BANK OF ISRAEL

62 | Monetary Policy Report

Second Half of 2024

January 2025

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Monetary Policy Report
Second Half of 2024

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

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

In accordance with Section 55(b) of the Law, the current Monetary Policy Report presents the reasons for the deviation of the inflation rate from the target range determined by the government for more than 6 consecutive months, from the publication of the CPI for July 2024, on August 15, 2024 through the publication of the CPI for November 2024. The inflation rate in that period was above the upper bound of the target range, and the reasons for that are discussed in Section B below ("Background conditions from the Monetary Committee's perspective").

The Monetary Policy Report for the second half of 2024 was prepared by economists in the Bank of Israel Research Department, under guidance from the Monetary Committee. The report is based on data published up to the interest rate decision reached on January 6, 2025, including the CPI for November 2024.

The Monetary Committee was established under the Bank of Israel Law, 5770-2010. In routine times the Committee has 6 members—the Governor, who serves as Committee Chairperson, the Deputy Governor, a Bank of Israel employee appointed by the Governor, and 3 members from among the public. The Monetary Committee members discuss the monetary policy, and at the end of the discussion there is a vote on 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 a majority of the Committee members participating in the vote. In the half-year reviewed, rather than 6 Monetary Committee members, there were 5 members—two from among the public instead of the regular 3.

Abstract

Monetary policy: The Monetary Committee kept the interest rate unchanged at 4.5 percent in all its decisions in the second half of 2024. 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 was determined in accordance with the convergence of inflation to its target, continued stability in the financial markets, economic activity, and fiscal policy.

Domestic real activity and the labor market: In the second half of 2024, there was some increase in activity with a recovery of private consumption. After GDP growth in annual terms of 0.1 percent in the second quarter, GDP expanded by 3.8 percent in annual terms in the third quarter. However, its level remained about 3.6 percent lower than its long term trend. A considerable part of the gap is explained by supply constraints deriving from a shortage of workers—a shortage of non-Israeli workers, the absence of workers who are serving in the military reserves, and in part of the half year, by a limitation on employment in the North. The labor market remains tight, with a low unemployment rate and a nominal wage that increased in the half year at a moderate pace.

The inflation environment: At the end of the second half of 2024, the annual inflation rate was 3.4 percent, compared to 2.9 percent at the end of the previous half year. In the third quarter of 2024, the inflation rate increased, with a broad rise in prices of tradable and nontradable components, while in the fourth quarter of 2024 it stabilized. One-year inflation expectations from the various sources remained relatively stable around the upper bound of the target range during most of the half year, and moderated toward the end. However, inflation is expected to increase over the first half of 2025 in view of the changes in taxes, particularly the VAT increase, alongside continued supply constraints, together with excess demand—and is expected to moderate to within the target range in the second half of the year.

The exchange rate and financial markets: During the second half of 2024, the financial market trading remained volatile, impacted mainly by geopolitical developments. The shekel weakened at the beginning of the period, but later on it strengthened. Similarly, the economy's risk premium increased markedly at the beginning of the period, but toward the end it declined notably—as measured by the CDS and government bond spreads. However, the risk premium remains high relative to the prewar period. The Israeli capital market had a positive year with increases in major equity indices, and was notable compared to leading markets worldwide. In the period reviewed, the Moody's (in September) and S&P (in October) rating agencies again lowered Israel's credit rating and added a negative rating outlook.

Fiscal policy: During the second half of 2024, the deficit target for 2024 was set at 7.7 percent of GDP, and for 2025 at 4.4 percent of GDP, with the allocation of a special reserve supplement of half a percent of GDP that may be used in case there is continued high intensity of fighting. However, the Research Department's forecast is that the deficit in 2025 is expected to be 4.7 percent of GDP. This is against the background of changes in the adjustment measures since the government decision and assessments regarding the supplements that will be given to the defense budget within the framework of the Nagel Committee. In 2026, the deficit is forecast to be 3.2 percent of GDP, mainly due to a decrease in the defense expenditure burden. The debt to GDP ratio is expected to increase to a level of 67 percent in 2024, to 69 percent in 2025, and to decline back to 67 percent in 2026. The Monetary Committee discussions also noted that the budget framework approved by the

government with the adjustment measures approved by the Knesset were significant steps that contributed to the markets' confidence in the Israeli economy and led to moderation of its risk premium. However, it is important that the budget framework for 2025 will be approved without additional changes, and that a declining path of the debt to GDP ratio will be adopted beginning in 2026. These steps will contribute to maintaining the markets' confidence and the economy's resilience.

