Chapter 3

Inflation and Monetary Policy

» In 2024, The annual inflation rate stood at 3.2 percent, slightly above the upper limit of the target range. Inflation accelerated in the second and third quarters of the year and moderated towards its end. Expectations remained anchored within the target range for most of the year.

» Price developments were influenced by the war and its extended duration, which caused prolonged supply constraints, while demand constraints declined during the year, partly due to the government's significant expenditures driven by the economy's wartime needs.

» Throughout the year, in view of the continuing war, monetary policy focused on maintaining the stability of the financial markets, utilizing a variety of policy tools and targeted measures, while returning inflation to the target range and supporting economic activity.

» In view of the moderation of inflation at the end of 2023 and the expectations for its continued moderation, the Monetary Committee lowered the interest rate in January to 4.5 percent. At that time, expectations were that the interest rate would continue to decline during the year.

» Later in the year, the committee left the interest rate unchanged, noting in its decisions that the policy path would be data dependent. The committee's assessment was that the current and expected interest rate environment would lead to the restraining of inflation without hindering economic recovery.

» At the onset of the war, there was an increase in the country's risk premium, as reflected in the yield spreads on government bonds and the CDS premium. Toward the end of the year, these indices declined significantly, but their levels remained higher than before the outbreak of the war.

» The exchange rate of the shekel was largely affected by geopolitical developments and the risk premium. Despite the increase in the country's risk premium due to the war, the shekel was appreciated at the end of 2024 compared to its level before the war.

» Contrary to developments in Israel, inflation in most developed countries moved toward the target in 2024, after having been high in the previous two years. Accordingly, central banks in these countries began to lower interest rates.

1. MONETARY POLICY TARGETS

According to the Bank of Israel Law, 5770–2010, the Bank of Israel has three primary objectives: (1) To maintain price stability, as its central goal. The government has defined price stability as an annual inflation rate within the range of 1–3 percent.[1] It is also stipulated that if inflation deviates from this target range, the Bank must implement policies that, in its assessment, will bring it back to within the target range within a period not exceeding two years. (2) To support other government objectives, particularly growth, employment, and the reduction of social disparities, provided that this does not compromise long-term price stability. (3) To support the stability and orderly functioning of the financial system. The Bank has a variety of tools at its disposal to achieve these objectives, and enjoys independence in their implementation. Since October 2011, monetary policy has been determined by the Monetary Committee.

With the outbreak of the war in October 2023, the Monetary Committee's immediate goal was to maintain financial stability to minimize the risk of economic disruption and a sharp rise in inflation. Accordingly, the Committee utilized measures and monetary tools to stabilize markets and reduce uncertainty, including market interventions to stabilize the exchange rate and provide liquidity as needed, and targeted measures to ease the burden on households and businesses. In 2024, in view of the continuation of the war, the policy focused on maintaining the stability of the markets and reducing uncertainty, alongside maintaining price stability and supporting economic activity.

2. INFLATION

a. Background

> The recovery of demand in 2024 was faster than that of supply, and pushed inflation upward.

In 2024, the Swords of Iron War, which broke out on October 7, 2023, continued with varying intensity. The war and the geopolitical situation had significant impacts on the economy. The war led to a sharp decline in both aggregate demand and supply of goods and services. In the initial months of the war, the decline in demand was assessed as being more significant. However, as the year progressed, the recovery in demand outpaced that of supply, which was primarily hindered by a prolonged shortage of workers, and this situation led to excess demand and accelerated inflation.

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[1] In November 2024, a summary report was published on the process of reevaluating the inflation target, which took place at the Bank of Israel before the war. The process included published research, dialogue with central banks, public conferences, a survey examining public knowledge and attitudes on inflation and price stability, and expert opinions from the professional community. The conclusion from the analysis was that it is advisable to maintain the existing inflation target range of 1–3 percent, as has been in place since 2003.

Furthermore, the war and its consequences strained the state budget and affected the perceived risk regarding the Israeli economy, which was reflected in increases in the various yields. In the last quarter of 2024, in view of a ceasefire agreement in the north and other developments in the Middle East, Israel's risk premium declined significantly, although it remained higher than its prewar level.

b. The development of inflation

Inflation accelerated during the second and third quarters of 2024. This followed the moderation of inflation in 2023, when it returned to the target range due to restrictive policy. In most OECD countries, inflation moderated in 2023 (Figure 3.3).[2] After the outbreak of the Swords of Iron War in October 2023, supported by the moderation in demand, the slowdown in inflation continued, and by December 2023, the annual rate entered the target range. The prolongation of the war and its effects, particularly supply constraints, led to an increase in inflation in the second and third quarters of 2024. Toward the end of the year, with some easing of the supply constraints, inflation moderated, and by the end of the year, it stood at 3.2 percent.

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For the year as a whole, the overall index and the core indices developed similarly (Table 3.1, and Figure 1 in Box 3.2), although for most of the year, headline inflation was slightly higher than that of the core indices. This development may indicate unique shocks affecting noncore components of the index. The analysis in Box 3.2 suggests that these shocks had an indirect impact on the core indices, but that it was limited.

Changes in taxation and regulation contributed about 0.4 percentage points to price increases during the year (Box 3.1).

The rise in inflation during the year is mainly explained by factors related to the war, which led to an increase in the prices of some goods and services. The inflation increase was driven by the rise in prices of nontradable goods and services (Figure 3.1), but the prices of tradable goods also rose, with volatility, influenced by changes in global commodity, food, and transportation prices, disruptions in import processes to Israel, and sharp changes in flight prices throughout the year. The volatility of the shekel also contributed to changes in the prices of tradable goods and services.

Three categories, which together account for about half of the CPI, stood out this year in their contribution to inflation: housing, food, and miscellaneous (Figure 3.2). Food prices rose by 4.3 percent this year. The miscellaneous category increased by 6.9 percent, mainly due to the contribution from the tobacco and cigarettes subcategory, which was affected by increased taxation (Box 3.1).

The food and housing components contributed prominently to inflation in 2024.

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[2] In many OECD countries, prices rose cumulatively since 2022 at much higher rates than in Israel, and the decline in inflation largely reflected an easing of energy and food supply difficulties that had intensified since the Russian invasion of Ukraine.

Figure 3.1 | Annual Inflation Divided Into Tradable and Nontradable Components, December 2021–December 2024 (percent)
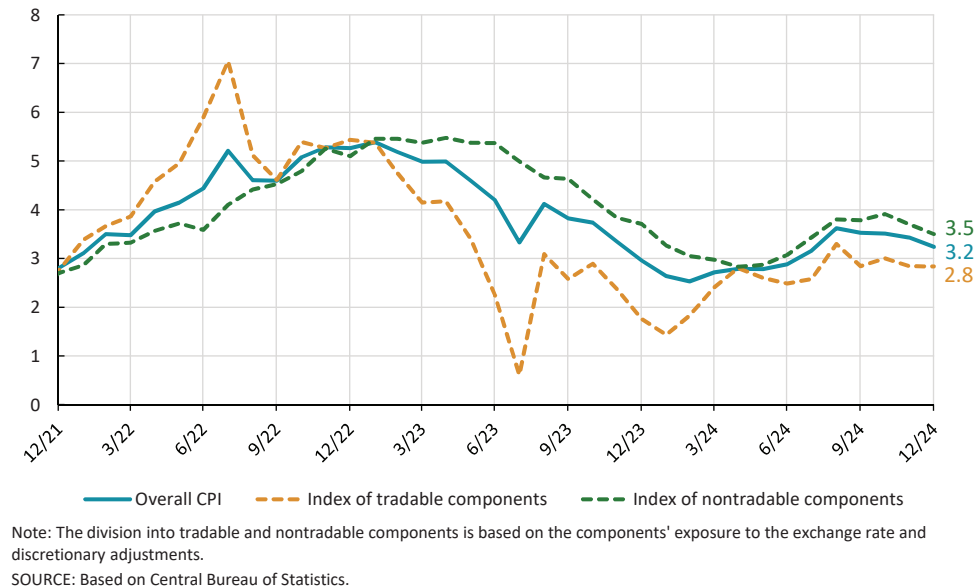
Note: The division into tradable and nontradable components is based on the components' exposure to the exchange rate and discretionary adjustments.
SOURCE: Based on Central Bureau of Statistics.

Figure 3.2 | Annual Inflation and Contributions of the Main Components, December 2021–December 2024 (percent)

- Fruits and vegetables (3.4%)
- Food (14.9%)
- Housing (26.0%)
- Dwelling maintenance (9.8%)
- Furniture and household equipment (3.6%)
- Clothing and footwear (3.0%)
- Health, education, and leisure (16.1%)
- Transportation excl. travel abroad (11.7%)
- Travel abroad (3.5%)
- Communications (2.3%)
- Miscellaneous (5.6%)
- Overall CPI

Note: The numbers in parentheses are the component's weight in the overall CPI (as of 2024).
SOURCE: Based on Central Bureau of Statistics.

Table 3.1 | Main indicators of inflation and monetary policy, 2020–2024

	2020	2021	2022	2023	2024	2024 Q1	2024 Q2	2024 Q3	2024 Q4
a. Inflation (percent)									
1. Actual inflation[a]	-0.7	2.8	5.3	3.0	3.2	3.3	3.3	5.3	0.8
2. Inflation excluding energy, fruits and vegetables	-0.4	2.7	5.0	2.7	3.3	2.9	5.3	3.9	1.0
3. One-year inflation expectations derived from the capital market	0.0	1.9	3.1	2.8	2.9	2.9	3.1	2.8	2.7
4. Ten-year inflation expectations derived from the capital market	1.6	2.0	2.3	3.0	2.9	3.1	2.9	2.8	2.8
5. Forecasters' one-year inflation forecasts[b]	0.5	1.2	2.8	2.8	2.9	2.6	2.9	3.0	2.9
b. Yields (percent)									
1. Bank of Israel declared interest rate	0.14	0.10	1.25	4.50	4.50	4.51	4.50	4.50	4.50
2. Real yield to maturity on one-year government bonds[b]	0.1	-1.9	-1.4	1.6	1.3	1.0	1.2	1.4	1.6
3. Nominal yield to maturity on ten-year government bonds[b]	0.8	1.2	2.6	3.9	4.7	4.4	4.8	4.9	4.7
4. Real yield to maturity on ten-year government bonds[b]	-0.5	-0.8	0.1	1.2	2.0	1.7	2.0	2.2	2.1
c. Change in the shekel exchange rate (percent)[c]									
1. Nominal effective	-4.8	-8.4	3.9	4.3	-5.1	-2.1	1.7	1.8	-6.4
2. Vis-à-vis the dollar	-6.6	-3.6	10.2	6.4	-1.5	-1.2	2.7	0.2	-3.1
3. Vis-à-vis the euro	2.3	-10.4	3.2	9.6	-5.4	-1.5	1.6	3.5	-8.6
d. Asset prices (percent)									
1. Overall yield on shares (general shares index, nominal)[c]	-0.4	30.9	-15.5	4.9	30.7	9.2	-6.2	9.7	16.3
2. Rate of change in home prices	4.0	13.1	14.7	-1.0	7.7	2.9	2.1	0.3	2.1
e. Additional background data (percent, quarterly data are seasonally adjusted)									
1. Unemployment in the primary working ages (25–64)	3.8	4.6	3.3	3.0	2.8	3.0	2.9	2.6	2.5
2. GDP growth[d]	-2.0	9.4	6.3	1.8	0.9	16.9	-0.3	5.0	2.0
f. Additional background data (percent)									
1. S&P Index of commodities excluding energy[e]	14.3	22.5	1.3	-7.3	7.6	0.4	7.2	-5.3	4.5
2. Brent crude oil price (per barrel)[e]	-22.9	48.7	8.9	-4.9	-5.4	-1.3	4.0	-7.4	-6.0
3. Israeli supply chain "pressure index"[f]	0.3	2.3	1.4	-0.2	0.7	0.5	0.7	0.9	0.6

