Index for May 2023. The inflation rate during this period exceeded the upper bound of the target range, and the explanations for this are provided in Section 2 below ("Background Conditions from the Monetary Committee's Viewpoint).

The Monetary Policy Report for the first half of 2023 was prepared by economists in the Research Department, under guidance from the Monetary Committee. The report is based on data published up to the interest rate decision reached on July 10, 2023.

* The data in this report are up-to-date as of July 10, 2023, and include CPI data up to May 2023.

Abstract

This report surveys monetary policy during the first half of 2023.[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

[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.

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. POLICY MEASURES

With the aim of returning inflation to a price stability environment in accordance with the target, the Bank of Israel continued the process of monetary tightening during the first half of 2023, raising the interest rate to 4.75 percent, after raising it to 3.25 percent at the end of 2022.

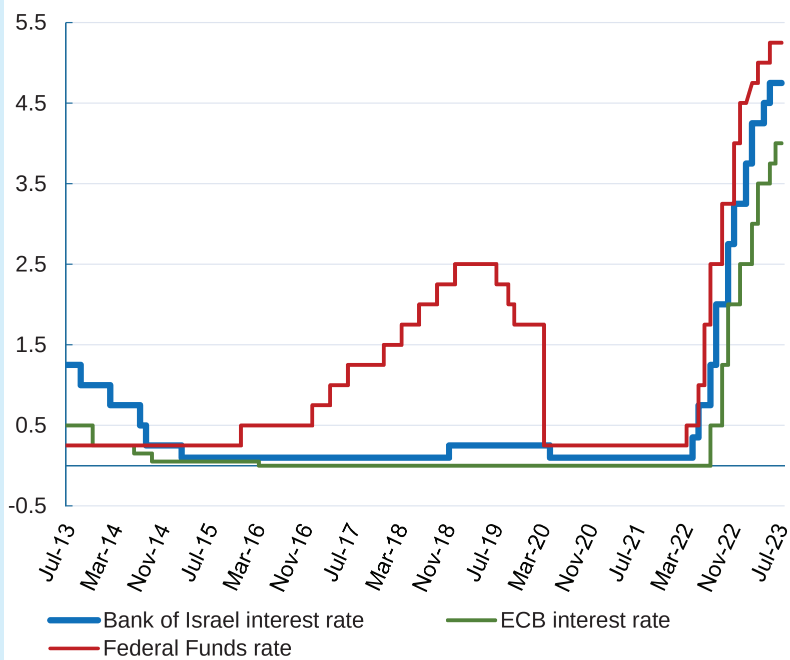
The Monetary Committee continued the process of monetary tightening in 2023, with the aim of returning inflation to its target. It did so by increasing the monetary interest rate, while examining the mix of economic developments in Israel and abroad. During the reviewed period, the Committee increased the interest rate four times: twice by 0.5 percentage points and twice more by 0.25 percentage points (Figure 1). At the end of the period, the interest rate was 4.75 percent. These measures are a continuation of the implementation of the narrowing monetary policy that began in 2021, as part of which the bond purchasing program and the use of other special tools that were operated during the COVID-19 crisis were stopped. The monetary tightening increased in 2022, with interest rate increases that were somewhat higher than the average of the forecasts that were prevalent at the time. During the reviewed period, the pace of interest rate increases slowed, from 0.5 percentage points in January and February to 0.25 percentage points in April and May. In July the interest rate was left unchanged. The Monetary Committee's assessment is that the monetary tightening is having a lagged effect, and that the effect will continue particularly inasmuch as the moderation of the inflation rate is reflected in an increase in the real interest rate.

The increase and persistence of inflation, in view of the strong economic activity and the tight labor market, was a main factor in the continuation of the restraining monetary policy. The Committee members noted that households' cumulative savings during the COVID-19 crisis is weakening the effect of monetary policy through the private consumption channel to some extent.[2] In contrast, an analysis presented to the Committee members showed the significant contribution that the interest rate increases made to restraining inflation through the exchange rate channel.

Medium- and long-range inflation expectations remained anchored within the target range during the period, but expectations for up to two years slightly exceeded the range for some of the time. Real interest rates increased during the period along the entire yield curve. The slope of the real yield curve remained flat.

[2] See a discussion of this topic in Box 2.1 of the Bank of Israel *Annual Report* for 2022.

Figure 1
Bank of Israel Interest Rate, Federal Funds Rate, and ECB Interest Rate, July 2013–July 2023 (percent)



SOURCE: Bank of Israel.

At the time of the January 2023 interest rate decision, annual inflation had increased to 5.3 percent, although the most recent data at the time showed some moderation in some of the components, mainly in the tradable goods.[3] However, the increase in prices remained broad, which led to the Committee's assessment that it reflected contributions by domestic demand factors. The Committee members believed that the monetary tightening process in Israel and abroad, as well as the moderation of demand, worked to moderate inflation. However, they noted that there was uncertainty regarding the extent of fiscal expansion and the development of wages, which in turn affected the pace of inflation's convergence to the target range. Five of the six Committee members believed that the interest rate should be increased by 0.5 percentage points to 3.75 percent, while one Committee member supported an increase of 0.75 percentage points, in view of the increase in inflation and the continued depreciation of the shekel in recent months.

At the time of the February 2023 interest rate decision, annual inflation continued to increase, and had reached 5.4 percent, with an increase in one-year expectations from the various sources.[4] Economic activity continued at a high level, and the labor market remained tight an in a full employment environment although the most recent data showed some moderation. National Accounts data for the fourth quarter of 2022 indicated that GDP had been higher than the pre-COVID-19 trend for the past five quarters. The housing market showed the beginning of a slowdown in the pace of home price increases. The Committee discussed

[3] The decision was made on January 2. The annual inflation figure available at the time was for November 2022.

[4] The decision was made on February 20. The annual inflation figure available at the time was for January 2023.

the global growth forecasts, which were revised upward as a result of the decline in concerns of an energy crisis in Europe, the reopening of China following the removal of COVID-19-related restrictions, and better-than-expected activity data from the US. The Committee members also discussed developments in the capital market, and noted that in contrast with the global equity indices, the Israeli equity indices reflected underperformance. At the end of the discussion, four of the five Committee members believed that the interest rate should be increased by 0.5 percentage points to 4.25 percent, and one Committee member supported an increase of just 0.25 percentage points.