The housing market: Activity in the construction industry is recovering gradually, but there are still considerable limitations, mainly workforce constraints, on activity due to the war. Home prices continued to increase during the reviewed half year, and the pace of annual increase remains high, at 6.7 percent (though September-October). The rate of increase of the housing component in the CPI was 4.1 percent at the end of the half year reviewed. Central Bureau of Statistics third quarter data show an increase compared to the previous quarter in building starts, building completions, and number of permits granted. However, compared to the corresponding quarter of last year, before the war—there was a decline. The Committee members reiterated the importance of maintaining a high stock of construction supply over time, above its current level, to support the stabilization of housing prices.

The global economy: Economic activity in the US remained robust, driven by personal consumption. In the eurozone, third quarter growth surprised to the upside, but looking forward the recovery in the eurozone is expected to remain moderate. Third quarter growth in China surprised to the upside as well, but the most recent data are still relatively weak. Inflation trends worldwide showed moderation in the reviewed period, but in the US the inflation rate remains stickier. In the reviewed period, the US Federal Reserve began a round of interest rate reductions that totaled one percentage point, but at the end of the period the expected interest rate path rose. The ECB continued its round of interest rate reductions.

The Research Department forecast: The Research Department updated its macroeconomic forecast during the period. The Research Department forecast that was published in January 2025 was compiled under the assumption that the direct economic effect of the war will continue at a moderate level of intensity until the end of the first quarter of 2025. The Department assumes that during the period of the forecast, the existing limitations on the supply side will gradually recede, and domestic demand will recover first at a pace slightly more rapid than that of supply. The forecast also considered the expected impact of the budget adjustments on economic activity. In the Department's assessment, geopolitical developments since the October forecast reduced the risks to the downside in the growth forecast. According to the Department's forecast, GDP grew by 0.6 percent in 2024, and will grow by 4.0 percent in 2025, and by 4.5 percent in 2026. According to the forecast, the annual inflation rate at the end of 2025 will be 2.6 percent and will be 2.3 percent in 2026.

A. Policy steps

The Monetary Committee kept the interest rate unchanged at 4.5 percent in all its decisions in the second half of 2024. 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 was determined in accordance with the convergence of inflation to its target, continued stability in the financial markets, economic activity, and fiscal policy (Figure 1).

In contrast to the previous half year, during which the annual inflation rate hovered within the inflation target range, in the second half of 2024 the annual inflation rate deviated from the upper bound of the target range alongside an expectation for price increases in the first half of 2025. In view of the developments, geopolitical uncertainty, and inflationary risks that tended to the upside, the Monetary Committee decided to keep the monetary interest rate unchanged. In the interest rate decisions during the entire half year reviewed, the Monetary Committee members unanimously supported the decision to keep the interest rate unchanged at 4.5 percent.

The interest rate discussions dealt mainly with the economic ramifications of the geopolitical uncertainty and the risk premium, and there were examinations of the developments and their potential future impact on the inflation environment, the level of economic activity, the fiscal situation, the financial markets including the foreign exchange market, the labor market, and the housing market. The Committee members discussed the possible future developments to align supply and demand in the economy, and the potential consequences of those processes on inflation.

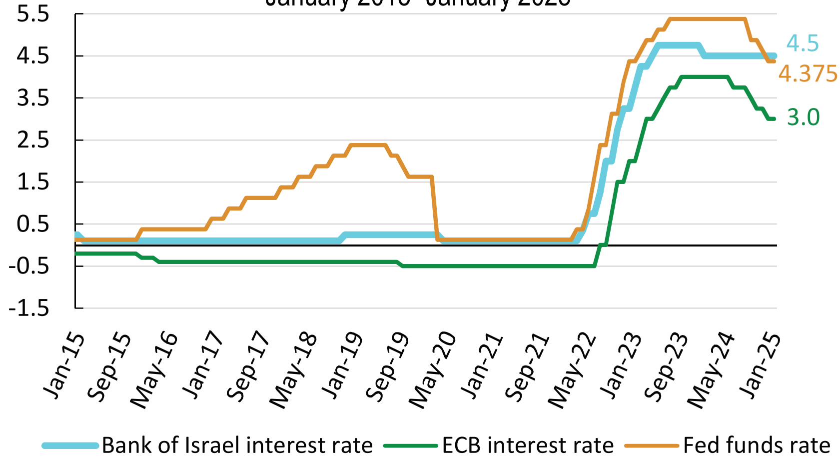
In the first part of the reviewed half year, the geopolitical uncertainty increased and the combat lengthened and intensified. As a result, the expenditures on the war grew, the risk premium rose alongside the lowering of Israel's credit rating an additional time by the rating agencies, and there was an increase in the inflation environment compared with its level in the previous half. In view of these, the Monetary Committee kept the interest rate unchanged, and the expected interest rate path rose.