[a] Change in CPI during the period. Quarterly figures are in annual terms as calculated by the Central Bureau of Statistics.
[b] Based on the zero coupon yield curve. Period average.
[c] Last week in the period compared to the last week in the previous period.
[d] Average in the period compared to average in the previous period, in annual terms.
[e] Average of last month in period compared with average of last month in previous period. Quarterly figures are the average in the quarter compared to the average in the pervious quarter.
[f] In terms of standard deviation, period average.
SOURCE: Bank of Israel, Ministry of Finance, Central Bureau of Statistics, and Bloomberg.
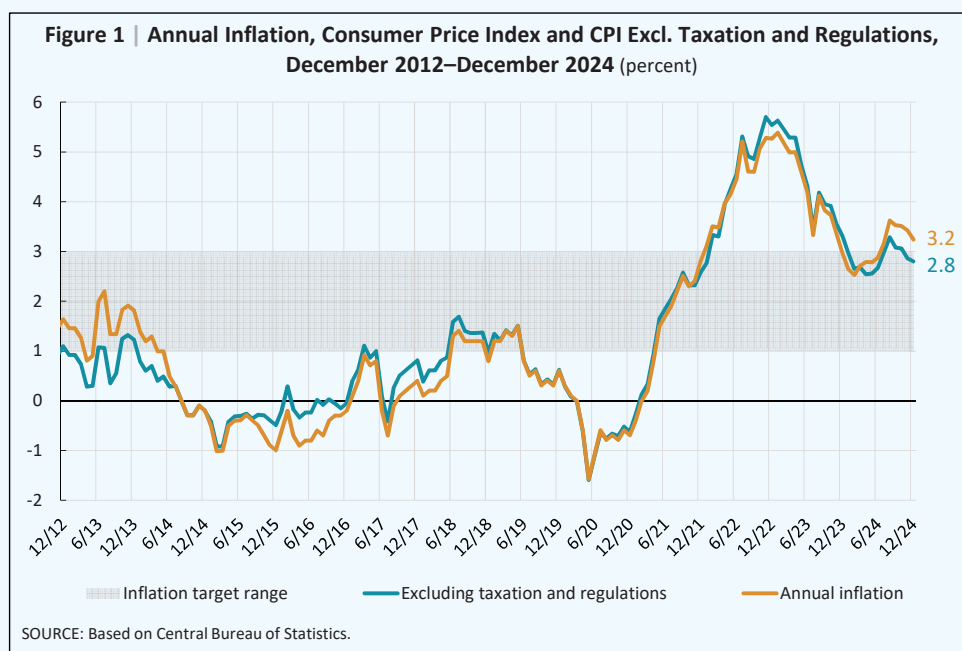
The housing component (housing services) rose by 4.1 percent in 2024, influenced by two main factors: a reduction in the supply of workers in the construction industry due to the war, which led to a decline in building completions, and the temporary removal from use of tens of thousands of dwellings, as many households were evacuated or left their homes and had to find alternative housing, a significant portion of which was government-funded. These effects were partly offset by several factors. The first was housing some of the evacuees and displaced persons in hotels (also funded by the government), which were largely vacant due to the decline in incoming tourism because of the war (Box 2.2). The second was a moderation in rental demand from reservists, and the third was negative migration.

The housing component increased under the effect of the shortage of workers in the construction industry and the removal from use of tens of thousands of dwellings.

BOX 3.1: THE IMPACT OF GOVERNMENT INTERVENTIONS IN PRODUCT AND SERVICE PRICES ON INFLATION
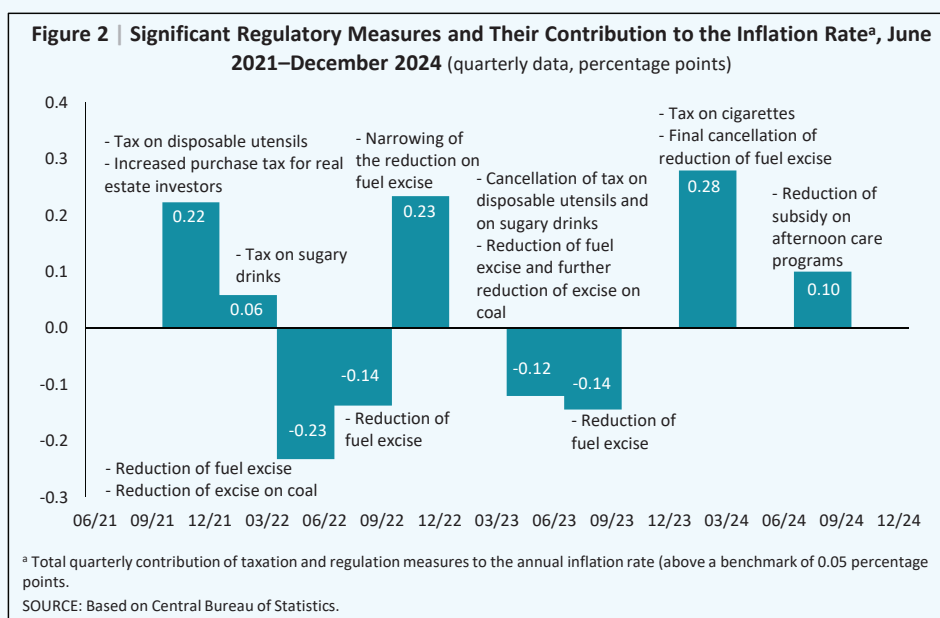
- Tracking the Consumer Price Index (CPI) excluding taxation and regulatory measures allows for distinguishing between temporary regulatory effects on the Index and underlying inflationary processes in the economy.
- In 2024, government taxation and regulatory measures contributed approximately 0.4 percentage points to the annual inflation rate.

Prices of goods and services in the economy are influenced by many factors, one of which is government policy. There are two main types of government interventions that affect prices. The first is through government updates to regulated prices at fixed times in order to adjust them to changes in input prices. This impact is mainly technical and includes an examination of relevant input prices, usually based on a predetermined input basket. The second type is policy-driven intervention—fiscal or social measures, including changes in indirect taxes (e.g., VAT, purchase taxes), direct subsidies for products and services (e.g., for after-school programs, public transportation), and specific regulations (e.g., price updates for water and electricity not due to input prices). The elimination or reduction of subsidies leads to an immediate price increase, and changes in indirect taxes directly affect the categories subject to the tax. To discern the impact of government policy on prices and thus identify the underlying inflation trend, the Bank of Israel Research Department calculates an index that excludes government policy interventions. Over time, there is a basic similarity between the development of the adjusted index and the overall index, but differences in their developments due to government interventions do arise (Figure 1).

Figure 1 | Annual Inflation, Consumer Price Index and CPI Excl. Taxation and Regulations, December 2012–December 2024 (percent)

Inflation target range — Excluding taxation and regulations — Annual inflation

SOURCE: Based on Central Bureau of Statistics.

Government policy measures have influenced price developments in recent years (Figure 2). Specifically, in 2021–2022, policy measures (taxation on sugary drinks, increased purchase tax for real estate investors, tax on disposable utensils) directly contributed about 0.3 percentage points to the increase in the CPI. At the beginning of 2024, the increase in the tax on tobacco products and the cancellation of the reduction in the excise tax on fuel added about 0.3 percentage points to the CPI. In our assessment, the 2025 budget plan contributed about 0.4–0.5 percentage points to the CPI at the beginning of 2025, due to a one percentage point increase in VAT, and about 0.2 percentage points more due to the freezing of the indexation of purchase tax brackets, changes in vehicle taxation, and an increase in public transit prices.[1]

These government interventions may also have an indirect impact on inflation in the medium-to-long term through several mechanisms.[2] Specifically, wage increases due to the desire to adjust workers' wages to rising prices; price adjustments in the production chain due to increased input costs; and updating the inflation expectations of firms and consumers, which affects pricing decisions and consumer behavior.

Figure 2 | Significant Regulatory Measures and Their Contribution to the Inflation Rate[a], June 2021–December 2024 (quarterly data, percentage points)

[a] Total quarterly contribution of taxation and regulation measures to the annual inflation rate (above a benchmark of 0.05 percentage points.

SOURCE: Based on Central Bureau of Statistics.

[1]   These contributions are calculated directly based on the expected price change, multiplied by the weight of the item in the CPI. For example, the cancellation of the excise tax discount on gasoline for transportation in January 2024 reflects an increase of about 4 percent in fuel prices, which is multiplied by the weight of fuel in the CPI. However, not all increases are calculated automatically. An example is the increase in the VAT rate from 17 to 18 percent in 2025, which theoretically reflects a price increase of 0.85 percent. However, in practice, the impact on different index categories varies. In some categories, the increase occurs directly and immediately—as with fuel prices—while in others, the price change depends on demand and competition characteristics in the industry. In these cases, the calculation is aided by a judgmental assessment based on the estimated effects observed in the past following similar VAT changes. It is important to emphasize that these calculations focus only on the direct impact and do not take into account indirect effects, such as the impact of changes on complementary product prices.

[2]   It is important to distinguish between one-off price changes for specific products and services, even if they may last for some time and be reflected in the annual inflation measurement, and ongoing inflation.

The dynamic and broad impact of government interventions on price levels has been examined in economic literature over the years. Research by Ebrill et al. (2001) and Tait (1981) found that increases in indirect taxes create a one-off shock to price levels but do not lead to a prolonged inflationary dynamic. In contrast, other studies found that indirect tax increases have a more prolonged impact on prices. Kondelis & Karabalis (2022) and Mozdzierz (2017) identified inflationary effects of indirect tax increases in several European countries that lasted for two years or more. Koutsouvelis and Papastathopoulos (2013) showed that the change in VAT in Greece significantly affected prices of transportation, alcohol and tobacco, restaurants and hotels, and food and nonalcoholic beverages, but had less impact on other products also subject to the tax increase.