At the time of the April 2023 interest rate decision, the annual inflation rate had declined slightly (5.2 percent), but by a lower pace than previous assessments.[5] Inflation figures continued to indicate that it was supported by domestic demand factors, with indications of “sticky inflation”. The Committee members’ assessment was that despite the apparent “stickiness”, the monetary tightening processes in Israel and abroad and the moderation of demand were working to moderate inflation. The Committee members noted that the budget proposal that was recently approved by the government complemented the narrowing monetary policy during the period. The public sector wage agreements that had recently been signed also lowered uncertainty in that area, and were consistent with restraining inflation and returning it to the target range. Alongside that, the housing component of the Consumer Price Index (reflecting rental prices) continued to increase, and even accelerated. The Committee members discussed economic activity, and their assessment was that while activity was converging to around the long-term trend, there were signs of a slowdown, including a decline in the demand for workers, particularly in the high-tech sector. There were price declines in the domestic capital market, and the Committee members noted that the market continued to reflect underperformance relative to global equity markets. A similar trend was observed in the yields of long-term government bonds, which increased slightly during the period in contrast with the global trend of declining yields. The Committee members discussed the tremendous uncertainty due to legislative processes with regard to the judicial system and their economic implications. At the end of the discussion, the Committee believed unanimously that the interest rate should be increased by 0.25 percentage points to 4.5 percent.

At the time of the May 2023 interest rate decision, annual inflation remained unchanged at 5.0 percent, following a downward surprise in the CPI in April.[6] However, the most recent data at the time showed signs of moderation in the pace of inflation. The Committee’s assessment was that the monetary tightening process in Israel and abroad was working to moderate inflation, but the trend of depreciation of the shekel, alongside the acceleration in the housing component of the Consumer price Index, were delaying inflation’s convergence to the target range. The Committee members believed that the depreciation of the shekel also reflected some increase in Israel’s risk premium. National Accounts data for the first quarter were surprisingly good, and indicated a relatively high level of growth. The labor market remained tight and the employment and participation rates were at record highs. However, the most recent data on current indicators continued to show moderation. The Committee’s assessment was that the interest rate was in a restraining environment that was in line with the moderation of inflation during the coming year. The

[5] The decision was made on April 3. The annual inflation figure available at the time was for February 2023.

[6] The decision was made on May 22. The annual inflation figure available at the time was for April 2023.

Committee members noted that should there be further developments that would be reflected in further depreciation, the Committee would have to increase the monetary tightening. At the end of the discussion, all of the Committee members believed that the interest rate should be increased by 0.25 percentage points to 4.75 percent.

At the time of the July 2023 interest rate decision, annual inflation had decline to 4.6 percent, and the CPI for May was lower than forecast.[7] In addition, there were increased indications of a moderating trend in inflation. Activity continued at a high pace, and National Accounts data for the first quarter were revised upward, and indicated growth at a relatively high pace. The labor market remained tight, and employment and participation rates were at record highs. However, the most recent data on current indicators continued to show moderation. There were also signs of moderation in the labor market, including a downward trend in the job vacancy rate, particularly in the high-tech sector. The Committee discussed developments in the housing market, particularly the moderation in the volume of transactions and in new mortgage borrowing. The pace of home price increases in the past 12 months continued to decline, and prices were unchanged relative to the beginning of the year. In contrast, the owner-occupied housing services component of the Consumer Price Index continued to increase. The Committee also discussed the Research Department's staff forecast, which was published together with the interest rate decision, and noted that the main risk to the forecast was the realization of a scenario in which legislative and institutional changes would be accompanied by an increase in the country's risk premium.

At the end of the discussion four of the Committee members believed that the interest rate should be left unchanged at 4.75 percent, while one member believed it should be increased by 0.25 percentage points to 5 percent. The Committee members emphasized that there was a distinct possibility of further increases in future decisions, if the inflation environment did not continue moderating as expected.

2. BACKGROUND CONDITIONS FROM THE MONETARY COMMITTEE'S VIEWPOINT

a. The inflation environment

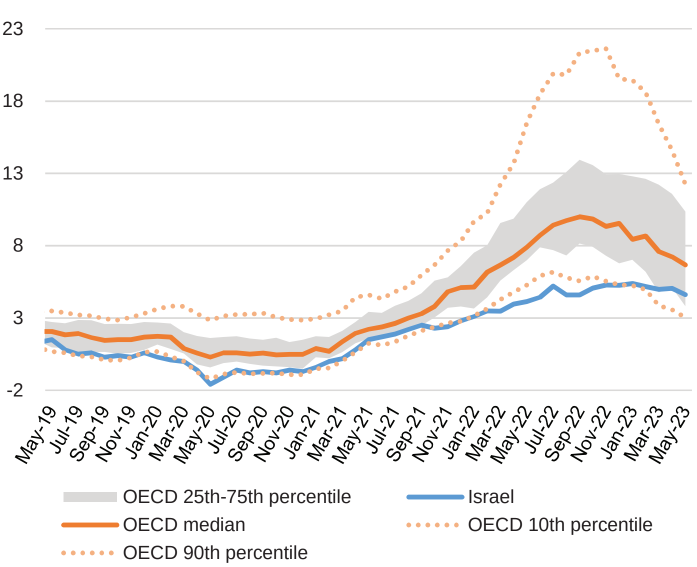
The first half of the year continued to be characterized by a high inflation environment that exceeded the upper bound of the target range. The annual inflation rate in May was 4.6 percent, lower than most advanced economies, and in the lowest quarter of OECD countries (Figure 2a). Some of the differences are explained by gaps between Israel and other countries in the development of the energy and food components (Figure 2b).

Annual inflation net of energy and fruits and vegetables was 4.9 percent in May, and with the further omission of the effects of taxation and regulation, it was 5.1 percent (Figure 3). Global commodity prices declined by 2.3 percent during the reviewed period, completing a one-year decline of 9.7 percent, while global oil prices declined by 7.5 percent during the period, completing a one-year decline of 36 percent (Figure 4). Despite the decline in global energy prices, this component in the Consumer Price Index increased by 3.6 percent,

[7] The decision was made on July 10. The annual inflation figure available at the time was for May 2023.

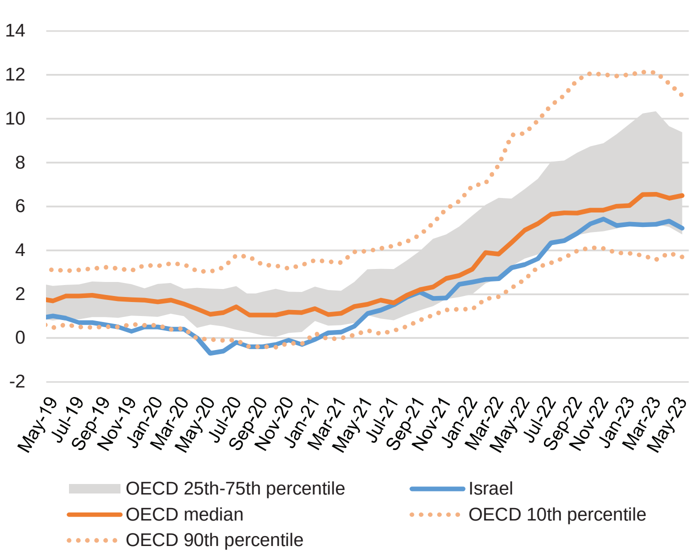
due to the depreciation of the shekel during the period, thereby contributing 0.2 percentage points to the annual inflation rate. Price increases were also supported by an acceleration in the housing component, which increased at an annual rate of 7.5 percent and contributed about 2 percentage points to annual inflation. Food prices also increased (4.2 percent annually), contributing 0.6 percentage points to annual inflation (Figure 5).