In the second part of the half year, against the background of the geopolitical developments, the economy's risk premium declined, although the level remained higher than its prewar level. The inflation rate stabilized at approximately 3.4 percent, higher than the target range but stable compared to the rising path in the first part of the half year. In the Committee's assessment, the increase in taxes during the first half of 2025, together with the supply constraints and the recovery in demand, are expected to increase the inflation rates during the first half of 2025. Later on, in the second half of 2025, the inflation rates are expected to moderate **to within the target.**

During the half year reviewed, the additional monetary tools that the Monetary Committee put into operation with the eruption of the war were not used. In the half year reviewed, use was not made of the program to sell foreign exchange, which the Committee put into operation at the beginning of the war. The focused program of monetary loans to ease the credit conditions for small and micro businesses that were adversely impacted by the war, which the Bank of Israel activated at the beginning of the war, reached its conclusion at the end of January 2024, and in total about 22,000 requests for loans were approved, at a total amount of approximately NIS 8.1 billion.

The Banking Supervision Department promoted several frameworks for assistance for the public and business owners during the reviewed half year. A broad outline for deferring households' loan payments to banks and credit card companies was extended in the reviewed half as well, in July and October 2024. In addition, in December 2024, a designated outline was formulated for businesses operating in the North, with the goal of assisting them as part of the economic rehabilitation ahead of the return to routine.

Figure 1
The interest rates of the Bank of Israel, the Federal Reserve, and the ECB
January 2015–January 2025



SOURCE: Bank of Israel.

B. Background conditions from the Monetary Committee's perspective

1. Real economic activity in Israel and the labor market

In the second half of 2024, there was some increase in activity with a recovery of private consumption. After GDP growth in annual terms of 0.1 percent in the second quarter, GDP expanded by 3.8 percent in annual terms in the third quarter of 2024. However, its level remained about 3.6 percent lower than its long term trend. A considerable part of the gap is explained by supply constraints deriving from a shortage of workers—a shortage of non-Israeli workers, the absence of workers who are serving in the military reserves, and in part of the half year, by limitations on employment in the North. The labor market remains tight, with a low unemployment rate and a nominal wage that increased in the half year at a moderate pace.

The growth rate accelerated in the third quarter of 2024, driven by the business sector. However, the gap between the actual GDP level and the long-term trend remained stable. After the level of activity remained unchanged in the second quarter, the GDP returned to growth in the third quarter (3.8 percent compared with 0.1 percent in the second quarter). Private consumption (8.4 percent) and fixed capital formation (24.4

percent, excluding ships and aircraft), drove the growth. However, the GDP level is approximately 3.6 percent below its trend. In the Committee's assessment, the supply constraints together with excess demand are expected to lead to the recovery of activity being accompanied by upward pressure on prices (Tables 1 and 2).

Initial indicators for the fourth quarter show continued recovery, but without notably closing the gap with the trend. However, for the most part these do not include the developments after the cease-fire. There was a marked increase in credit card expenditures, and the aggregate balance of the Business Tendency Survey conducted by the Central Bureau of Statistics increased, though it is still lower than its prewar level, and in some industries an improvement is not seen.

The cease-fire in the North since the end of November and the decline in the intensity of fighting in the South are expected to support a recovery of activity in the economy. In December, about 0.7 percent of the work force were released from reserves duty, with the share of those temporarily absent in November due to reserves service relatively high at 1.4 percent. The return of those serving in the reserves to their workplace is expected to ease the supply constraints, to accelerate the recovery of activity, and to bring its level close to the trend line.