In the context of Israel, empirical studies have found that even in the short term, the impact of indirect tax increases on prices is not clear. A study by Oren-Yiftach et al. (2007) found that the increase in VAT did not affect the short-term prices of the products examined—including food, cleaning, and hygiene products—but there was an increase in the likelihood of price adjustments in the direction of the VAT change. Similarly, a study by Ribon and Sayag (2017) did not find evidence of VAT changes having a significant impact on consumer prices, but did indicate that these changes are reflected, albeit with a low coefficient, mainly in the prices of relatively elastic products such as food, fuel, clothing, and footwear. However, in some cases, the impact of changes in indirect taxation on prices may be more significant. Braude and Ribon (2022) showed that following the imposition of the tax on disposable utensils, the prices of disposable cups increased at a rate higher than expected based on the tax increase alone, indicating the existence of additional factors affecting the transmission from taxation to prices.

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BOX 3.2: DECOMPOSITION OF THE CONSUMER PRICE INDEX – THE IMPACT OF CHANGES IN VOLATILE COMPONENTS ON CORE INFLATION

- Cumulative fluctuations in the volatile components of the Consumer Price Index—those not included in the core—indirectly affect the development of core inflation, albeit to a limited extent.

In recent years, inflation rates globally and in Israel have been characterized by sharp changes: very low inflation during the COVID-19 years followed by a sharp increase (see Figure 3.3 in the main chapter). In most OECD countries, this increase was attributed primarily to rising commodity prices due to supply disruptions, partly due to the war in Ukraine, alongside a rapid recovery in demand post-COVID.

This box analyzes the development of inflation while identifying the impact of structural components and changes resulting from temporary factors, based on the approach presented by Dao et al. (2024). Specifically, the analysis is based on decomposing inflation into two components. The first is "core" inflation, which reflects the inflation environment and is influenced by the business cycle[1]—a relationship typically expressed through the "Phillips curve." The second is the gap between core inflation and overall inflation, which reflects temporary, nonstructural factors. In certain situations, factors outside core inflation may indirectly influence it through mechanisms such as expectation adjustments or the indexing of wages and prices to the general price level.[2]

Dao et al. (2024) find that the rise in global inflation in the years following COVID-19 is explained by these temporary shocks outside the core index—particularly energy prices—which affected the overall index both directly and indirectly, due to their transmission to core inflation. Conversely, the state of the economy was a secondary factor in accelerating inflation at that time.
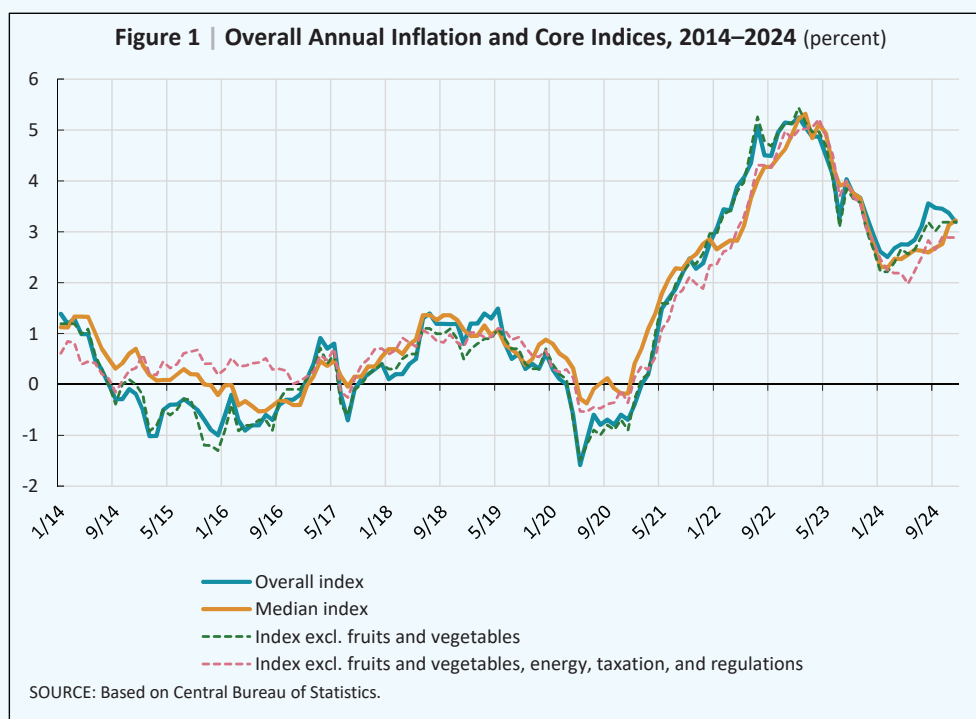
Similar to Dao et al. (2024), we estimated the factors influencing core inflation in Israel, particularly examining whether fluctuations not included in it indirectly affect it. For this purpose, we examined three alternative measures of the core index: the median of monthly price changes, and two adjusted indices—the index excluding fruits and vegetables and the index excluding energy, fruits and vegetables, and taxation and regulation.

Figure 1 presents the different indices. It shows that the median is less volatile than the other indices[3], and the development of the index excluding only fruits and vegetables is very similar to that of the overall index. Over time, the trends of all indices are similar.

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[1] A slightly different possible distinction refers to the core as the part of inflation characterized by price rigidity. See Cecchetti (1997).

[2] Tenreyro (2023) discusses the fact that the more frequent the shocks (from the supply side) and the more significant their impact on expectations and actual inflation, the more monetary policy needs to respond to them.

[3] The standard deviation of the monthly change in the median for the years 2014 to 2024 is 0.23, compared to 0.36 for the overall index, 0.35 for the index excluding fruits and vegetables, and 0.31 for the index excluding fruits, vegetables, energy, and taxation and regulation.

Figure 1 | Overall Annual Inflation and Core Indices, 2014–2024 (percent)

Legend:
— Overall index
— Median index
---- Index excl. fruits and vegetables
---- Index excl. fruits and vegetables, energy, taxation, and regulations

SOURCE: Based on Central Bureau of Statistics.

What Explains Core Inflation? Similar to Dao et al. (2024) and others before them, we find that core inflation is influenced by several factors. A fundamental factor reflecting the long-term inflation environment is the expectations for inflation 5 to 10 years ahead.[4] In the short term, core inflation is also influenced by the state of the business cycle, which can be estimated using various indicators, including the ratio of job vacancies to the unemployment rate, i.e., the gap between supply constraints and demand constraints in firms' activity. Since Israel is a small and open economy, we included the exchange rate and commodity prices (including energy, in dollars) among the factors influencing core indices, as they affect the local prices of imports (for private consumption).[5]

Additionally, we examine whether temporary shocks that are not part of the core index and are not supposed to affect the inflation environment have an indirect influence on the development of prices that are not directly affected by them. To avoid the impact of the period following the outbreak of the war in October 2023 on the estimated relationships, and to allow for the assessment of the estimation's fit in 2024, we estimated the equations from 2014 to September 2023.[6] The dependent variable is the monthly change (in annual terms) of the core index in different definitions.

As expected, the results presented in Table 2 show that the state of the business cycle affects the development of the core index. The stronger the demand—as reflected in the gap between supply

[4] Dao et al. (2024) impose a unit coefficient on long-term expectations but also allow for a nonzero constant. The results in such a formulation are very similar to those obtained here when combining the impact of expectations and the constant.

[5] The exchange rate and commodity prices were included with a lag. When core inflation is the median of price changes, it also includes changes resulting from energy and commodity prices, if they are not large.

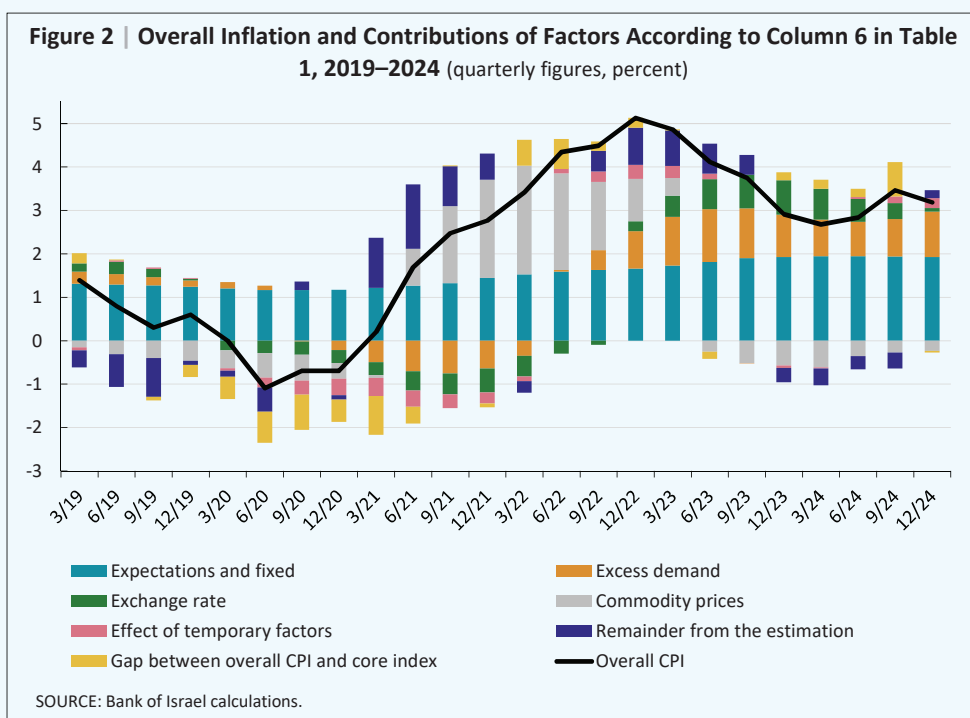[6] Estimation until the end of 2024 does not materially change the results.

constraints and demand constraints or the state of the labor market—the higher the rate of price change tends to be.[7] The exchange rate and commodity prices, mainly reflecting oil prices, both influence the rate of price increase to a similar extent, likely due to their impact on the prices of tradable goods in the index.