Figure 2a
Annual Inflation in Israel and the OECD,
May 2019–May 2023 (percent)



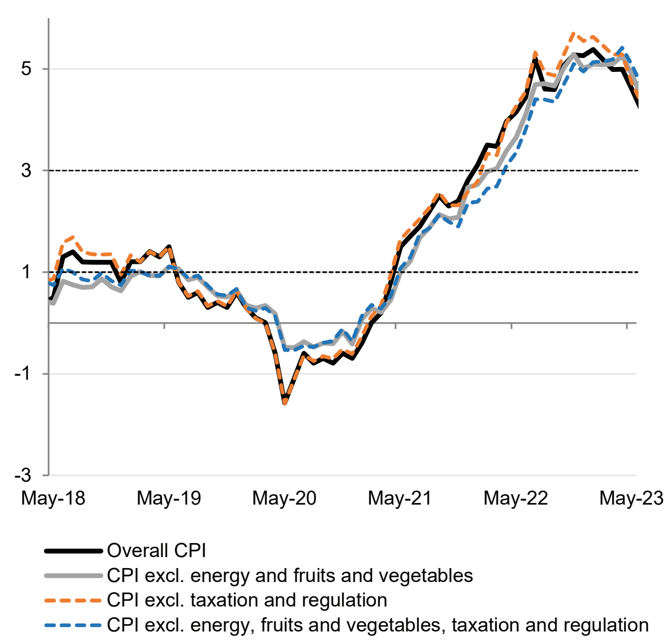
SOURCE: Based on OECD.

Figure 2b
Inflation Excluding Food and Energy in Israel and the OECD,
May 2019–May 2023 (percent)



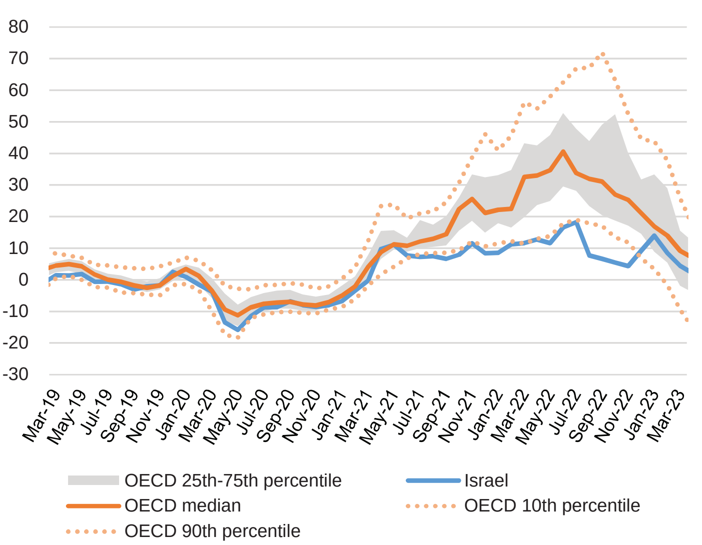
SOURCE: Based on OECD.

Figure 3
Overall CPI, CPI Net of Energy and Fruits and Vegetables, and Net of Institutional Intervention, May 2018–May 2023
(percent)



SOURCE: Central Bureau of Statistics.

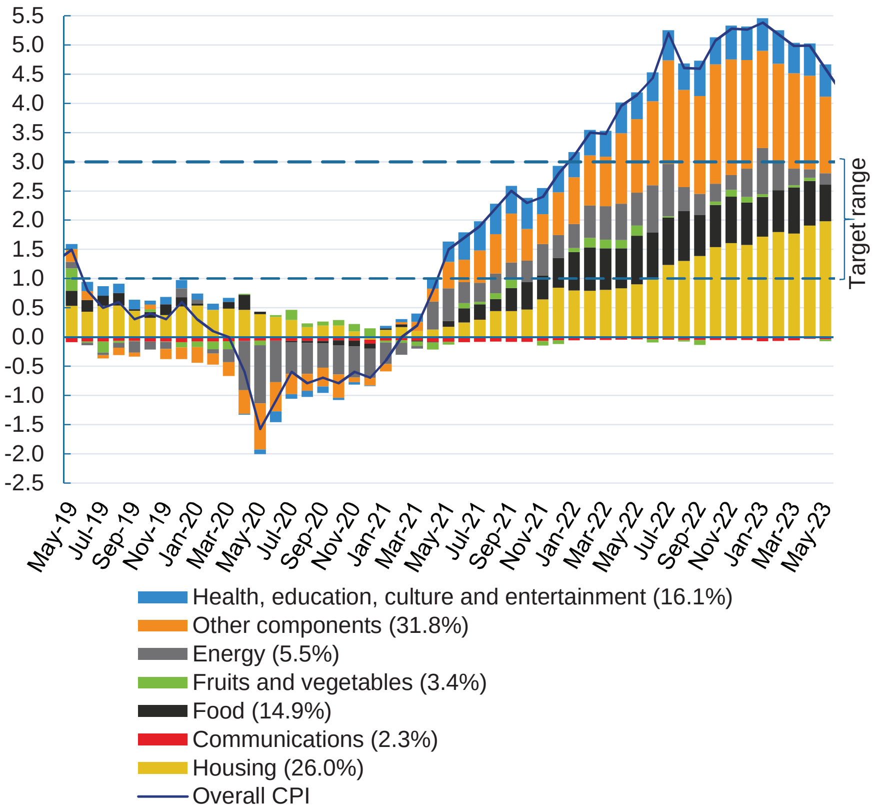
Figure 4
Annual Rate of Change in Energy Prices, Israel and OECD, March 2019–March 2023 (percent)



SOURCE: Based on OECD.

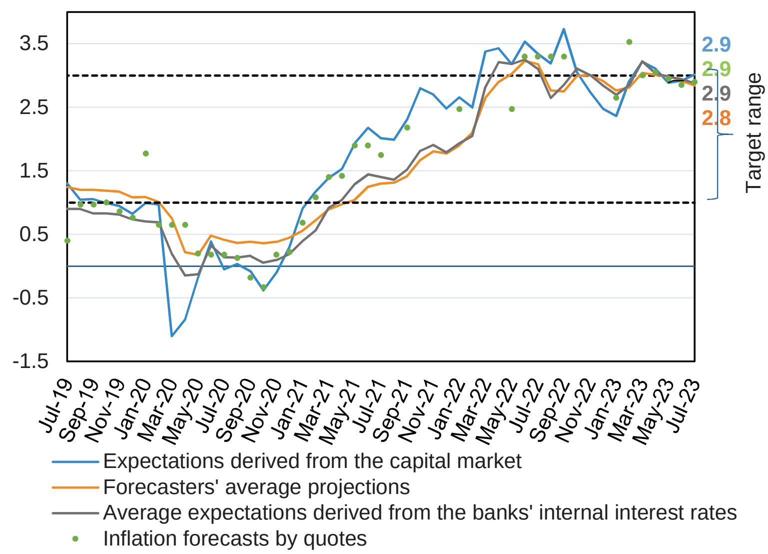
Short-term inflation expectations, for one year and one year forward in one year, continued to range around the upper bound of the target during the reviewed period, and sometimes above it (Figures 6 and 7). Despite the high inflation environment, longer-term inflation expectations (beyond two years) remained anchored within the target range. At the time of the July decision, one-year expectations derived from the capital market were 2.9 percent, and professional forecasters expected inflation of 2.8 percent.