In contrast, the slow recovery of the construction industry is liable to weigh on the pace of recovery. A notable part of the gap between GDP and its trend derives from the construction industry. Significant growth in the construction industry is expected due to the need to rehabilitate residences and infrastructures in the areas of fighting, but without a significant increase in the labor input in the industry, the supply constraints in it will become more severe.

The labor market remains tight. The ratio of job vacancies to unemployed people continued to increase in October, and is at a high level. The release of reservists in December is expected to ease, to some extent, the labor market tightness. The labor market participation rate (ages 15+) has been relatively stable since the beginning of the year at a level lower than its prewar level. Despite the tight labor market and the contraction of the labor supply, the nominal wage increased at a moderate pace during the half year, and although the real wage is higher than its prewar level, it remains at a gap from its long term trend (Figures 2a and 2b).

During the half year, the Committee members closely followed the supply and demand limitations in order to assess their impact on the various industries. The Business Tendency Survey by the Central Bureau of Statistics indicates that the workers limitation is dominant in the construction, business services, and manufacturing industries, while the demand limitation is dominant in the hospitality, transport, trade, and information and communication industries (Figure 3).

Table 1 | National Accounts data available at the time of the interest rate decision

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

Decision date		27/05/2024	08/07/2024	28/08/2024	09/10/2024	25/11/2024	06/01/2025
	2024:Q1	14.1	14.4	17.3	17.2	16.6	16.8
	2024:Q2			1.2	0.7	0.3	0.1
GDP	2024:Q3					3.8	3.8
	2024:Q1	21.0	21.3	25.5	25.4	26.2	26.3
	2024:Q2			-1.9	-2.7	-0.5	-0.9
Business sector product	2024:Q3					5.4	4.7
	2024:Q1	26.3	26.9	23.5	23.4	24.2	24.4
	2024:Q2			12.0	11.4	13.2	13.1
Private consumption	2024:Q3					8.6	8.4
	2024:Q1	49.2	48.5	34.7	34.2	46.2	46.6
	2024:Q2			1.1	4.0	8.5	8.5
Fixed capital investment	2024:Q3					21.8	23.3
	2024:Q1	-10.4	-5.5	0.0	0.1	1.3	1.2
Exports excluding diamonds	2024:Q2			-7.1	-8.3	-5.9	-5.7
and startups	2024:Q3					5.2	4.7
	2024:Q1	13.9	17.0	17.0	17.4	17.3	17.2
Civilian imports excluding ships,	2024:Q2			-7.3	-5.7	-3.1	-3.3
aircraft, and diamonds	2024:Q3					26.7	26.1

SOURCE: Based on Central Bureau of Statistics.

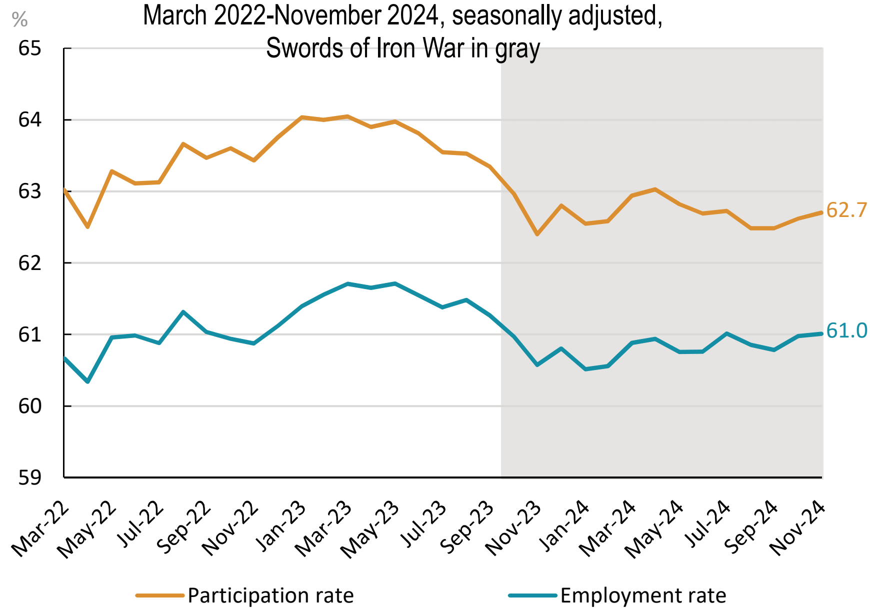
Table 2 | Development of GDP, imports, and uses