Table 1	Estimation of Factors Explaining the Monthly Rate of Change in Core Indices^, 2014–2023/9						
Core Index	Excluding Fruits and Vegetables	Excluding Fruits, Vegetables, Energy, and Taxation	Excluding Fruits, Vegetables, Energy, and Taxation	Median	Median	Median	Median
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Constant	-2.57***	-0.85	-2.41*	-0.32	-0.38		-0.83
5–10 Year Inflation Expectations	1.63***	0.97***	1.87**	0.82***	0.89**	0.71***	1.06***
The gap between supply constraints and demand constraints	0.34***	0.27***	0.14	0.18**			
Job Vacancy to Unemployment Rate (deviation from average)					2.60***	2.61***	3.04***
Exchange Rate Change (NIS/USD)	0.08***	0.12***	0.04**	0.10***	0.08***	0.08***	0.07***
Commodity Price Change (USD)	0.12***	0.09***		0.08***	0.08***	0.08***	0.08***
Deviation of Overall Index from Core (Indirect Impact)	0.15***	0.01	0.10*	0.07*	0.05	0.05*	
Fruit and Vegetable Price Change (Deviation from Average)							0.03*
Monthly Seasonality +Dummy Variables	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Adj. R2	0.47	0.58	0.52	0.44	0.47	0.57	0.47

^ In annual terms.
# In the last year, with a lag of one month.
* Indicates a significance level of 10%, ** 5%, and *** 1%, based on a calculation adjusting for possible serial correlation (Newey-West).
+ The sum of coefficients is constrained to be zero.

[7] The analysis here does not allow for identifying the mechanism—wage increases or the widening gap between production costs and prices.

The interesting variable—the indirect impact of shocks—is significant in most formulations. This variable measures the change in the last 12 months in the price of index components not included in the core index. Accordingly, when the core index is defined as the index excluding energy, fruits, vegetables, and taxation, this variable reflects the development of these components. Therefore, when commodity prices are also included in the estimation, no additional impact of this variable can be identified (Column 2 in Table 1). Omitting the commodity variable allows the shock to be significantly expressed (Column 3). The results for the median are of particular interest. The gap between the median and the overall index in price development over the past year affects the development of the median itself; meaning there is evidence that fluctuations in the overall index have an indirect impact on the inflation environment (Columns 4 and 6). It is important to note that the gap between the median and the overall index is not correlated with changes in commodity prices or the exchange rate. Therefore, it seems that the indirect impact found does not necessarily reflect changes in energy prices, but rather a more general impact of price index fluctuations. In an additional examination, presented in Column 7, the shocks that are not in the core are represented by the annual change in fruit and vegetable prices, which are very volatile and not correlated with changes in energy prices (a correlation of -0.2 for the annual change). Despite this, and despite their volatile nature, fruit and vegetable prices do have a small impact on the development of the core index. This means that price changes, even if they result from factors not reflecting the basic state of the economy, affect the inflation environment. Similar results are obtained when the core index is represented by the index excluding fruits and vegetables (Column 1).

Figure 2 | **Overall Inflation and Contributions of Factors According to Column 6 in Table 1, 2019–2024** (quarterly figures, percent)

SOURCE: Bank of Israel calculations.

Based on the estimation, it is possible to assess the contribution of each component to explaining overall inflation. Figure 2 presents the contributions obtained from the estimation in the formulation presented in Column 6, along with the gap between the estimated core inflation and overall inflation.

The figure shows that in 2024, fluctuations in the index that are not included in the core index (the median) directly contributed to price increases, especially in the middle of the year. Beyond that, the indirect impact of these fluctuations on the core also had a small positive contribution throughout 2024. Activity, as estimated by the ratio of job vacancies to the unemployment rate, contributed to price increases[8], the exchange rate was not a major factor, and commodity prices even contributed to moderating price increases. The figure also shows that the contribution of the state of economic activity to price development during the COVID-19 period and at the beginning of the inflation acceleration process in 2022 was relatively negligible, similar to the result obtained by Dao et al. (2024).
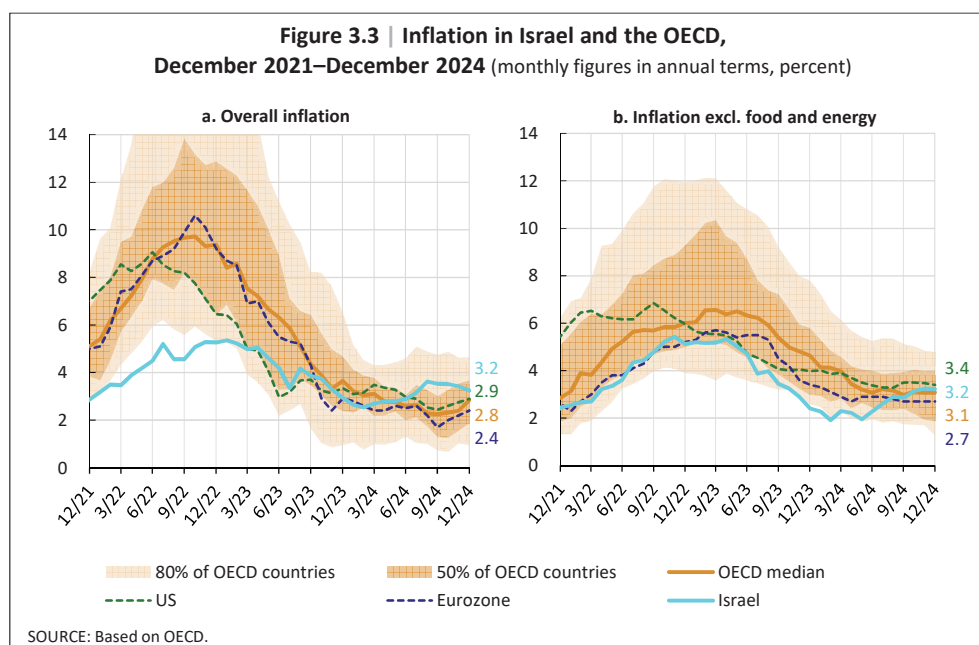
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[8] The impact of excess demand, derived from an estimation including the gap between supply constraints and demand constraints (Column 4), moderates at the end of 2024, with an increase in the unexplained residual at the end of 2024 (not shown).

c. Developments in the advanced economies

In 2024, unlike previous years and against the backdrop of the Swords of Iron War, which was a unique local development, inflation in Israel increased, contrary to global trends. Inflation in most advanced economies continued the "soft landing" trend—a decline and convergence toward central bank targets while maintaining employment levels and economic activity[3]—that it has shown since late 2022 (Figure 3.3). Consequently, the median annual inflation rate in the OECD declined from 3.7 percent in 2023 to 2.8 percent by the end of 2024. This occurred despite a 7 percent increase in nonenergy commodity prices (with food prices rising by about 9 percent) and an increase in transportation costs[4], alongside a 3 percent decline in the price of Brent crude oil (Table 3.1). Core inflation in the OECD, expressed in inflation excluding food and energy, moderated from 4.6 percent at the end of 2023 to 3.1 percent at the end of 2024. Accordingly, central banks in advanced economies began a round of interest rate cuts during 2024 and signaled further future rate reductions.

Figure 3.3 | Inflation in Israel and the OECD, December 2021–December 2024 (monthly figures in annual terms, percent)

a. Overall inflation

b. Inflation excl. food and energy

80% of OECD countries | 50% of OECD countries | OECD median
US | Eurozone | Israel

SOURCE: Based on OECD.

Inflation in Israel rose to the upper part of the distribution among advanced economies.

This year, after many years during which inflation in Israel was at the lower end of the distribution among advanced economies, it moved to the upper part of this distribution (Figure 3.3a). By the end of the year, inflation in Israel was about 0.5 percentage points higher than the median inflation rate of the OECD countries. The inflation rate excluding food and energy in Israel (Figure 3.3b) increased—both absolutely and relative to the distribution of OECD countries—moving from the bottom of the distribution to the median.

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[3] In the leading eurozone countries (Germany, France, and Italy), GDP growth was low in 2024.

[4] See Haggai Etkes and Nitzan Feldman (2024), "The Impact of Houthi Attacks on International Trade: Is Israel an Outlier?", *Selected Research and Policy Analysis Notes*.

d. The main forces affecting inflation

The main event affecting the economy this year was the war. Against this backdrop, the main economic forces contributing to the rise in inflation this year were supply constraints, primarily due to labor shortages, impaired productivity and import disruptions, the recovery of demand supported by fiscal policy, and an increase in the risk premium.

1. Supply-side constraints

The war affected the supply of output, particularly in the business sector, through several channels: a broad impact on the labor market—both in terms of the number of employees and working hours; damage to capital stock—in factories and agriculture in conflict areas and restricted access to these areas, as well as reduced investments due to the increased risk premium; productivity disruptions; disruptions to the import of raw materials; and more. Consequently, the level of business output decreased, creating inflationary pressures.

> The war impaired the economy's production capacity this year, mainly due to a shortage of workers, which acted to increase inflation.

(a) Labor market constraints—worker shortages and impaired productivity

The war led to a sharp decline in the labor supply, both due to the prohibition on the entry of Palestinian workers, whose numbers remained low throughout 2024, and due to extensive reserve mobilization, with only partial improvement in both constraints during the year (see Chapter 5). The impact on the labor supply affected inflation through two main channels:

Increased production costs due to labor shortages, increased wages, and impaired labor productivity.

The shortage of workers led to a decline in the supply of goods and services in the market.   This led to a shortage relative to demand and increased pricing markups due to the strengthened market power of some producers and retailers. It should be noted that reserve soldiers did contribute to GDP through their contribution to security, but this came at the expense of their contribution through their civilian professions and, accordingly, at the expense of the supply of civilian goods and services (see Chapter 2).

The tightening of the labor market was reflected in the rise of the job vacancy to unemployment ratio from 0.9 in the first quarter of the year to 1.2 in the fourth quarter (Table 1.3). Box 3.2 shows that the tightening of the labor market contributed about one percentage point to inflation during 2024 (a contribution that worked through several channels, not just through wage increases).

The demand for workers was correlated with the rise in nominal wages in 2024 (by industry, Chapter 5, Figure 5.10), such that the nominal wages increased by about 6

percent in 2024, and contributed to inflation. Buzaglo-Baris (2024)[5] found that the transmission from nominal wages (of Israeli workers) to inflation is about 0.1, so it can be inferred that the wage increase since the start of the war contributed up to 0.6 percentage points to inflation during 2024. Furthermore, the unit labor cost increased by about 4.2 percent (Chapter 1), reflecting an increase in marginal costs and inflationary pressures.

(b) Import disruptions

Another factor that impacted supply and contributed to inflation in 2024 was disruptions in import processes to Israel caused by the war (see Chapter 2), due to disruptions in economic ties with countries and firms worldwide.[6] This included widespread flight cancellations[7], as well as disruptions in the trade routes through the Gulf of Aden, which increased transportation costs and delays. An indication of the impact of trade disruptions can be seen in the supply chain pressure index, which rose after the outbreak of the war and remained at a high level throughout 2024 (an average level of 0.66 standard deviations) (Figure 3.4).