Figure 5
Contributions of the Main CPI Components to Inflation[a,b], May 2019–May 2023 (percent)



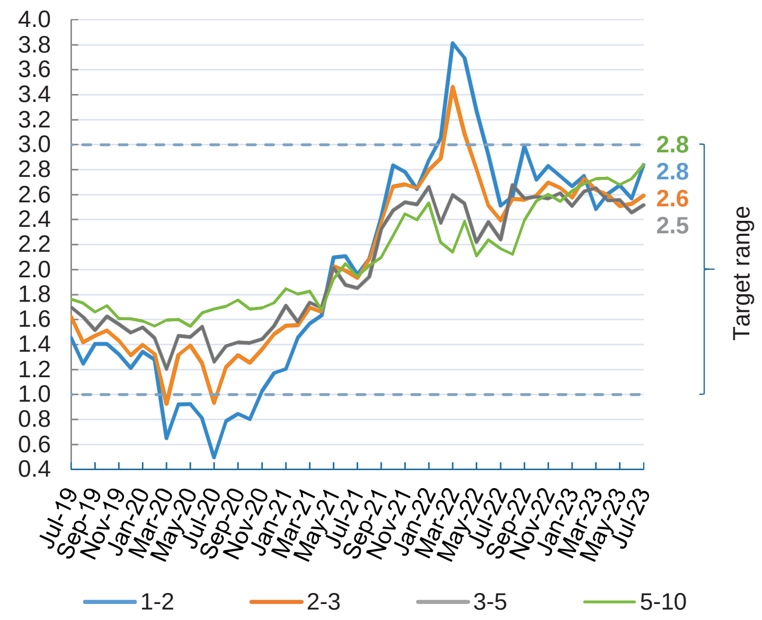
[a] The component's weight in the overall CPI (as of 2021) appears in parentheses.
[b] Other components includes furniture and household equipment, clothing and footwear, miscellaneous, home maintenance, and transportation, excluing subcomponents connected to energy prices.
SOURCE: Based on Central Bureau of Statistics data.

Figure 6
One-Year Inflation Forecasts from Various Sources[a], July 2019–July 2023 (percent)



[a] Monthly averages.
SOURCE: Bank of Israel.

Figure 7
Forward Inflation Expectations Derived from the Capital Market[a], July 2019–July 2023 (percent)



[a] Monthly averages.
SOURCE: Bank of Israel.

During the reviewed period, the Committee members discussed the causes of the high inflation environment in Israel and the extent of its persistence. The increase in inflation in Israel, similar to other developed economies, began in 2021 with the recovery from the COVID-19 crisis and the cancellation of various restrictions that were intended to deal with the spread of the virus. During that period, there was increased demand for goods and services that could not be consumed during the crisis, partly due to accommodative monetary policy and expansionary fiscal policy. This was accompanied by continued disruptions in the supply chains and in shipping, which weighed upon the expansion of supply. The increase in global demand alongside various supply barriers led to a global increase in prices. As a small and open economy, Israel was affected by this through higher prices for tradable goods, and later on of nontradable goods and services, which were influenced by higher priced of imported inputs. The acceleration of inflation was also supported by increased demand for goods and services in the domestic market in view of the tight labor market and the increase in savings among some households during the crisis.

This trend increased with the outbreak of the war between Russia and Ukraine and the international sanctions that accompanied it. These led to further increases in food and energy prices, resulting in higher prices in Israel. Over time, and with the persistence of high inflation, there were increasing indications that the price increases were broad and that they encompassed a wide range of components. Accordingly, the Monetary Committee continued its monetary tightening process with determination, with the aim of returning inflation to its target.

In parallel with the acceleration in the global inflation environment, the shekel began depreciating at the beginning of 2022, in contrast with the trend of appreciation that had been prevalent in previous years. This development contributed to an acceleration of inflation and weighed monetary policy's efforts to restrain it. The Committee members noted that the depreciation at the beginning of 2022 reflected developments in the global equity markets, particularly the slowdown in the technology industries.

At the beginning of 2023, the depreciation of the shekel resumed. Various analyses presented to the Committee members shows that, in contrast to the (negative) common correlation observed in recent years between the shekel exchange rate and the trend of US equity markets, the depreciation at that time was not explained by the equity market trends in the US or the strengthening of the US dollar globally. In addition, during the period, the dollar yield gaps of Israeli government bonds vis-a-vis US bonds and the Israeli capital market showed underperformance relative to foreign capital markets. Furthermore, Moody's lowered its credit rating forecast, and publications regarding the uncertainty and risks in Israel were distributed by other ratings agencies, the IMF, and the OECD. These, alongside other indications, strengthened the perception that the depreciation of the shekel now reflected an increase in Israel's risk premium, in view of the possibility of significant legislative changes with regard to the judicial system that may have an impact on the economy.

During the reviewed period, the Committee was shown various assessments that indicated the possibility that the continued depreciation, combined with the high inflation environment, had led to a strengthening of the pass-through from the exchange rate to domestic prices and thereby strengthened the contribution of the depreciation to inflation.

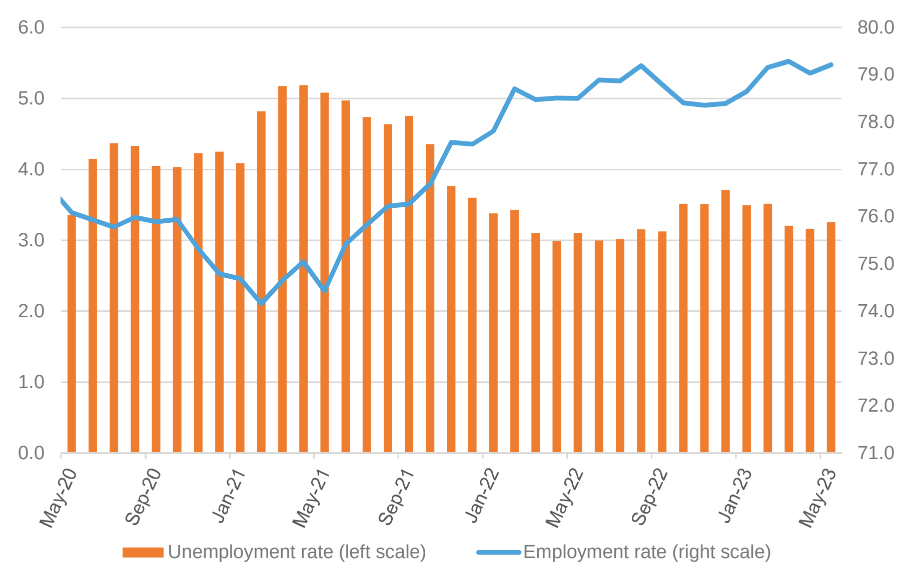
The high inflation environment was also supported by an acceleration of the housing component in the Consumer Price Index, which reflects rent prices. During the reviewed period, the housing component increased by about 2.3 percent (5.6 percent in annual terms), contributing 0.6 percentage points to the overall index during the period. The Committee members repeatedly noted throughout the reviewed period that the shekel's depreciation and the acceleration in the housing component were two main factors delaying the convergence of inflation to the target range. Despite this, the Committee's assessment was that the monetary tightening process in Israel and abroad, the moderation of demand, the easing of the supply chain interruptions, and the decline in commodity and oil prices, as well as the slowdown in the global inflation environment, would help moderate inflation in Israel.