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

	2021	2022	2023	2023/2	2023/3	2023/4	2024/1	2024/2	2024/3
GDP	9.5	6.4	2.0	2.7	-0.1	-20.8	16.6	0.3	3.8
Business sector output	11.6	7.5	1.2	2.2	-1.9	-32.5	26.2	-0.5	5.4
Civilian imports excl. ships, aircraft and diamonds	18.6	12.3	-7.2	-8.9	-8.1	-32.8	17.3	-3.1	26.7
Private consumption	11.3	7.4	-0.9	-0.6	-1.0	-24.2	24.2	13.2	8.6
of which : excl. durables	10.6	7.3	0.0	-0.5	1.0	-24.7	28.4	7.3	9.0
Public consumption	5.1	0.2	8.0	3.3	7.9	85.8	-0.7	-0.4	-10.8
of which : excl. defense imports	4.6	1.0	7.2	6.3	4.1	81.0	-5.7	-2.3	-8.6
Gross domestic investment	15.0	13.0	-2.8	5.1	-5.3	-67.8	69.1	-23.9	49.4
of which : fixed capital formation	14.1	10.8	-1.4	5.0	-0.2	-67.9	46.2	8.5	21.8
Exports excl. diamonds	13.5	9.4	0.0	1.4	2.6	-20.9	-5.1	-8.1	7.0
of which : excl. startups	12.1	9.5	-0.2	1.1	1.3	-24.2	1.3	-5.9	5.2

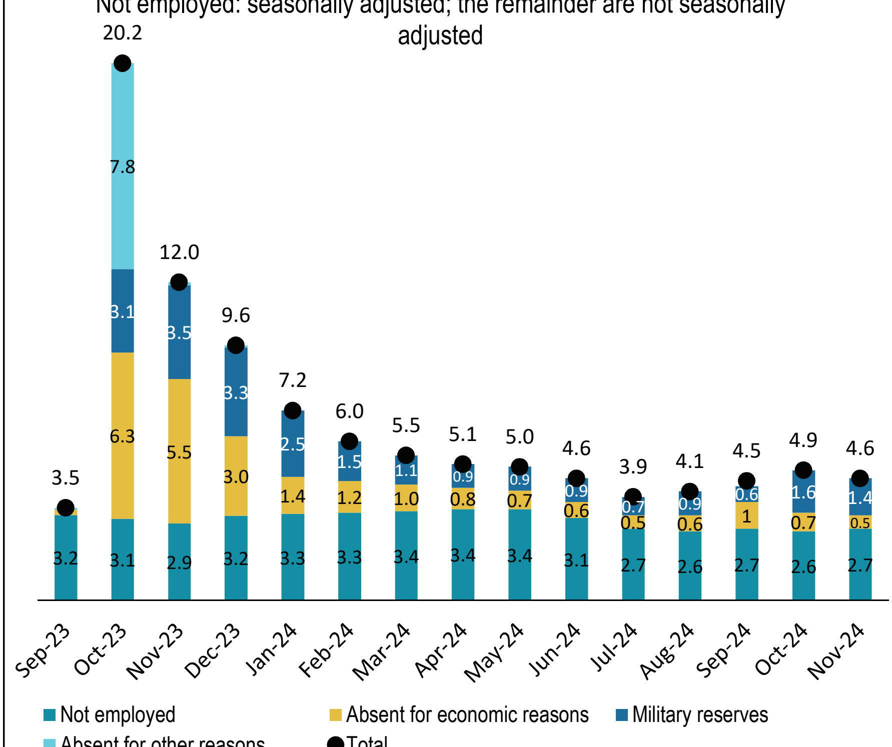
SOURCE: Based on Central Bureau of Statistics.

Figure 2a
Employment and participation rates, ages 15+
March 2022-November 2024, seasonally adjusted,
Swords of Iron War in gray