Figure 3.4 | Supply Chain Pressure Index in Israel, December 2021–December 2024
(monthly figures in terms of average standard deviation, percent)
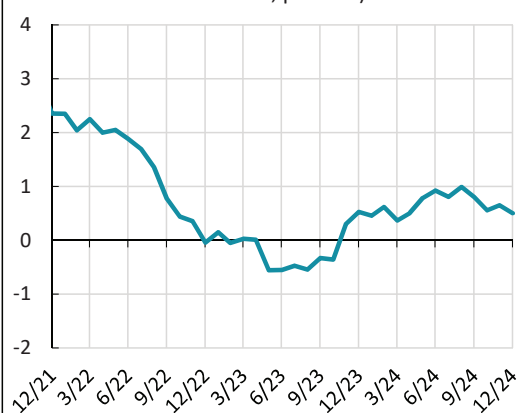
Note: The pressure index is calculated using the PCA method on supply chain indices.
SOURCE: Based on the Bank Hapoalim Purchasing Managers Index and Bloomberg.

2. Recovery in consumption, fiscal policy, and excess demand

In the first quarter of 2024, there was some recovery in private consumption, which had significantly declined at the beginning of the war (in the last quarter of 2023). This was in addition to domestic purchases by the public sector, which largely offset the slowdown in private sector demand and even beyond. Notable examples include funding for hotel stays and rental payments for evacuated residents, which offset the impact of the absence of tourists and of some young people from the rental market

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[5] Shira Buzaglo-Baris (2024). "Wage and Price Inflation: An Industry-Level Study", Discussion Paper Series 2024.09, Bank of Israel Research Department. This paper examined the transmission from wages to prices, and vice-versa, using industry data, given industry productivity.
[6] Box 2.2 shows that the impact of the Turkish embargo on import prices to Israel was limited.
[7] The price of flight tickets did not affect annual inflation, but the reduction in flight supply complicates imports, such as Israelis' flights abroad (import of tourism services).

due to reserve duty. The government also made transfer payments and grants to reservists and evacuees, supporting their and their families' demand while they were removed from the civilian labor supply—a combined development, the overall impact of which contributed to the creation of excess demand. Credit relief measures, such as the program for deferring household loan repayments, also helped reduce disruptions to routine activities, thereby contributing to the recovery of demand.

Nominal private consumption grew by 6.9 percent in 2024 (compared to its average level in 2023, and by 5.8 percent compared to its average level from the fourth quarter of 2022 to the third quarter of 2023), while the nominal GDP growth rate over the past decade averages about 6 percent per year. In real terms, the contribution to growth from private consumption and public purchases (excluding defense imports) was 5.4 percent in 2024. (The average level of real private consumption was 3.7 percent higher in 2024 than it was in 2023, and 1.7 percent higher than in the first three quarters of 2023. See Chapter 2).

The economy was influenced in 2024 by forces that constrained the supply side, temporarily lowering the potential output level, reflecting production capacity. A deviation of demand from this level ("excess demand") leads to the development of an "output gap," which leads to an increase in inflation. To check if the demand recovery indeed reflected such excess demand, an "excess demand index" is presented (Chapter 1, Figure 1.3), based on reported demand and supply constraints in the Central Bureau of Statistics Business Tendency Survey.[8] The estimate from the survey shows that from the beginning of 2024, the demand constraint eased without a corresponding improvement in the supply constraint, creating a demand gap.

> The excess demand index, based on the Central Bureau of Statistics Business Tendency Survey, increased from the beginning of 2024.

The war also affected inflation through another channel. Box 3.3 shows that the increase in the government deficit relative to its prewar level (an increase of 5.4 percent of GDP) contributed to the rise of about 0.5–1 percent in one-year inflation expectations. This finding reflects the capital market's assessment that expansionary fiscal policy contributes to inflation due to its contribution to aggregate demand, while the restraining effect of expectations of future taxation, which acts to curb demand, is likely secondary.

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[8] This index was found to be more correlated with inflation than other indicators, such as deviations of output or unemployment from their statistical trends.

BOX 3.3: THE DEFICIT AND INFLATION EXPECTATIONS

- The increase in the government budget deficit, compared to the period before the war, contributed about 0.5–1 percentage points to the increase in inflation expectations.

Government expenditures were high in 2024, mainly due to the war. These expenditures led to a high deficit and a significant increase in public debt. Expansionary fiscal policy can lead to rising inflation through the expansion of domestic demand, especially when there are supply constraints in the economy. A high government deficit can also lead to market assessments that the government will struggle to repay future debt through taxation or through spending cuts, an assessment that will also act to raise inflation expectations.[1]

Empirical evidence regarding the direction and magnitude of fiscal policy's impact on inflation is mixed. Some studies have found that fiscal expansion leads to rising inflation (Ferrara et al., 2021), while others have shown that the effect is not significant or even negative (Jørgensen & Ravn, 2022).[2] Coibion, Gorodnichenko & Weber (2021) and Grigoli & Sandri (2024) conducted experiments among households, in which a group of participants received information that the government debt trajectory would increase. They found that these participants adjusted their inflation expectations upwards, indicating that they believe the increase in debt has an inflationary effect. Hazell & Hobler (2024) used high-frequency data to show that the high government deficit in the US during the COVID-19 period explains about 30 percent of the inflation in 2021–2022. Gomez Cram et al. (2023) documented an increase in inflation expectations in the days following the publication of future fiscal measures with an expansionary impact on the government deficit.

In this box, we examine whether an increase in the deficit environment is indeed perceived as inflationary in Israel. Focusing on inflation expectations (rather than actual inflation) allows us to identify the inflationary impact of the deficit based on high-frequency data. Since inflation expectations influence actual inflation (Lucas, 1972), the impact of the increase in the deficit on inflation expectations indicates a risk channel for rising inflation, also related to fiscal policy.

Data: The analysis focuses on daily-frequency data and examines the change in one-year inflation expectations derived from the capital market (breakeven) in a short time window around the publication date of the cumulative deficit for the last twelve months as a percentage of GDP.[3] The sample includes the period from January 2015 to December 2024.
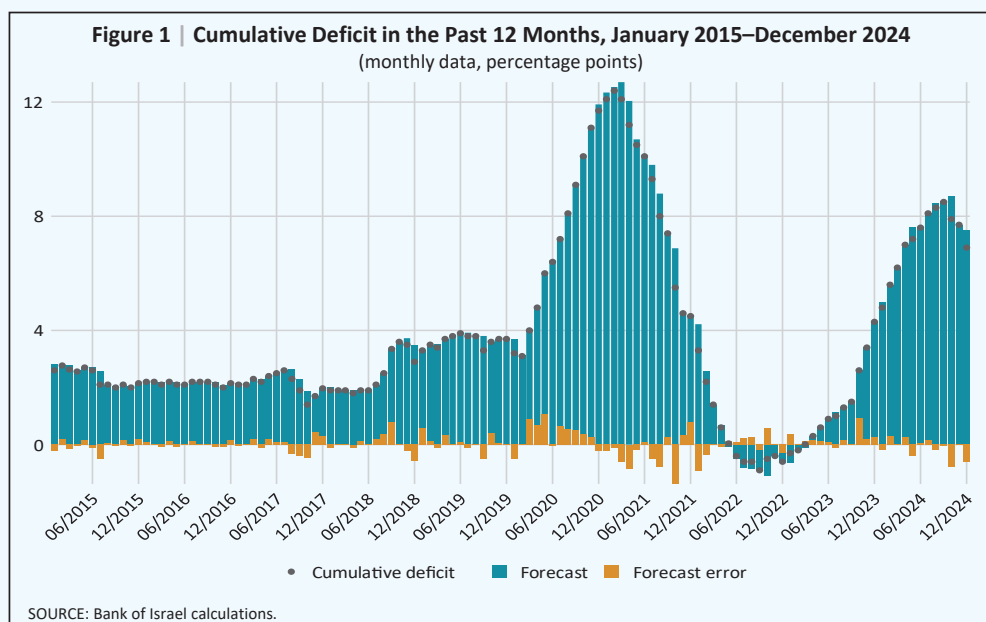
Methodology and Results: The monthly publication of the cumulative deficit figure for the last twelve months as a percentage of GDP (Figure 1) refers to the month just ended and includes both an anticipated component (including the previous eleven months that were already known) and an unanticipated

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[1] Cochrane (2023), based on the fiscal theory of the price level, describes how high government expenditures may lead to an increase in inflation expectations. The theory emphasizes the importance of responsible fiscal policy for maintaining price stability, as high government debt can lead to inflationary pressures through the public's perception that the value of the real debt will be eroded by inflation aimed at meeting obligations.

[2] Jørgensen & Ravn (2022) describe how fiscal expansion encourages the rapid adoption of technologies that increase productivity, thereby acting to lower prices.

[3] The information is usually published between the 5th and 12th of the month, and the timing is not known in advance.

component. Since the capital market is forward-looking, only the unanticipated component of the deficit may have an impact on the change in inflation expectations at the time of publication. Economic forecasters and market participants do not publish a deficit forecast on a regular basis, making it difficult to isolate the surprising component of the deficit and examine its impact on inflation expectations. To address this limitation, we constructed a statistical forecast for the cumulative deficit.[4] The analysis uses forecast errors as an estimate of the deficit surprise.

Figure 1 | Cumulative Deficit in the Past 12 Months, January 2015–December 2024
(monthly data, percentage points)

SOURCE: Bank of Israel calculations.

The estimation is based on a Local Projection equation to estimate the cumulative response of inflation expectations to deficit information:
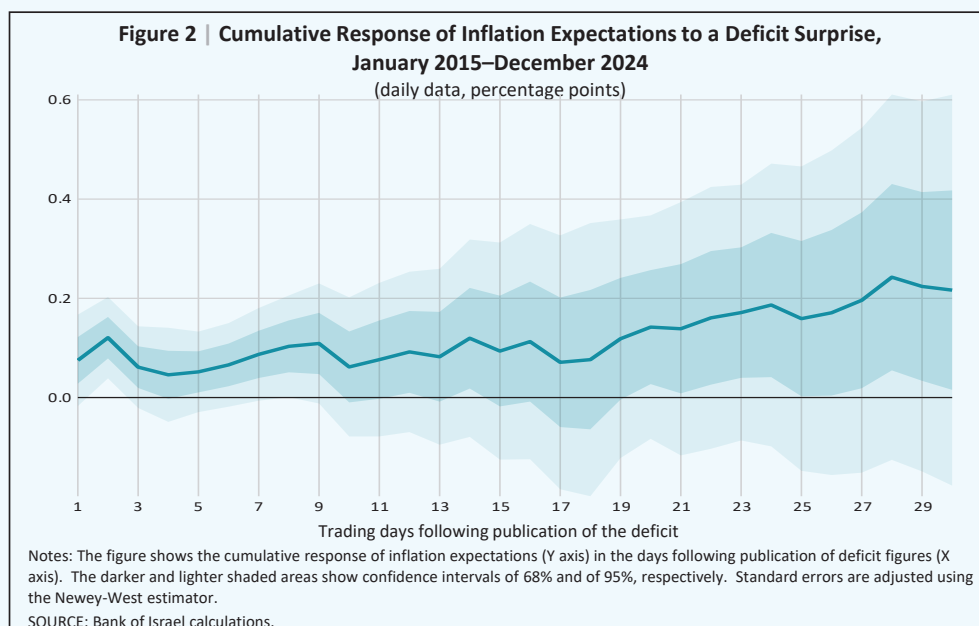
$$\Delta_{t-1,t+h}\pi^{e} = \alpha^{h} \times I(ReleaseDate) + \beta^{h} \times I(ReleaseDate) \times ForecastGap_{t} + \gamma^{h}\Delta_{t-1,t+1}X + \epsilon_{t+h}$$

where $\Delta_{t-1,t+h}\pi^{e}$ is the change in one-year inflation expectations derived from the capital market between the previous trading day and the h next trading day; I *(ReleaseDate)* is a dummy variable for the date on which the deficit is published; and $ForecastGap_{t}$ is the deficit forecast error from the statistical model. The control variables included in X are the changes in the exchange rate against the

