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**BANK OF ISRAEL**

Office of the Spokesperson and Economic Information

Press Release:

**The Monetary Committee decides on August 28, 2024 to leave the interest rate unchanged at 4.5 percent**

* **Since the outbreak of the war, and in recent months in particular, geopolitical uncertainty and its economic ramifications have increased. These, alongside the fiscal uncertainty, are also reflected in the high yield spreads between Israeli government bonds and US bonds, and in CDS spreads that are near record levels.**
* **Inflation has been on an upward trend in recent months and is slightly above the upper bound of the target range. The rise in the inflation rate primarily reflects the increase in the rate of change in prices of the nontradable components.**
* **Since the previous interest rate decision, the shekel has remained unchanged against the dollar and has weakened by about 3 percent vis-à-vis the euro and by 1.4 percent in nominal effective exchange rate terms.**
* **In the housing market, home prices and new mortgage volume continue to increase. The constraints on activity in the construction industry, in view of the war, are still significant, and construction industry activity is recovering slowly.**
* **In the labor market, there is a labor supply constraint due to the impact of the war, and there has been an increase in the number of job vacancies and a decline in the unemployment rate.**
* **Worldwide, economic activity continues to expand, the inflation rate is moderating, and the markets are expecting several interest rate reductions over the course of the year by the Fed and the ECB.**

**In view of the continuing war, the Monetary Committee’s policy is focusing on stabilizing the markets and reducing uncertainty, alongside price stability and supporting economic activity. The interest rate path will be determined in accordance with the convergence of inflation to its target, continued stability in the financial markets, economic activity, and fiscal policy.**

Since the outbreak of the war, and in recent months in particular, geopolitical uncertainty and its economic ramifications have increased. These, alongside the fiscal uncertainty, are also reflected in the high yield spreads between Israeli government bonds and US bonds, and in CDS spreads that are near record levels. The level of economic activity is lower than the trend line and even lower than its level in the corresponding quarter of 2023, and is greatly impacted by supply limitations.

The inflation environment has been on an upward trend in recent months. The CPI increased by 0.1 percent for June and by 0.6 percent for July. The inflation rate over the past 12 months is 3.2 percent, slightly above the upper bound of the target **(Figure 1)**. Net of energy and fruit and vegetables, inflation is at a year over year pace of 2.8 percent **(Figure 2)**. The increase in inflation primarily reflects the increase in the rate of change in prices of nontradable components, which is 3.4 percent in annual terms, and 5.4 percent in the past 3 months (in annual terms). In contrast, the inflation rate of tradables has been relatively stable in recent months, and was 2.6 percent in July **(Figures 3–4)**. Inflation expectations for the coming year increased and are around the upper bound of the target. One-year inflation expectations derived from the capital market are volatile, and are at 2.8 percent. Forecasters project that annual inflation will remain above the upper bound of the target range in the coming months, will increase in the beginning of 2025 (among other reasons due to the expected increase in VAT), and will then moderate to around the upper bound of the target rate in the middle of 2025 **(Figure 5)**. The Committee assesses that there are several risks for a possible acceleration in inflation: geopolitical developments and their impact on economic activity, shekel depreciation, prolonged supply limitations on activity, and fiscal developments.

Against the background of the various developments in the war and the geopolitical environment, increased volatility can be seen in the foreign exchange market. Since the previous interest rate decision, the shekel has remained unchanged against the dollar, and weakened by about 3 percent vis-à-vis the euro, and by about 1.4 percent in nominal effective exchange rate terms.

National Accounts data indicate that GDP expanded in the second quarter of 2024 by a moderate rate of 0.3 percent in quarterly terms (1.2 percent in annual terms) **(Table 1)**. The moderate rate of growth in the second quarter distanced GDP from its trend line, and its level is below the trend line by about 3 percent, and by about 5 percent for business sector product **(Figure 10)**. In parallel, GDP data were revised upward for the fourth quarter of 2023 and the first quarter of 2024, which partly offset the deviation from the trend line for the second quarter data. Supply limitations, primarily in view of the shortage of workers, particularly in the construction industry **(Figure 16a)**, are a main factor in the gap of GDP from its growth trend line, and it is expected that this will not contract as long as the shortage of non-Israeli workers, the considerable mobilization of the reserves, and the limitations on activity in the Northern border area continue. Most of the uses are below their trend, and in particular investments and exports, while public consumption remains high. This trend, alongside the increase in inflation, is consistent with an economy characterized by supply limitations on activity, and in particular in view of the fiscal expansion deriving from the war.

Current indicators of the state of economic activity point to continued moderate growth of activity in July–August. The aggregate balance of the Business Tendency Survey conducted by the Central Bureau of Statistics for July indicates continued slight improvement in companies’ economic situation **(Figure 11)**. However, the net balance is lower than its level before the war. The most notable gap in activity compared to before the war is reported in the construction and accommodation industries. However, in other industries as well, economic activity has not yet returned to routine **(Figure 25)**. Business Tendency Survey data for July indicate that there are supply limitations at a higher level than before the war, particularly in the construction industry, while demand limitations remained mainly in the accommodation and transport industries, which are impacted by the sharp decline in tourism. Credit card expenditure volume has remained stable since the beginning of the third quarter, after the sharp decline recorded in the beginning of the war and the recovery that followed **(Figure 12)**. Foreign trade data indicate that goods exports and imports (excluding diamonds) increased in July **(Figure 20)**.