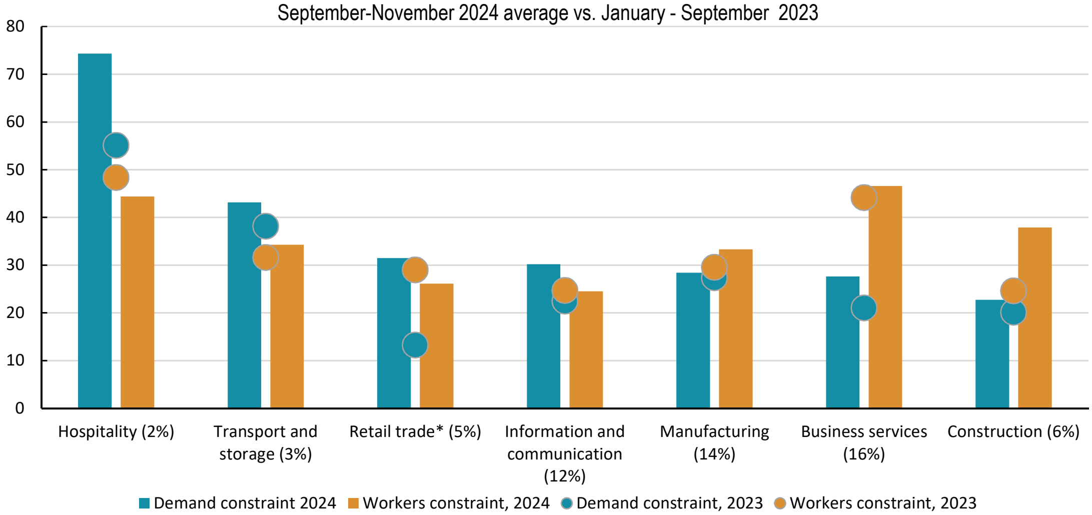
SOURCE: Central Bureau of Statistics Labor Force Survey.

Figure 2b
Unemployment rate, ages 15+ (percent)
September 2023 - November 2024
Not employed: seasonally adjusted; the remainder are not seasonally adjusted



SOURCE: Central Bureau of Statistics Labor Force Survey.

Figure 3
Limitations on activity, Business Tendency Survey
September-November 2024 average vs. January - September 2023



*Retail trade companies were not asked directly about the demand constraint. Therefore, the blue column in this industry reflects the company's response to the constraint termed "the security situation". In parentheses: An estimate (there isn't full overlap between the industries in the Business Tendency Survey and National Accounts industries) of the industry's share of GDP.
SOURCE: Bank of Israel.

2. The inflation environment

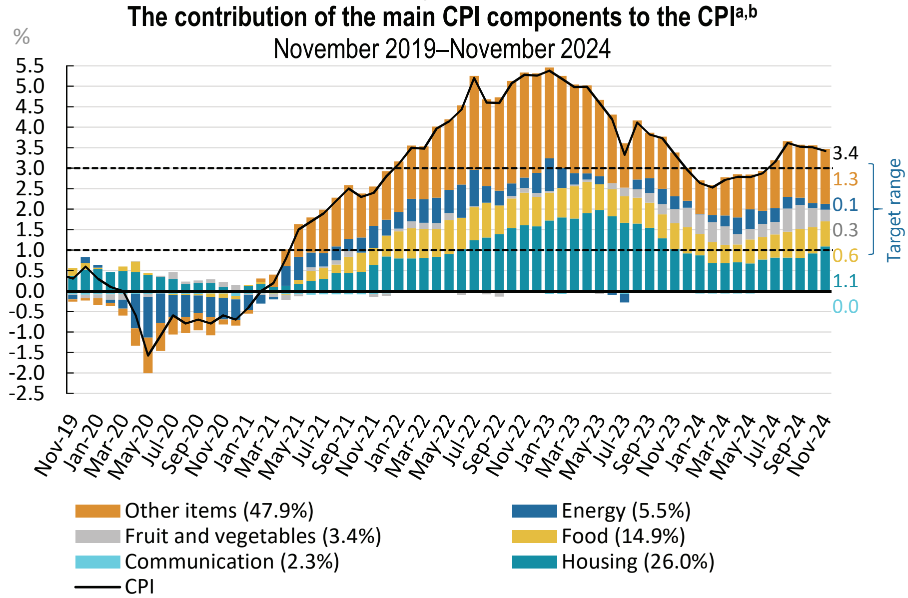
At the end of the second half of 2024, the annual inflation rate was 3.4 percent, compared to 2.9 percent at the end of the previous half year. In the third quarter of 2024, the inflation rate increased, with a broad rise in prices of tradable and nontradable components, while in the fourth quarter of 2024 it stabilized. One-year inflation expectations from the various sources remained relatively stable around the upper bound of the target range during most of the half year, and moderated toward the end (Figure 4). However, inflation is expected to increase over the first half of 2025 in view of the changes in taxes, particularly the VAT increase, alongside continued supply constraints, together with excess demand—and is expected to moderate to within the target range in the second half of the year. The year over year inflation rate net of energy and fruit and vegetables was 3.3 percent in the November CPI (Figure 5). The stabilization of the rate of increase in prices includes the prices of both tradable and nontradable (excluding housing) items.