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[4] The forecast for one period ahead is based on an ARMA(1,1) model, estimated on the basis of historical deficit data up to the publication date of the new monthly figure. The publication of the cumulative deficit refers to the month just ended, and there are almost no other data published before it (such as labor market data, which could provide an indication of the revenue side). Since the forecast is based on a statistical model, its ability to identify the anticipated component in significant deficit changes that were assessed by the market before the publication is limited.

dollar, the price of a barrel of oil, and inflation expectations in the United States relative to the previous trading day. The equation also includes seven lags of the daily change in inflation expectations, dummy variables for the year and the month, and dummy variables for the days of interest rate decisions and for the days of Consumer Price Index (CPI) releases.
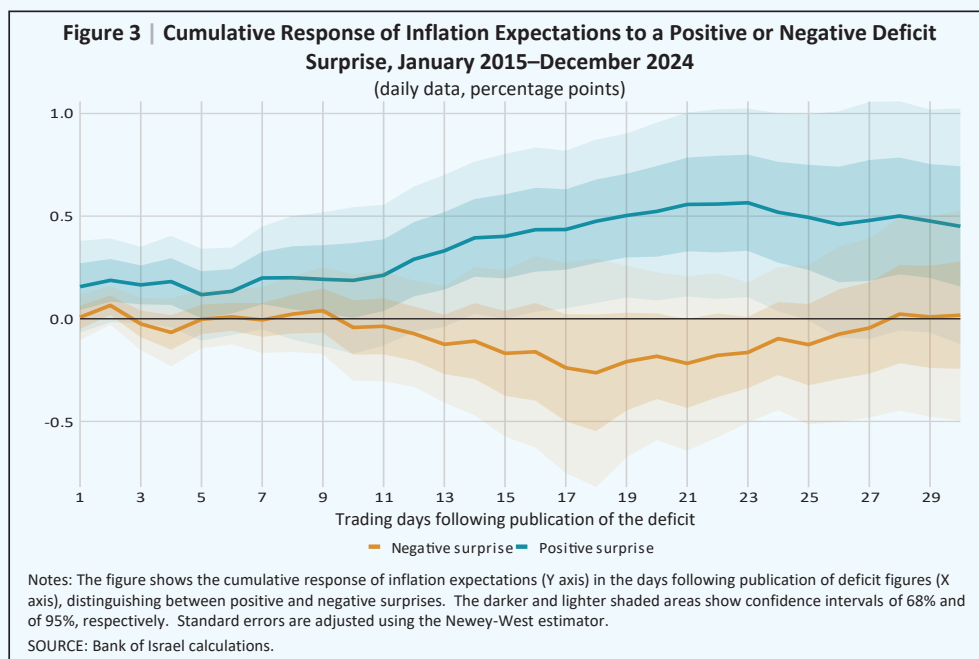
Figure 2 presents the coefficient β^h for the 30 trading days following the deficit announcement. It appears that after a deficit surprise of one percent of GDP[5], inflation expectations rise by 0.1–0.2 percentage points, with the response being significant mainly in the first week after the announcement.[6] Similar results are obtained in an estimation based on a sample ending in September 2023 (before the war), indicating that the estimated effect is not solely a result of 2024. A positive but slightly weaker response is also found for long-term inflation expectations (5–10 years forward). Figure 3 examines whether the market's response to positive surprises differs from its response to negative surprises. The results of both tests indicate that inflation expectations derived from the capital market respond significantly to higher-than-expected deficits, while lower-than-expected deficits do not have a significant impact on expectations.[7] The use of deficit surprises allows for a clean identification of the transmission to inflation expectations and indirectly calculates the contribution of the deficit increase in 2024. It appears that the increase in the government deficit relative to its level before the war (an increase of 5.4 percent of GDP) had a significant contribution (about 0.5–1 percent) to the rise in inflation expectations.

Figure 2 | Cumulative Response of Inflation Expectations to a Deficit Surprise, January 2015–December 2024
(daily data, percentage points)

Trading days following publication of the deficit

Notes: The figure shows the cumulative response of inflation expectations (Y axis) in the days following publication of deficit figures (X axis). The darker and lighter shaded areas show confidence intervals of 68% and of 95%, respectively. Standard errors are adjusted using the Newey-West estimator.
SOURCE: Bank of Israel calculations.

[5]   The average surprise (in absolute terms) during the sample period is 0.25 percent of GDP.
[6]   It should be noted that measuring inflation expectations from the capital market includes premia related to liquidity and the risk of government bond markets (indexed and nominal). Deficit information may therefore indicate short-term borrowing needs and influence market participants' expectations regarding the mix of upcoming issuances.
[7]   As a placebo test, we reestimated the equation by advancing the deficit announcement and surprises by five days. An insignificant response of inflation expectations was found in the LP within a horizon of up to five days, supporting the assessment that the change in the deficit was not anticipated.
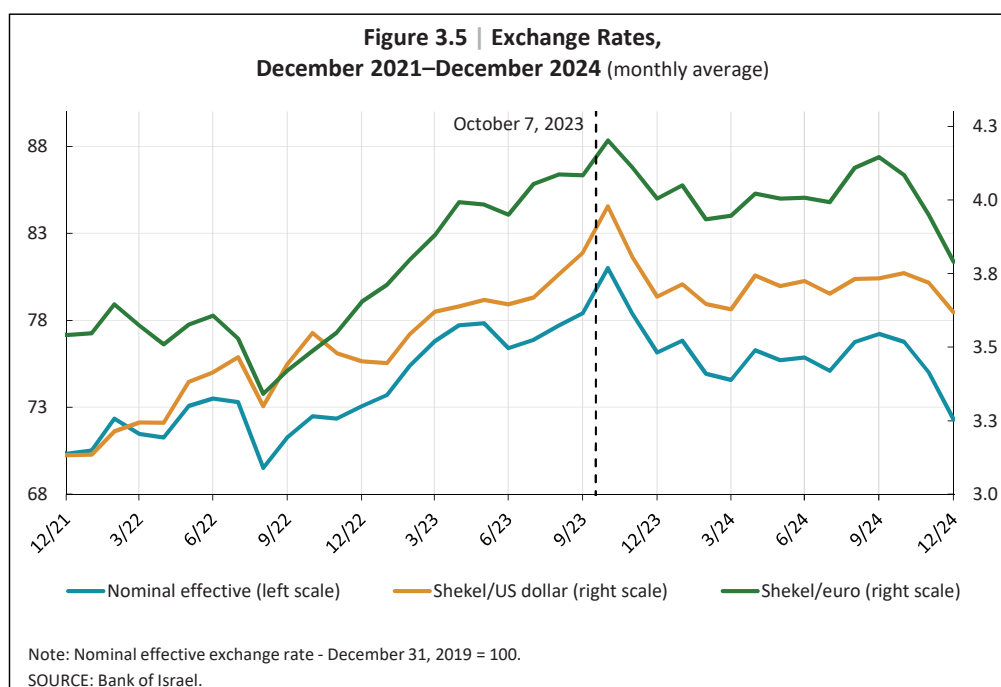
Figure 3 | Cumulative Response of Inflation Expectations to a Positive or Negative Deficit Surprise, January 2015–December 2024
(daily data, percentage points)

Trading days following publication of the deficit

Negative surprise — Positive surprise

Notes: The figure shows the cumulative response of inflation expectations (Y axis) in the days following publication of deficit figures (X axis), distinguishing between positive and negative surprises. The darker and lighter shaded areas show confidence intervals of 68% and of 95%, respectively. Standard errors are adjusted using the Newey-West estimator.

SOURCE: Bank of Israel calculations.

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Lucas Jr., R.E. (1972). "Expectations and the Neutrality of Money". Journal of Economic Theory, 4(2)" 103–124.

(3) The shekel exchange rate

The exchange rate is sensitive to the influence of numerous forces, such as the risk premium, changes in the current account surplus, and more. With the outbreak of the war, the shekel depreciated significantly, reaching levels of NIS 4.08 to the US dollar and NIS 4.32 to the euro. However, following the Bank of Israel's announcement at the beginning of the war regarding its plan and commitment to mitigate fluctuations in the shekel's exchange rate and provide the necessary liquidity[9], and its intervention in the market as part of the plan, there was a sharp appreciation toward the end of 2023. Throughout 2024, the shekel remained relatively stable and slightly appreciated compared to the prewar level (Figure 3.5). The volatility around this level was mainly influenced by geopolitical developments. Over the year as a whole, the shekel appreciated by 5 percent in terms of the nominal effective exchange rate (December 2024 average compared to December 2023 average). At the end of the year (December average), the exchange rate of the shekel against the US dollar was 3.62, and the rate against the euro was 3.79.

**Figure 3.5 | Exchange Rates,
December 2021–December 2024** (monthly average)

Note: Nominal effective exchange rate - December 31, 2019 = 100.
SOURCE: Bank of Israel.

The increase in Israel's risk premium due to the war (a significant portion of which was offset toward the end of the year) was a major force driving the depreciation of the shekel. Conversely, two main factors worked this year to offset this effect and appreciate the shekel. First, the current account surplus of the balance of payments

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9   https://www.boi.org.il/en/communication-and-publications/press-releases/a09-10-23/

totaled 3.2 percent of GDP in 2024 (Chapter 2, Table 2.6). While this is lower than its level in 2023, in view of the prolongation of the war and the slowdown in the high-tech industry, the surplus remains a significant contributor to appreciation of the shekel. It should be mentioned that in recent years, natural gas discoveries and the growth of high-tech exports have contributed prominently to the surplus. The second factor in the shekel's appreciation is the relative restraint in the Bank of Israel's interest rate trajectory, compared to other central banks that began a process of lowering interest rates.

