BANK OF ISRAEL

Office of the Spokesperson and Economic Information

January 15, 2024

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

The discussions took place on December 31, 2023 and January 1, 2024.

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 January 1, 2024, 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 reduce the interest rate by 0.25 percentage points, to 4.5 percent. All members of the Monetary Committee supported the decision.

The discussion focused on the economic developments since the eruption of the "Swords of Iron" War on October 7, economic activity, the labor market, the housing market, inflation and expectations, and developments in the foreign exchange and financial markets. In addition, the Committee discussed the government's budgetary handling of the defense and civilian needs deriving from the war.

Main points of discussion

The Committee discussed the state of the economy after 3 months from when the "Swords of Iron" War broke out, and examined the developments since then. The war has significant economic ramifications, both on real activity and on financial markets. Economic activity indicators show a gradual improvement in activity, after a notable contraction in business activity with the eruption of the war. Market volatility moderated and financial markets are operating effectively. The level of uncertainty regarding the expected scope and duration of the fighting is very high, and this impacts as well on the extent of the adverse impact on activity.

The Committee discussed the effects of the war on economic activity. According to indicators of economic activity and the state of employment, there has been a gradual recovery after the sharp decline that occurred with the eruption of the war. However, it was emphasized that there is a very high level of variation among industries. In November and December, there was a recovery in the scope of credit card purchases, with total purchases returning to a level similar to that in routine times, except for the tourism industry. The Committee members discussed whether supply shocks are dominant over demand, or the opposite, and assessed that at this stage it cannot be determined. In addition, they discussed various scenarios in this regard, including the impact of an increase in demand and from the freeing up of supply limitations on the expected path of inflation.

The Committee discussed labor market developments. In November, the broad unemployment rate declined from 9.7 percent in October to 8.5 percent, and the scope of those absent from work for other non-economic reasons (that could be related to the war but not because of reserves duty) declined from 7.8 percent in October to 0.4 percent in November. A flash survey by the Central Bureau of Statistics indicated an improvement in the state of the labor market based on businesses' reports as well.

The Committee discussed the inflation environment and the war's impacts on it. The year over year inflation rate continued to decline, with stability in inflation expectations in the target range. The CPI for November 2023 declined by 0.3 percent and inflation over the preceding 12 months moderated but remained above the upper bound of the target, at 3.3 percent. Net of energy and fruit and vegetables, inflation in the past year was 2.9 percent. Moderation can also be seen in inflation dynamics in quarterly and semiannual measurement. In addition, the year over year growth rate of the CPI's nontradable components, which include mainly housing services and the services industries, declined but remained relatively high at 3.8 percent, while the year over year growth rate of tradable CPI components declined to 2.4 percent. Likewise, the Committee members discussed expectations from the various sources indicating the entry of the inflation rate to within the target range in the first quarter of 2024. Moreover, the slowdown in global activity and the moderation of imported inflation are moderating factors for domestic inflation. In addition, capital market expectations for inflation over the first year, over the second year, and onward, are within the target range. The Committee also discussed the effect of the development of inflation on the real interest rate, which reflects a restrictive monetary environment, even given the interest rate reduction. However, emphasis was placed on the fact that there are several risks to a possible acceleration of inflation: the effects of the war and its development on activity in the economy, a depreciation of the shekel, and fiscal policy that is of an expansionary nature as long as alongside the increase in defense and civilian expenditures, necessary budgetary adjustments would not be made. It was emphasized to the Committee that the Research Department's expectation is for an interest rate path that is more moderate than market expectations.

The Committee members discussed foreign exchange market developments. Since the previous interest rate decision, the shekel strengthened against the dollar by 2.7 percent, against the euro by 1.7 percent, and in terms of the nominal effective exchange rate by 2 percent. During the course of 2023, the shekel weakened vis-à-vis most major currencies worldwide, with high volatility.

The Committee discussed the effects of the war on the financial markets. In the capital market, domestic equity indices increased, similar to the global trend during the period. However, the domestic market's underperformance relative to the rest of the world from the beginning of 2023 is still notable. Against the background of market expectations for interest rate reductions in Israel and abroad, long-term government bond yields declined, but more moderately than around the world. Corporate bond spreads that had widened with the outbreak of the war, returned to close to their level of before the war. The risk premium, as measured by CDSs and by the spread between dollar-denominated government bonds and US government bonds declined as well, though they are still at a high level.