The trend of inflation in Israel during the half year reviewed is different than its trend worldwide. While during the half year reviewed the annual inflation rate increased in Israel, in major economies worldwide it declined. Thus, at the end of the half year, the year over year inflation rate in Israel was at a level higher than the OECD median, in contrast to previous half-years (Figures 6a and 6b).

The average forecast of inflation for the next 12 months by external forecasters and inflation expectations from all the sources declined, mainly at the end of the half year reviewed, and are at a level ranging between 2.4 percent and 2.7 percent (Figure 7). Based on the forecasters' assessments of the annual inflation path during the coming year, it is expected to increase to a level of approximately 4 percent in the beginning of 2025, mainly due to the VAT increase, and then to decline gradually to within the target range. The recovery of demand at a pace more rapid than that of supply is a risk factor to the stabilization of inflation within the target range. Expectations for the second year and onward remained within the target range (Figure 8).

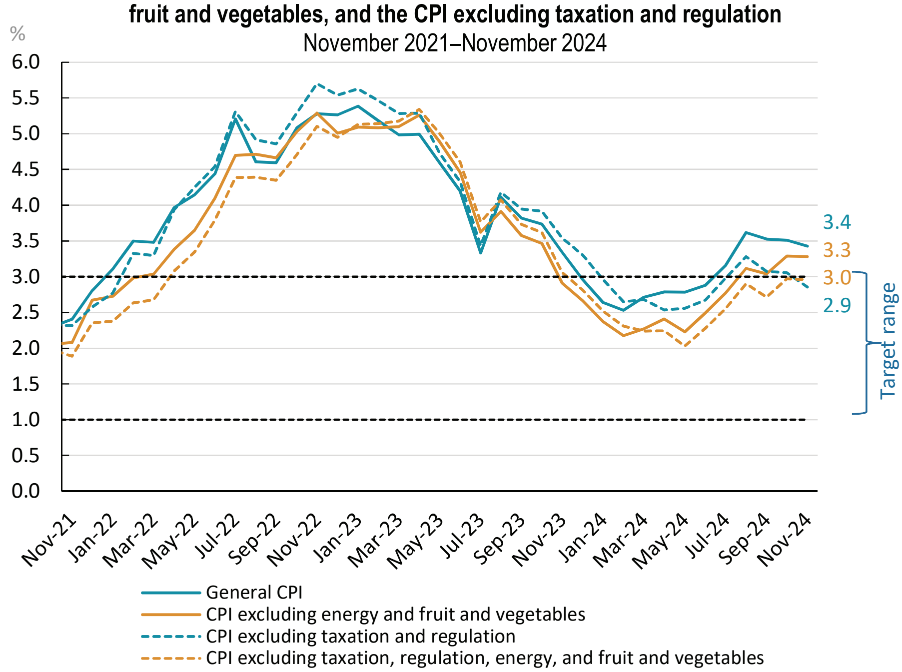
In the Committee's assessment, there are several risks to a possible acceleration of inflation: geopolitical developments and their impact on economic activity, continued supply limitations, shekel volatility, and fiscal developments.

Figure 4
The contribution of the main CPI components to the CPI[a,b]
November 2019–November 2024