b. Real inflation in Israel and the labor market

The data and indicators presented to the Committee during the surveyed period continued to point to a high level of activity, above the trend from before the COVID-19 crisis, but also to some moderation in the most recent data. National Accounts data for the first quarter indicated growth that was close to potential, which was affected by increases in fixed capital formation and in services exports excluding startups, alongside moderation in private consumption (Table 1). Alongside the National Accounts data, the most recent figures of some current indicators, including credit card expenditures and VAT receipts, pointed to some moderation. Tax revenue during the first half was in line with Research Department assessments, and was lower than in the same period of 2022. In the high-tech industries, there appeared to be a slowdown that was reflected in a lower number of job vacancies and in a decline in capital raised by companies. In addition, demand for Israeli exports in these fields remains high.

The labor market is strong and in a full employment environment. However, there appears to be a decline in the tightness of the labor market, due to an increase in the participation rate and a decline in the job vacancy rate, particularly in the high-tech sector. In the first months of the year, the increase in the unemployment rate that was apparent in the previous half-year was halted, and the rate resumed its decline alongside increases in the participation rate and in the employment rate (Figure 8). Nominal wages in the business sector continued to increase in line with the trend, but real wages eroded due to price increases. The public sector wage agreement for the coming years was moderate. The pace of nominal wage increases in the business sector in the past year was slightly higher than its long-term increase, but it is clear that wages were not a main factor in the acceleration of inflation during the reviewed period.

Figure 8
Unemployment Rate and Employment Rate, Aged 25–64, May 2020–May 2023 (percent)



SOURCE: Based on Central Bureau of Statistics.

Table 1
National Accounts data available at the time of the interest rate decision
(seasonally adjusted, quantitative rate of change from the previous period, annual terms)

		31/3/23	30/4/23	31/5/23	30/6/23	31/7/23
GDP	2022:Q3	2.1	1.7	1.8	1.8	1.8
	2022:Q4	5.8	5.6	5.3	5.3	5.3
	2023:Q1				2.5	3.1
Business output	2022:Q3	1.2	0.7	0.8	0.8	0.8
	2022:Q4	7.3	6.9	6.4	6.4	6.4
	2023:Q1				3.3	3.8
Private consumption	2022:Q3	-1.2	-1.3	-1.4	-1.4	-1.4
	2022:Q4	10.6	10.1	10.2	10.2	10.2
	2023:Q1				-1.7	-1.7
Fixed capital formation	2022:Q3	14.0	13.6	13.4	13.4	13.4
	2022:Q4	4.8	3.2	-0.9	-0.9	-0.9
	2023:Q1				14.7	15.3
Exports excl. diamonds and startups	2022:Q3	3.7	3.3	3.8	3.8	3.8
	2022:Q4	-7.9	-8.4	-6.5	-6.5	-6.5
	2023:Q1				0.4	3.1
Civilian imports excl. ships, aircraft and diamonds	2022:Q3	-4.1	-4.0	-3.9	-3.9	-3.9
	2022:Q4	0.8	0.0	0.3	0.3	0.3
	2023:Q1				-8.1	-9.9

SOURCE: Based on Central Bureau of Statistics.

Table 2
Development of GDP, imports, and uses

(seasonally adjusted, quantitative rate of change from the previous period, annual terms)

	2020	2021	2022	2021:Q4	2022:Q1	2022:Q2	2022:Q3	2022:Q4	2023:Q1
GDP	-1.9	8.6	6.5	19.4	-3.1	6.4	1.8	5.3	3.1
Business sector output	-2.4	10.3	7.8	22.9	-2.4	8.4	0.8	6.4	3.8
Civilian imports excl. ships, aircraft and diamonds	-7.2	18.2	12.1	28.3	14.0	9.9	-3.9	0.3	-9.9
Private consumption	-7.9	11.1	7.7	16.2	1.5	8.6	-1.4	10.2	-1.7
of which : excl. durables	-8.6	10.4	7.6	24.0	2.5	3.8	-0.2	7.4	0.3
Public consumption	2.8	4.2	0.7	9.6	-9.9	2.6	5.8	2.7	1.9
of which : excl. defense imports	2.6	3.7	1.1	12.6	-11.3	3.8	2.0	11.5	-3.2
Gross domestic investment	1.2	12.6	12.4	22.5	14.9	-3.4	19.6	2.9	-3.5
of which : fixed capital formation	-3.9	11.7	9.0	18.0	-0.1	7.1	13.4	-0.9	15.3
Exports excl. diamonds	-1.9	13.3	9.2	32.0	-6.0	16.8	2.4	-8.3	3.3
of which : excl. startups	0.2	11.8	9.2	25.7	0.6	13.5	3.8	-6.5	3.1

SOURCE: Based on Central Bureau of Statistics data.