The economy's risk premium was influenced mainly by the geopolitical situation but also by perceptions regarding the fiscal situation and fiscal management, as reflected in some rating agency reports. These perceptions were influenced by the increase in the debt-to-GDP ratio, a result of the large fiscal expenditure due to the war and its consequences, which, alongside its contribution to the recovery of demand, led to an increase in public debt. Another factor that influenced the risk premium is the understanding that a significant and prolonged increase in defense and other expenditures due to the war is expected. In an empirical examination of the Israeli economy's data, Brender and Ribon (2015)[10] found that a one percentage point increase in the public debt-to-GDP ratio raises the long-term yields of government bonds by 0.1 percentage points. Therefore, if the debt-to-GDP ratio remains high after the war, it can be expected that the yields on the debt will also be higher than before the war.

From the outbreak of the war and throughout most of the year, the economy's risk premium was significantly higher than before the war. This was reflected in the rise in yields on dollar-denominated government bonds relative to US Treasury bills (Figure 3.6), the increase in CDS prices (Chapter 1, Figure 1.1), the downgrade of Israel's rating by international rating agencies (and the addition of a negative rating outlook), and the continued underperformance of the Israeli stock market compared to international benchmarks, such as the S&P index[11], for most of the year (Chapter 1, Figure 1.8). Quantitatively, in the last quarter of 2023, the dollar spread increased by about 0.45 percentage points (0.4 percentage points immediately after the outbreak of the war), and in the second quarter of 2024, it increased by an additional 0.3 percentage points (Figure 3.6). In the last quarter of the year, against the backdrop of geopolitical developments related to the war, the risk premium declined significantly—as reflected in the CDS spread and government bond yields—and the stock market narrowed the gap relative to global stock markets. However, the risk premium is still higher than before the war.

[10] Adi Brender and Sigal Ribon (2015). "The Effect of Fiscal and Monetary Policies and the Global Economy on Real Yields of Israel Government Bonds", Discussion Papers Series 2015.02, Bank of Israel Research Department.

[11] Such a development may force institutional investors to make adjustments in their asset portfolios to maintain the composition of the asset portfolio (and/or adjustments in their foreign currency exposure hedging positions) – that is, to sell dollar-denominated assets. This exerts pressure to appreciate the shekel, thereby offsetting part of the depreciating effect of the increased risk premium. See Chapter C in the Bank of Israel reports for 2022 and 2023.

The exchange rate was also influenced by the Bank of Israel's intervention to maintain the shekel's stability at the start of the war.

The exchange rate was also influenced by the intervention program announced by the Bank of Israel at the start of the war. The program was announced with a scope of up to $30 billion. In practice, purchases only amounted to about $8 billion. The high foreign exchange reserves, which stood at about $210 billion at the beginning of the year, and the program announced by the Bank of Israel signaled to market participants the Bank's commitment and ability to maintain market stability and proper functioning. Accordingly, the pressure on the exchange rate moderated during the period.

Figure 3.6 | Israel's Risk Premium as Reflected in the Difference in Nominal Yields on Dollar-Denominated 10-Year Government Bonds of Israel and the US, January 2023–December 2024 (daily data, percent)
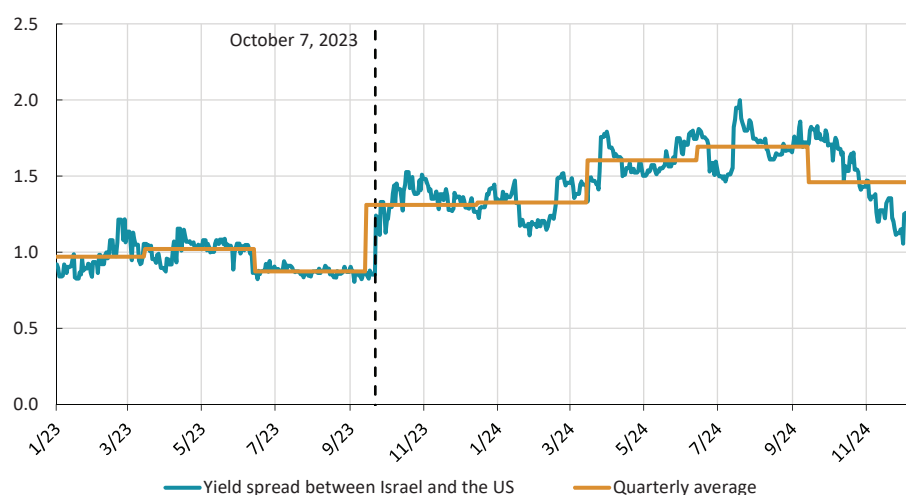
SOURCE: Bank of Israel and based on Bloomberg.

According to Bank of Israel estimates, the increase in the risk premium weakened the shekel by about 2 percent during 2024, and its cumulative contribution to inflation amounted to about 0.75 percentage points. Nevertheless, due to the combination of all factors and developments, including those that worked to appreciate the shekel, the exchange rate in most of 2024 was characterized by volatility around a given level, with the shekel appreciated compared to the prewar period.

3. MONETARY POLICY

a. The considerations behind monetary policy and its measures

The Bank of Israel's policy measures during 2024 were part of a comprehensive approach that began with the outbreak of the Swords of Iron War in late 2023. Immediately following the outbreak of the war, the Monetary Committee focused on steps to stabilize the markets, particularly the foreign exchange market, and to reduce uncertainty. This included an intervention program to stabilize the exchange rate and provide liquidity as needed. These measures aimed to maintain financial stability, as any disruption could significantly harm economic activity and cause a sharp rise in inflation. Since the outbreak of the war, and throughout 2024, the Committee emphasized that decisions would be based on economic developments and the geopolitical environment, given the high level of uncertainty (a policy known globally as data-dependent). The Committee monitored the stability of the financial markets—particularly the risk premium and the foreign exchange market—as well as the inflation environment and economic activity, including the fiscal situation, labor market, and housing market.

Immediately following the outbreak of the war, the Monetary Committee focused on stabilizing the markets and reducing uncertainty.

In its first decision of the year, on January 1, 2024, the Committee lowered the interest rate by 0.25 percentage points to 4.5 percent, in view of the continued decline in the inflation environment, a decline in the combat intensity relative to the beginning of the war, the easing of concerns about a significant depreciation, and the assessment that the government would make the necessary budgetary adjustments due to the costs of the war.

On January 1, 2024, the Committee lowered the interest rate to 4.5 percent.

Later in the year, in view of geopolitical developments and the continuation of the war, there was a growing assessment that the supply constraint was more significant than the demand constraint. This was reflected in the acceleration of actual inflation and concerns that the recovery in activity would be accompanied by price pressures. Therefore, the Committee left the interest rate unchanged in all subsequent decisions throughout the year. These decisions align with Israel's macroeconomic environment this year, as lowering the interest rate is not an effective tool for addressing supply constraints such as labor shortages. An accommodative policy could have increased excess demand, thereby raising inflation without significantly contributing to economic activity. Throughout the year, the policy continued to focus on reducing uncertainty and maintaining the stability of financial markets, particularly the foreign exchange market, alongside maintaining price stability.

Later in the year, the Committee left the interest rate unchanged, with the assessment that the supply constraint was more significant than the demand constraint.

Various estimates and analyses indicated that the interest rate environment was sufficiently restrictive to support the process of inflation converging to its target. According to the analysis presented below, the development of the real interest rate indicates relative stability in the degree of monetary policy restraint.
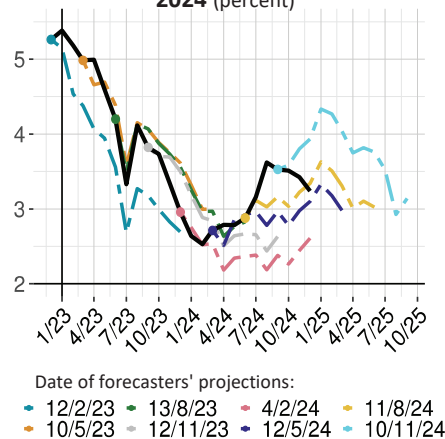
b. The development of inflation expectations and the expected interest rate

The forecasters' average one-year projections increased in the second quarter, and the expected pace of interest rate reductions moderated.

At the beginning of 2024, following the developments after the outbreak of the Swords of Iron War in late 2023, it appeared that consumer demand had significantly moderated, and accordingly, so had inflation and inflation expectations (Figure 3.7). During the first quarter of 2024, the forecasters' average projections indicated inflation expectations for a one-year horizon close to the midpoint of the target range. Consequently, market expectations pointed to a significant downward trajectory for interest rates later in the year (Figure 3.8).

During the second quarter of 2024, particularly after the publication of the March CPI (in mid-April), perceptions changed, leading to a firmer assessment that supply constraints were significant and would be resolved only gradually, while demand showed signs of a quicker recovery. Accordingly, the forecasters' average one-year projections[12] increased, and the expected pace of interest rate reductions moderated.
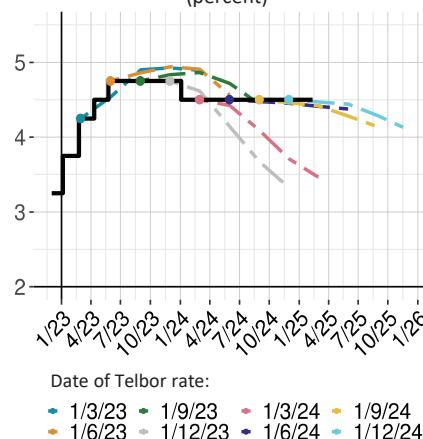

Figure 3.7 | Actual Inflation and Average of Forecasters' Inflation Projections to a 1-Year Horizon, December 2022–December 2024 (percent)

Date of forecasters' projections:
- 12/2/23
- 13/8/23
- 4/2/24
- 11/8/24
- 10/5/23
- 12/11/23
- 12/5/24
- 10/11/24

Figure 3.8 | Bank of Israel Interest Rate and the Forward Rates Taken from the Telbor Market, December 2022–December 2024 (percent)

Date of Telbor rate:
- 1/3/23
- 1/9/23
- 1/3/24
- 1/9/24
- 1/6/23
- 1/12/23
- 1/6/24
- 1/12/24

Notes: Figure 3.7 shows the development of actual annual inflation (black line) and the average of the forecasters' projections for the development of annual inflation with a horizon of up to one year, at various dates during the year (see legend). Figure 3.8 shows the Bank of Israel interest rate (black line), and the forward rate for various ranges as taken from the Telbor market, at various dates throughout the year (see legend).