The cumulative deficit in the government budget in the past 12 months continued to increase in July, totaling 8.1 percent of GDP. To the extent that there won’t be additional unexpected additions to the defense budget, it is expected to be 6.6 percent at the end of 2024. The uncertainty surrounding the State budget for 2025, and the implementation of adjustments required to reduce the deficit on an ongoing basis, contributes to an increase in the risk premium and is liable to weigh on the return of inflation to its target.

There is a supply limitation in the labor market, among other things in view of the shortage of non-Israeli workers and the absence of workers who are on reserve duty in the security forces or were employed in the Northern border area, which contributes to a tight labor market. The employment rate in July among ages 15 and older was 61 percent, compared to 60.8 percent in June (seasonally adjusted). The moderate decline in the broad unemployment rate continues, and the rate was 3.3 percent, compared to 3.7 percent in June. (Including those serving in the reserves, the rate is 4.0 percent in July compared to 4.6 percent in June). **(Figure 13)**. The job vacancy rate is 4.6 percent in July, similar to the June figure. This rate is higher than the rate just before the war, even net of the construction industry **(Figure 15)**. In the construction and the accommodation and food service industries there is a high rate of job vacancies, while the job vacancy rate in services and manufacturing remains stable. From the beginning of 2023, there has been an acceleration in the rate of increase in average wage per employee post compared to previous years, and the growth rate of nominal wages hovers around 7 percent **(Figure 14)**. However, the (nominal) cost of labor per unit of (real) GDP increased by a moderate rate and the level of real wages is near the trend line.

Housing market activity continues to recover. Home prices continued to increase on a year on year basis, and the rate is at 4.7 percent **(Figure 17)**. In July, the increase in mortgage volume continued, with NIS 9.1 billion in mortgages taken out **(Figure 18)**. The housing component in the CPI increased in July by 0.8 percent. This includes the owner-occupied housing services index, which increased by 0.7 percent, and by 2.6 percent for the past year overall, similar to its pace in the previous month. There was an increase of 2.6 percent for renters who renewed their lease and 3.4 percent for new renters. In the first quarter of the year, building starts and building permits were relatively stable. Alongside these, the limitations on construction industry activity in view of the war, and particularly the shortage of workers, is still significant, and the activity in the construction industry is recovering only slowly **(Figure 16b)**.

In the capital market, domestic equity indices increased during the reviewed period. However, the underperformance of the domestic equities market relative to the global market since the start of the war remains significant **(Figure 29)**. In the government bond market, yields declined but more moderately than the global trend **(Figure 26)**. The growth rate of business credit in recent months is slower than the prewar period, and in the most recent data (June) credit to large businesses increased, and to the rest of the business sector it contracted slightly. There has been some increase in various indicators of risk in business credit and in consumer credit for households, which originates in credit card companies, but the levels are not higher than in the past.

In the reviewed period, ratings agency Fitch downgraded Israel’s credit rating from A+ to A, with a “negative” outlook. As the ratings agency explained, the decision reflected the security reality, but also an assessment of fiscal policy management, and emphasized a future policy framework. In view of the increase in geopolitical uncertainty, Israel’s risk premium, as measured by the spread between dollar-denominated government bonds and US government bonds, remained high and even rose to a record level during the period reviewed. The 5-year CDS spread also increased, and remains at high levels.

Global economic activity continues to expand. Economic activity in the US remained robust and concerns of a recession dissipated. In the eurozone, although second quarter growth surprised to the upside, the economic weakness in Germany is expected to continue to impact on eurozone activity in the third quarter. In China, second quarter growth was below forecasts and it can be seen that activity continues to be relatively weak in the beginning of the third quarter as well. Investment houses’ global growth forecast for 2024–25 remained essentially unchanged **(Figure 30)**. The global Purchasing Managers Index for July indicates moderate expansion in the pace of activity, with activity accelerating in the services sector and the manufacturing sector at a level reflecting moderate contraction. World trade volume increased in June by 0.7 percent, after declining in May by 0.3 percent. In the US, second quarter data indicated significant moderation in inflation, compared to first quarter data **(Figure 34)** and the overall CPI declined to 2.9 percent in July, as the core rate also moderated, to 3.2 percent. In the eurozone, the inflation rate increased slightly in July, to 2.6 percent, while the core CPI remained unchanged at 2.9 percent. In their most recent decisions, the Fed and ECB kept their monetary interest rates unchanged. The path of interest rate reductions is expected to be more rapid **(Figure 36)** and the US Federal Reserve Chair signaled, in his address at Jackson Hole, the start of interest rate reductions in the US.

The minutes of the monetary discussions prior to this interest rate decision will be published on September 11, 2024. The next decision regarding the interest rate will be published on Wednesday, October 9, 2024.

Interest rate decision dates for 2024 and 2025 are available at:

https://www.boi.org.il/en/economic-roles/monetary-policy/interest-rate-announcement-dates-2024/