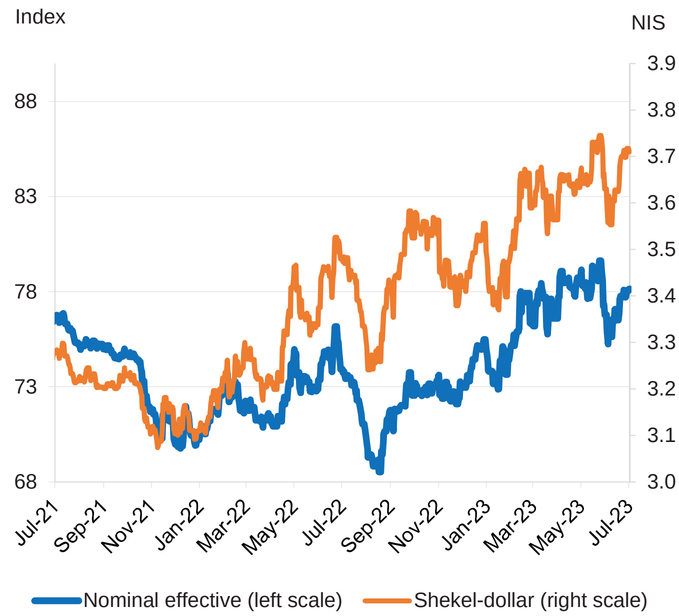
c. The exchange rate

The shekel exchange rate was in a trend of depreciation during the first half of the year, with higher volatility than in the past. At the beginning of the year, the shekel appreciated somewhat, but toward the end of January, the trend of depreciation began against the major currencies. Compared to its level at the end of 2022, the shekel weakened against the US dollar (5.6 percent) and the euro (8.5 percent), and depreciated by 4.6 percent in terms of the nominal effective exchange rate.[8]

An analysis presented to the Committee indicated that the depreciation of the shekel during the first half of the year was not due to a strengthening of the US dollar worldwide or to the trend of the US equity markets (which increased), in contrast to the positive correlation between the strength of the shekel and the equity markets in recent years. Based on the correlation, as it was until the end of 2022, between the exchange rate and the US equity markets, the assessment is that in the first half of 2023 there was an excess depreciation of about 10 percent. According to Research Department estimates, the pass-through from the US dollar exchange rate to domestic prices is about 10–20 percent. As such, we can cautiously conclude that the excess depreciation contributed at least one percentage point to inflation. During the surveyed period, the Committee members were presented with an analysis that showed that there are signs of a strengthening pass-through from the exchange rate to domestic prices, which may be due to the extended depreciation combined with the high inflation environment, which has intensified the contribution of the depreciation to inflation (Figure 10).

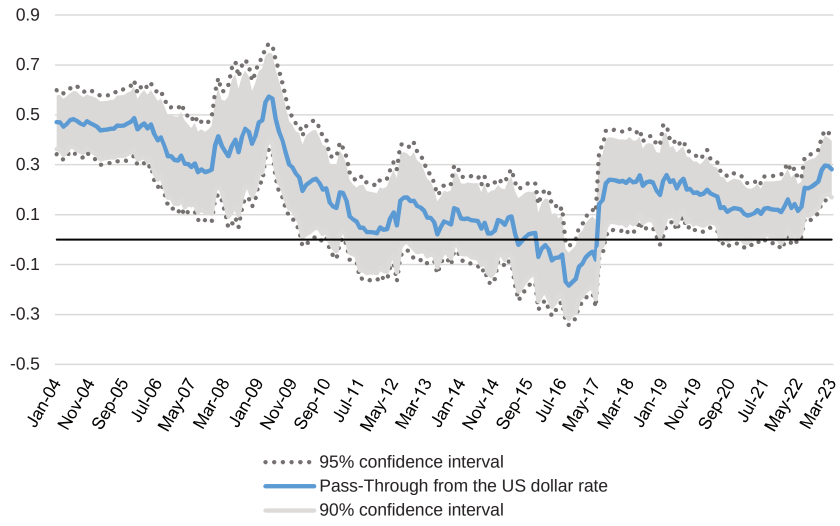
[8] Monthly average of the exchange rate at the time of the interest rate decision in July (from June 10 to July 9) compared to its average level in December 2022.

Figure 9
Selected Exchange Rates, Monthly Average,
July 2021–July 2023



SOURCE: Bank of Israel.

Figure 10
Pass-Through from the US Dollar Exchange Rate to Inflation, January 2004–March 2023
(End date of a 48-month rolling window, percent)



SOURCE: Bank of Israel.

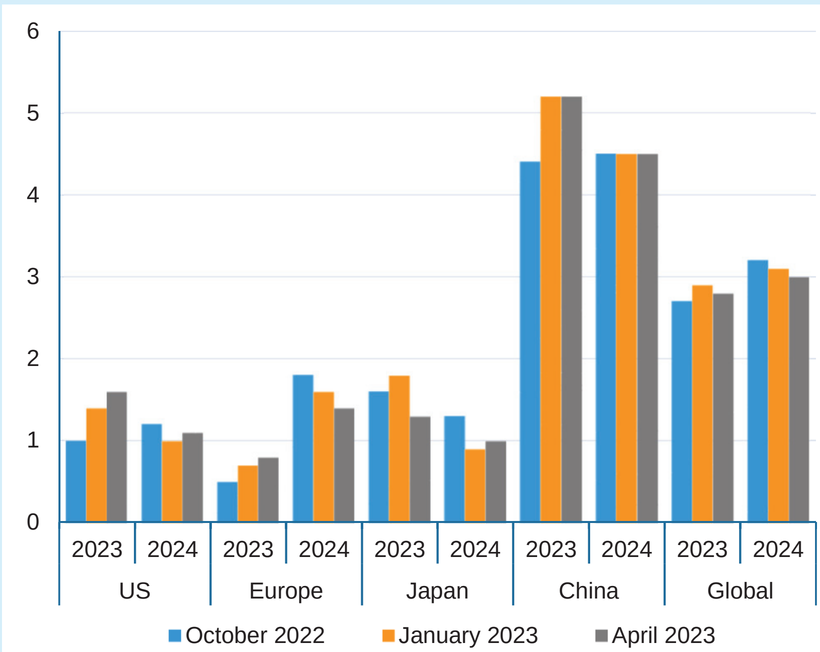
d. The global economy

During the reviewed period, global economic activity remained relatively moderate. The concern of a serious recession in Europe abated, and the Chinese economy recovered, although more moderately than previous assessments. Alongside this, the terms of credit and financial conditions tightened and there were difficulties in regional banks in the US. The global inflation environments remained high, but is in a moderating trend. The easing of supply chain disruptions and of shipping prices, alongside lower energy prices, contributed to this. Core inflation remained high in many countries.

In view of these trends, central banks continued the monetary tightening process, but toward the end of the period, a number of central banks began signaling a future slowing of the process, and some even started this process. During the period, the US Federal Reserve slowed the pace of interest rate increases to 0.25 percentage points, and left the rate unchanged in its June decision. However, it did signal two further increases later in the year. In its May and June decisions, the European Central Bank moderated its interest rate increases to 0.25 percentage points, and signaled a process of continued rate increases.

In view of global developments during the reviewed period, the international agencies and investment houses revised their growth forecasts for this year upward (Figure 11). The global growth forecasts for 2024 declined slightly, and they expect continued moderate growth.

Figure 11
IMF Annual Growth Forecasts for 2022 and 2023 (percent)



SOURCE: International Monetary Fund.