The Committee discussed the various developments in the credit market, in which the slowing trend in bank credit to businesses and households continued, in parallel with the general slowdown of economic activity. The banks and credit card companies expanded and extended the framework for deferring loans that was formulated by the Banking Supervision Department, which provides cash flow relief for households and businesses in the coming period. Risk indices in credit to medium sized, small and micro businesses increased slightly.

The Committee discussed developments in the housing market and the difficulties in activity in this industry in view of the war. Housing market activity continued to moderate. In the past 12 months, home prices declined by 1.3 percent. In September-October 2023, the Home Price Index remained unchanged, and prices of new homes declined by 0.4 percent. The scope of transactions and new mortgage volume remained at low levels compared to the past two years; in November mortgages totaling NIS 5.5 billion were taken out. The housing component in the CPI declined by 0.4 percent, and the annual rate of increase continued to moderate, reaching 3.9 percent. According to Central Bureau of Statistics construction data for the third quarter, just before the war the number of construction permits, starts, and completions were relatively high despite the moderation of activity in the industry in the past year. However, the absence of Palestinian workers since the eruption of the war led to a sharp decline in activity, and is expected to be reflected in fourth quarter data. The Committee members discussed the importance of maintaining a high supply of construction over time, beyond the need to maintain activity in the immediate term, which will support stability in housing prices.

The Committee also discussed the updated macroeconomic forecast compiled by the Research Department. The forecast was based on the assumption that the war's direct economic impact reached its peak in the fourth quarter of 2023, and that the war will continue until the end of 2024, but at a decreasing magnitude. Similar to the previous forecasts, the forecast is based on the assumption that the war will be focused mainly on the Southern front. According to the forecast, GDP is expected to grow by 2 percent in each of 2023 and 2024, as in the November forecast, and by 5 percent in 2025, so that the output gap is expected to close in that year. Year over year inflation over the 4 quarters of 2024 is expected to be 2.4 percent, and during 2025 to be 2 percent. The assessment with respect to the budget for 2024 is still exposed to uncertainty about government decisions regarding the budget's handling of the security and civilian needs deriving from it. In view of the effects of the war, it is expected that the adverse impact in economic activity will lead to a decline in tax revenues, while in parallel the government's expenditures on defense and on civilian assistance plans will increase. The Department's assessment is that all these are expected to be reflected in a marked increase in the government's budget deficit, estimated to be 4 percent of GDP in 2023, and is expected to total 5.7 percent of GDP in 2024 and 3.8 percent tin 2025.

The Department assumed that the government would make cumulative adjustments, of a permanent nature, that will reach an annual scope of NIS 30 billion by the end of 2025. These adjustments should already be set in 2024 and a considerable portion of them should be realized this year already. This adjustment will lead to the debt to a GDP ratio expected to be 66 percent of GDP at the end of 2024 and 2025. Further, on, these adjustments will allow a desired path of a declining debt to GDP ratio, so that in 2030 this ratio will decline to 63 percent.

The Committee discussed global conditions as well. Economic activity in major economies is moderating, while in the background, global manufacturing and world trade continued to indicate weakness. The security incidents in Israel, which caused an increase in geopolitical tension in the Middle East, impacted moderately on global financial markets. Investment houses' growth forecasts remained unchanged and their assessment is for global growth of 2.7 percent in 2024. The inflation environment moderated in a notable portion of countries, but remains above central bank targets. The Fed and the ECB kept the interest rate unchanged, but the expected path of the interest rate according to the markets declined markedly, and accordingly several interest rate reductions are expected during the course of 2024.

After the discussion, all the Monetary Committee members were of the view that the interest rate should be reduced by 0.25 percentage points, to 4.5 percent.

In view of the 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 continued convergence of inflation to its target, continued stability in the financial markets, economic activity, and fiscal policy.

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
Ms. Shulamit Nir, Research Department
Ms. Dana Orfaig, Research Department
Ms. Nava Ostrov, Monetary Committee Secretariat
Mr. Daniel Shlomiuk, Bank spokesperson's office