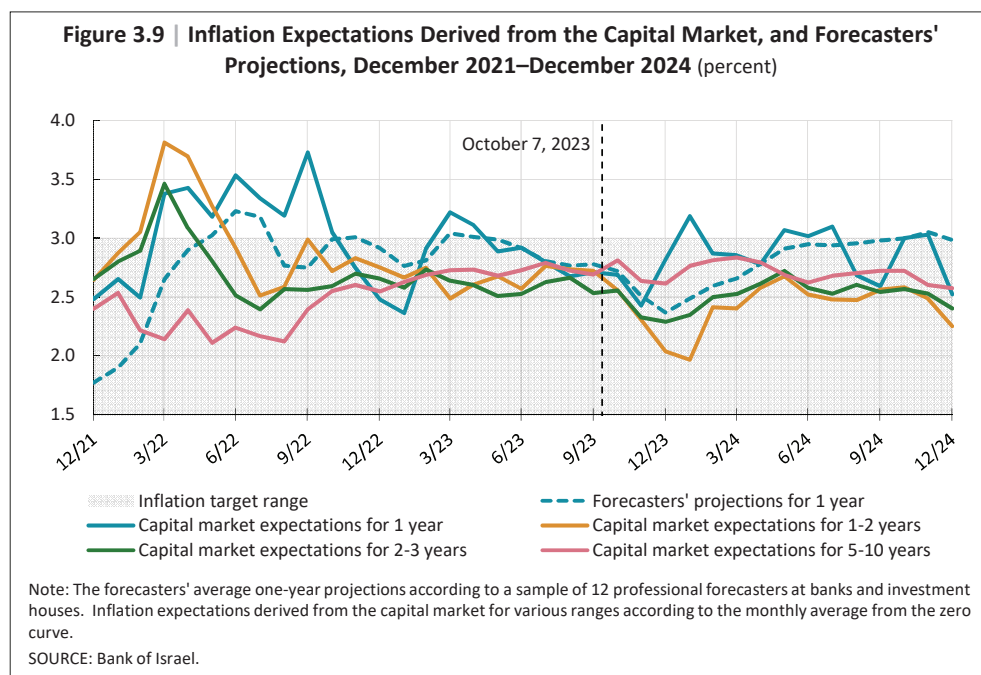SOURCE: Bank of Israel and based on Central Bureau of Statistics.

Inflation expectations remained anchored within the target range almost throughout the entire year and across all horizons, despite the continuation of the war.

Inflation expectations derived from the capital market increased in the first quarter (Figure 3.9), and remained anchored within the target range throughout most of the year and across all horizons (especially for horizons longer than one year—medium and long-term). This development indicates the effectiveness and credibility of monetary policy as perceived by market participants. Although one-year market

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[12] Inflation expectations for the beginning of 2025 increased due to legislative changes initiated by the government, primarily the increase in VAT (Box 3.1).

inflation expectations, which are more influenced by short-term developments, were volatile during the year, they remained around the upper bound of the target range and did not significantly exceed it.

Figure 3.9 | Inflation Expectations Derived from the Capital Market, and Forecasters' Projections, December 2021–December 2024 (percent)

Note: The forecasters' average one-year projections according to a sample of 12 professional forecasters at banks and investment houses. Inflation expectations derived from the capital market for various ranges according to the monthly average from the zero curve.
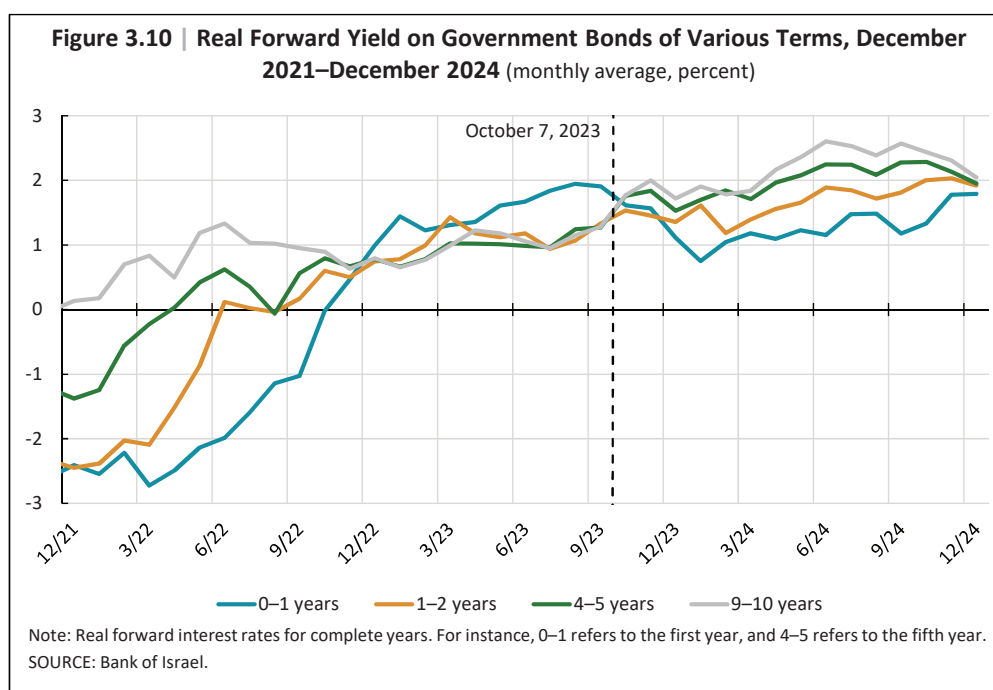SOURCE: Bank of Israel.

c. The extent of monetary restraint and effectiveness

The slope of the real yield curve reversed after the start of the war. Before the war, it was negative (meaning that the one-year interest rate was higher than the longer-term interest rates), whereas after the start of the war, the curve became upward sloping (Figure 3.10) and remained so throughout the year, with some volatility. To assess the degree of accommodation (or restraint), it is necessary to examine the gap between the real yield for a short-to-medium-term horizon and the natural interest rate for that horizon. The short-term natural interest rate, also known as the "neutral interest rate," is the real interest rate consistent with price stability and economic activity appropriate to the potential output, given the shocks affecting the economy.

The short-term real interest rate declined following the outbreak of the war, but increased later in the year (Figure 3.10). This development, partly reflecting the monetary policy adopted, aligns with the trajectory that allows for the return of inflation to its target without harming economic activity, i.e., the trajectory of the neutral interest rate. As described above, at the beginning of the year, the decline in demand was more significant than the supply disruption, whereas later in the year, the recovery in demand alongside continued supply constraints, mainly due to labor shortages, corresponded with an increase in the neutral interest rate—the rate needed to stabilize inflation and maintain activity at potential levels.

The short-term real interest rate declined following the outbreak of the war, but increased later in the year, in line with developments.

Figure 3.10 | Real Forward Yield on Government Bonds of Various Terms, December 2021–December 2024 (monthly average, percent)

Note: Real forward interest rates for complete years. For instance, 0–1 refers to the first year, and 4–5 refers to the fifth year.
SOURCE: Bank of Israel.

The trajectory of the Bank of Israel's interest rate, both actual and expected, contributed to anchoring inflation expectations within the target range.

The trajectory of the Bank of Israel's interest rate, both actual and expected, contributed to anchoring inflation expectations across different horizons and moderating inflationary pressures, which helped to temper annual inflation towards the end of the year. Inflation expectations remained anchored within the target range throughout most of the year and across all horizons, despite the ongoing war. This is firstly because many of the fears of economic damage due to the war did not materialize. Another factor is the credibility that market participants attribute to the monetary policy and to the Bank of Israel, thanks to its independence and determination in reducing inflation after its increase in 2022, and particularly during the war period.

Another achievement of the policy was the reduction of the risk of a financial crisis, which could have been caused by a liquidity crisis or a foreign exchange crisis—thanks to the Bank's swift action at the outbreak of the war.

4. THE MONETARY BASE AND THE MONETARY AGGREGATES

The interest rate is the cost of money—the alternative cost of holding liquidity—and therefore changes in interest rates, in addition to changes in economic activity, affect the demand for liquidity. When the nominal interest rate is used as a policy tool, the central bank sets a completely flexible money supply in the short term at the declared interest rate, and the monetary base—that is, the total amount of currency in circulation and the commercial banks' demand deposits at the Bank of Israel[13]—is determined by the demand for liquidity at this interest rate. The monetary base[14] is influenced both by flows outside the control of the Bank of Israel, such as government injections, and by flows directly influenced by the Bank's activities, such as foreign exchange and bond purchases and the issuance of short-term bills (MAKAM). The Bank absorbs or injects liquidity to meet the demand for the monetary base according to the monetary interest rate[15]. The monetary base increased by about NIS 8 billion during 2024, a growth rate of approximately 2.4 percent from December 2023 to December 2024 (Table 3.2), similar to the growth rate in the previous two years.

The money supply—the M1 aggregate—consists of cash held by the public and the public's demand deposits in banks. This aggregate remained virtually unchanged in 2024 (a negligible increase of 0.4 percent), following its decline in the previous two years. The public's demand deposits remained unchanged, while total cash increased slightly (at a rate of 1.6 percent). Short-term interest-bearing deposits grew: term deposits up to three months by 29 percent, and self-renewing overnight deposits by 7.1 percent. The total money aggregates (Column 7 in Table 3.2) increased by 6.6 percent.

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[13] Banks are required to make deposits in demand deposits at the Bank of Israel as part of their liquidity requirements.

[14] According to the current framework for analyzing monetary policy, changes in the money supply by themselves do not have special significance in influencing the economy. The relevant variable for economic decisions by market participants is the expected interest rate trajectory, which the central bank influences by setting the monetary interest rate.

[15] The Bank adjusts the monetary base to the interest rate taking the total of other injections into account, through interest-bearing deposits it offers to banks in auctions, which are not included in the monetary base, and through the issuance of short-term bills (MAKAM).

Table 3.2 | Rate of change in the monetary aggregates, 2020–2024

	0	1	2	1+2=3	4	5	6	3+4+5+6=7
	Monetary base[a]	Cash held by the public	Demand deposits	M1[b]	Term deposits up to 3 months	Term deposits of 3 months to 1 year	SRO[c]	Total[d]
	(Average in December compared to average the previous December)							
2020	25.8	23.3	30.7	29.4	24.7	12.2	25.9	26.0
2021	12.6	6.9	25.2	22.0	-3.6	12.6	23.8	17.5
2022	3.0	6.0	-12.9	-10.0	34.6	85.0	-7.9	4.9
2023	1.6	8.8	-19.8	-14.6	24.9	17.3	-15.5	-3.1
2024	2.4	1.6	0.1	0.4	29.0	-6.3	7.1	6.6
	(Quarterly average compared with the average of the previous quarter)							
2024								
Q1	0.5	0.3	-0.3	-0.2	7.3	5.1	6.2	3.7
Q2	1.8	2.3	0.7	1.1	6.1	-0.2	0.5	1.8
Q3	1.2	1.3	0.7	0.9	5.4	-4.4	-2.2	0.3
Q4	0.3	-0.6	-0.1	-0.2	8.6	-5.2	3.9	1.7

[a] Total banknotes and coins in circulation and current deposits by the commercial banks with the Bank of
[b] M1 = cash and demand deposits.
[c] Self-renewing overnight deposit - a liquid daily deposit.
[d] M1+SRO+unindexed deposits of up to one year.
SOURCE: Bank of Israel and Central Bureau of Statistics data.