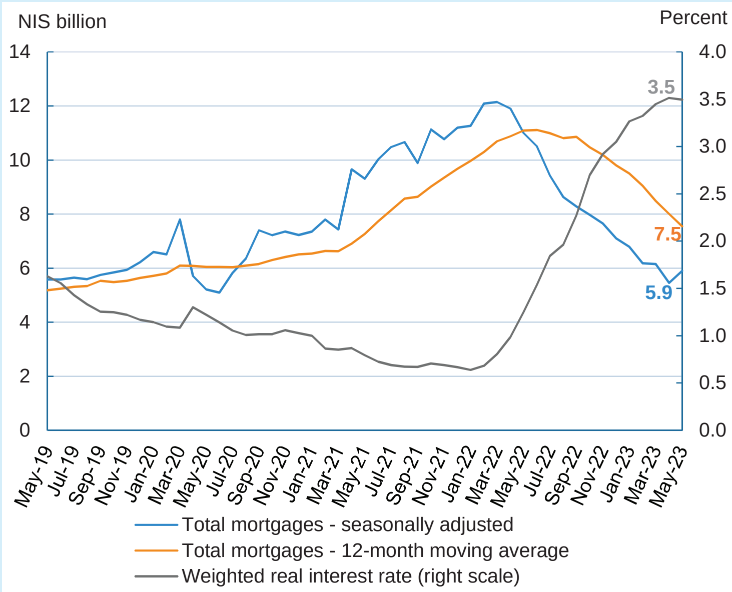
e. The credit market and developments in the financial markets

During the period, the pace of growth of business credit to small and medium businesses moderated, and credit to micro businesses declined. In contrast, credit to large businesses continued to expand at a high rate, despite the increase on financing costs. There was some increase in the rate of bank credit in arrears among micro businesses. Corporate bond spreads widened slightly during the reviewed period. An analysis presented to the Committee members showed that in most industries, there are no signs of an excessive increase in risk, despite the rapid change in financial conditions. In contrast, the real estate and construction industry appears to be more sensitive to changes in the interest rate environment.

In parallel with the increase in the interest rates, the flow of new mortgages narrowed (Figure 12). New mortgages were characterized by slightly lower leverage than those taken out in the past two years, and the PTI rate continued to increase. In view of the increase in the cost of credit, there was a marked slowdown in consumer credit as well. Despite the increase in the burden of household debt, the rate of arrears in bank housing and consumer credit remained relatively low, with a slight increase in the most recent figures. As part of households' dealing with the increase in the burden of debt, there was an increase in the volume of withdrawals from medium- and long-term savings.

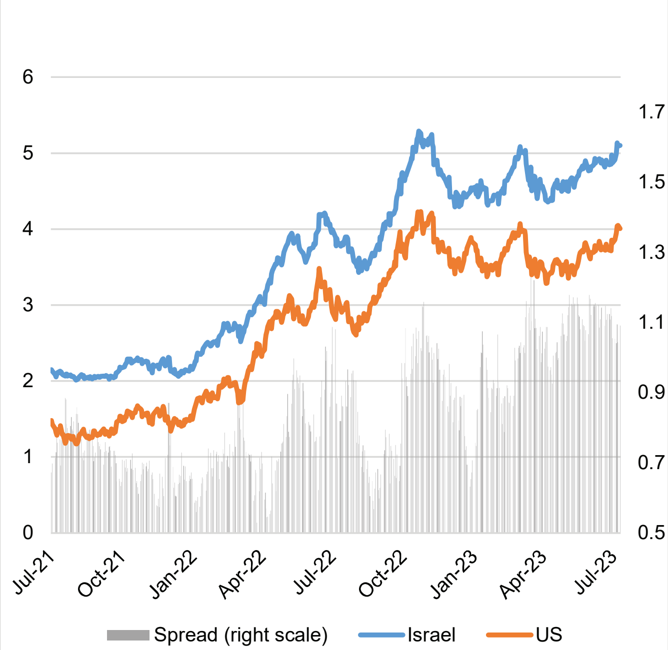
The reviewed period featured sharp volatility in the financial markets. Uncertainty surrounding legislative changes with regard to the judicial system led to underperformance in the equity market relative to the global markets. In the mutual funds, there was a diversion of investments from equity tracks in Israel to money market funds and to funds investing in equities abroad, and there was some increase in the spread between 10-year Israel government US dollar-denominated bonds and US Treasury bonds (Figure 13). In addition, during the period, the Moody's credit ratings agency lowered its ratings forecast for Israel from positive so table, and left the credit rating unchanged. The S&P ratings agency left both its rating and its forecast unchanged, but published a warning that the legislative measures may lead to harm to the economy and to a lowering of the rating.

Figure 12
Total New Mortgages and Weighted Real Interest Rate on Mortgages, May 2019–May 2023



SOURCE: Banking Supervision Department, Bank of Israel.

Figure 13
Yields on US and Israeli US-Dollar Government Bonds, July 2021–July 2023 (daily data, percent)



SOURCE: Based on Bloomberg.

Table 3
Developments in the domestic asset markets

	01/23	02/23	03/23	04/23	05/23	06/23
Yield to maturity (monthly avg., percent)						
3-month *Makam*	3.6	3.9	4.2	4.3	4.4	4.6
1-year *Makam*	3.9	4.2	4.7	4.6	4.6	4.8
5-year unindexed bonds	3.4	3.7	3.9	3.8	3.8	3.8
10-year unindexed bonds	3.4	3.6	3.9	3.9	3.8	3.8
20-year unindexed bonds	3.5	3.7	4.1	4.2	4.2	4.1
1-year indexed bonds	1.4	1.2	1.3	1.4	1.6	1.7
5-year indexed bonds	0.8	0.9	1.2	1.1	1.1	1.2
10-year indexed bonds	0.8	0.8	1.1	1.1	1.1	1.1
Yield gap between government bonds and AA-rated corporate bonds (percentage points)[a]	1.5	1.7	1.8	1.7	1.6	1.5
Equity market (rate of change during the month)						
General shares index	0.6	-5.6	-0.3	2.0	0.1	2.6
Tel Aviv 35	0.0	-3.5	0.3	1.6	-1.2	0.2
Foreign exchange market (rate of change during the month)						
Dollar/shekel	-1.3	5.6	-1.4	0.7	2.0	-0.4
Euro/shekel	0.3	3.4	1.1	1.8	-0.9	1.3
Nominal effective exchange rate	-0.1	3.9	-0.4	0.8	0.5	-1.1

[a] The calculation is for fixed-rate indexed bonds, excluding convertible and structured bonds, with a yield of up to 100 percent and a term to maturity of more than 6 months.

SOURCE: Bank of Israel.

f. Financial stability

The domestic financial system remained stable in the first half of 2023. Financial stability during that period was influenced by two main factors. The first was the continued tightening of monetary policy and the slowdown in economic growth in Israel and abroad, alongside difficulties in the global banking system. The second was the lack of certainty surrounding the implications of legislative changes regarding the judicial system in Israel for the functioning of the economy and on the financial system as a whole.

g. Fiscal policy

During the surveyed period, the budget surplus narrowed due to a decline in tax revenue. The budget surplus in the first months of the year was still high by historical comparison due to relatively restrained public expenditure and a high level of revenue relative to the multiyear path. Tax revenue in the first half of 2023 was slightly lower than the Research Department’s previous assessments and declined by 9.4 percent in real terms relative to the first half of 2022, when revenues were particularly high. The lower state revenues in recent months mainly reflected declines in corporate income tax and in tax revenues from the real estate market, but direct taxes were still higher than the precrisis trend, while indirect taxes were slightly lower than it. As part of the budget that was approved, government expenditure was not increased beyond the growth derived from automatic stabilizers and from commitments by previous governments. This was despite the expansionary coalition agreements that were signed when the government was established. The wage agreement signed with the public sector was more moderate than expected.

h. The housing market

The increase in housing prices was halted during the first half of the year, and there are signs of a turnaround in the most recent data. In the past 12 months, home prices increased by about 9.8 percent (data from March), after the pace of increase reached a record of 20 percent in September 2022. Between January and March, there was a turnaround, and home prices declined by a cumulative rate of about 0.2 percent. The halt in the price increases was accompanied by a sharp decline in new mortgage borrowing and in the number of housing transactions. In parallel, there was an increase in the stock of unsold homes among contractors. There were also developments on the supply side. The number of building starts and of building permits declined during the first quarter, after reaching record highs in mid-2022, but they remain higher than in the past. Data on building completions remained relative low, in view of the extended duration of construction.

The housing component of the Consumer Price Index (which reflects rental prices) continued to increase, and even accelerated. Looking at the year as a whole, the housing component increased by about 7.5 percent, and contributed about 2 percentage points to the overall CPI.

The Committee members noted throughout the reviewed period that the acceleration in the housing component and the depreciation of the shekel were the main factors delaying the convergence of inflation back to the target range.

3. THE MACROECONOMIC FORECAST AND THE COMMITTEE'S ASSESSMENT REGARDING THE EXPECTED PATH

a. The Research Department's macroeconomic forecast

The Bank of Israel Research Department published three macroeconomic staff forecasts during the reviewed period, alongside the interest rate notices in January, April, and July. The forecast published in April differed from the routine quarterly forecasts, in that it included two different forecasts based on two potential 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 resolved in a way that does not affect economic activity moving forward. The second scenario presents an analysis of the potential economic implications if legislative and institutional changes are 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 forecast based on this latter scenario shows a wide range of potential harm to GDP and to other economic variables, depending partly on the intensity and persistence of the shocks to the risk premium, the markets, and demand. According to the detailed analysis in the forecast, if the effect of the changes weakens relatively quickly, the cumulative impact on these three channels would average about 0.8 percent of GDP each year over the next three years. In a scenario with greater persistence of the shocks, the impact would be an average of about 2.8 percent of GDP per year over the next three years.

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. The unemployment rate is expected to increase, to an annual average of 3.7 percent in 2023 and of 4.1 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 an increase in Israel's risk premium, continued depreciation of the shekel, harm to exports, and declines in domestic investment and in demand for private consumption.

Table 4
Research Department forecasts

(percent rate of change unless noted otherwise)

Forecast for the year	**2022**			**2023**				**2024**
Forecast date	**07/22**	**10/22**	**01/23**	**07/22**	**10/22**	**01/23**	**04/23**	**04/23**
GDP	5.0	6.0	6.3	3.5	3.0	2.8	2.5	3.5
Private consumption	7.5	8.0	7.0	4.5	3.5	4.0	3.5	4.5
Fixed capital formation (excl. ships and aircraft)	5.0	8.0	9.0	3.0	3.0	3.0	1.5	4.5
Public consumption (excl. defense imports)	4.0	4.0	1.0	3.0	4.0	3.5	2.0	3.0
Exports (excl. diamonds and startups)	3.0	8.0	10.5	2.5	2.5	2.0	2.0	3.0
Civilian imports (excl. diamonds, ships and aircraft)	7.5	12.5	11.5	3.0	3.5	4.0	3.0	6.0
Unemploument rate - annual average (ages 25–64)	3.3	3.1	3.2	3.5	3.5	4.0	4.1	4.0
Government deficit (percent of GDP)	0.7	0.3	-0.3	1.2	1.0	1.8	0.9	0.9
Debt to GDP ratio	66.0	65.0	62.0	63.9	63.0	62.0	59.0	58.0
Inflation[a]	4.5	4.6	5.2	2.4	2.5	3.0	3.9	2.3
Forecast date	**07/22**	**10/22**	**01/23**	**04/23**				
Inflation in the coming year[b]	3.3	2.7	3.0	3.4				
Interest rate in one year[c]	2.75	3.5	4.0	4.75				

[a] The average of the Consumer Price Index in the fourth quarter of the year compared with the average in the fourth quarter of the previous year.

[b] In the four quarters ending in the same quarter in the following year.

[c] In the same quarter in the following year.

SOURCE: Bank of Israel.

b. The expected path of inflation and growth

The data and indicators presented to the Committee during the first half of the year showed that inflation in Israel is high and that it encompasses a wide range of components from the CPI. However, the most recent data showed signs of some moderation. In addition, long-term forward expectations derived from the capital market remained anchored within the target range, and both the capital market and the professional forecasters projected that inflation would return to the target range during the coming year.

During the reviewed period, the Committee members discussed the significant depreciation of the shekel, and the assessments and analyses presented to them showed that the depreciation was mainly due to domestic factors and only slightly to the global environment. Conservative assessments indicate an “excess depreciation” that has so far contributed one percentage point to inflation. During the Monetary Committee discussions, the Committee members noted that as long as the shekel continues to weaken, it may weigh upon inflation’s return to the target range, and even tighter monetary policy may therefore be necessary.

Economic activity data on the Israeli economy indicated a high level of activity: a high growth rate and a tight labor market, with high employment rates and low unemployment rates. However, the current indicators indicated the beginning of a moderating trend: a declining job vacancy rate, moderating credit card expenses, slowing activity in the real estate market, and a sharp decline in the pace of fundraising by high-tech firms. These signs hint to the start of a trend of restraint in the economy, due partly to the interest rate policy that is acting to lower inflation.

The macroeconomic forecasts published during the first half of the year presented two potential scenarios with regard to the legislative process concerning the judicial system. The picture presented by these forecasts is that the main risk at this time is the realization of a scenario in which legislative and institutional changes are accompanied by an increase in the country’s risk premium, continued depreciation of the shekel, harm to exports, and declines in domestic investment and in demand for private consumption. The April forecast even presented a quantitative assessment of the economic implications of this scenario. The Committee members emphasized the importance of a return of stability and certainty to the Israeli economy, as well as the need to make sure that legislative changes be made with broad consensus, while maintaining the strength and independence of the State’s institutions.

The Committee’s assessment is that the current interest rate level is sufficiently restraining to support a decline of inflation to its target. However, the road to convergence to the target remains long, there is a high level of uncertainty, and there are a number of upward risks to inflation. As such, the members noted that the Committee sees a considerable likelihood of continued increases in the interest rate in its future decisions, should the inflation environment not continue to moderate as expected.