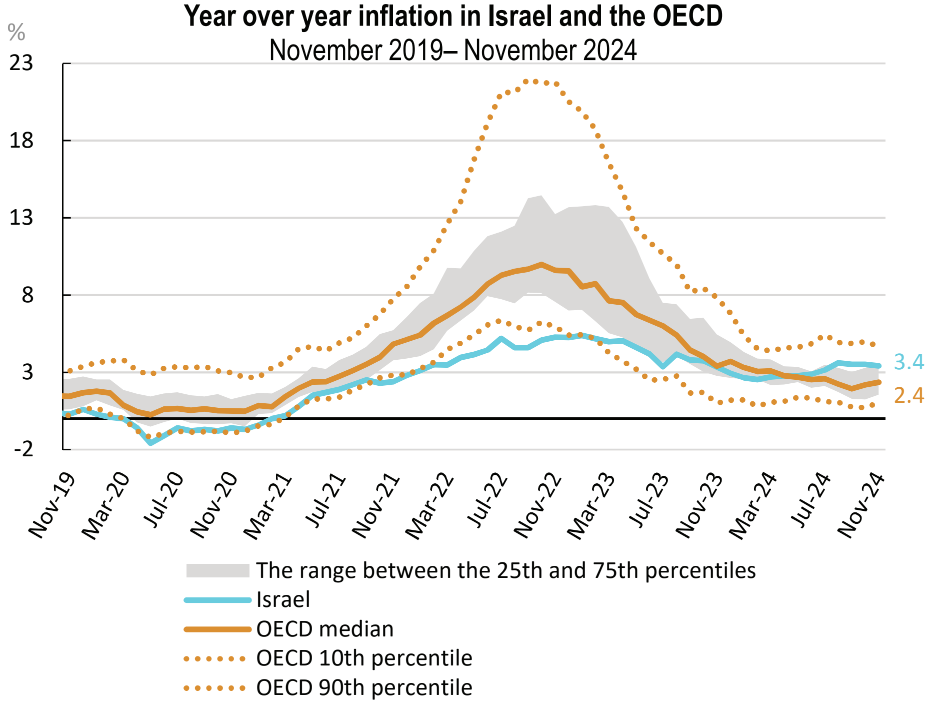
[a] The number in parentheses is the share of the relevant component in the overall CPI (as of 2023)
[b] Other components are furniture and household equipment, clothng and footwear, miscellaneous, and household maintenance and transportation, net of subcomponents related to energy prices.
SOURCE: Based on Central Bureau of Statistics data.

Figure 5
Inflation as reflected in the general CPI, the CPI excluding energy and fruit and vegetables, and the CPI excluding taxation and regulation
November 2021–November 2024



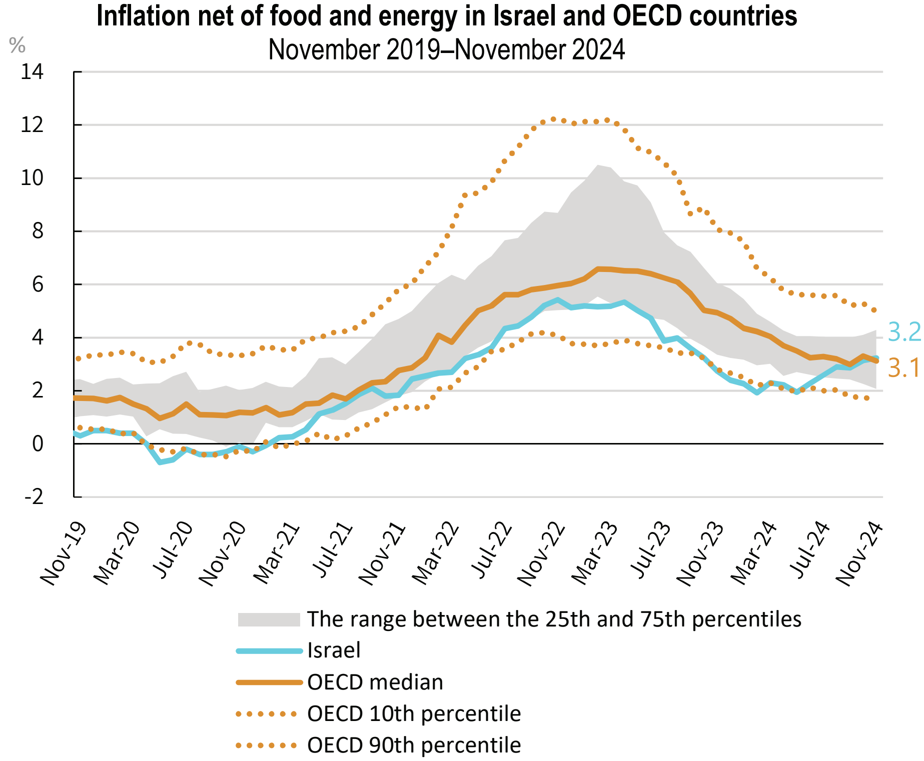
SOURCE: Bank of Israel.

Figure 6a
Year over year inflation in Israel and the OECD
November 2019– November 2024



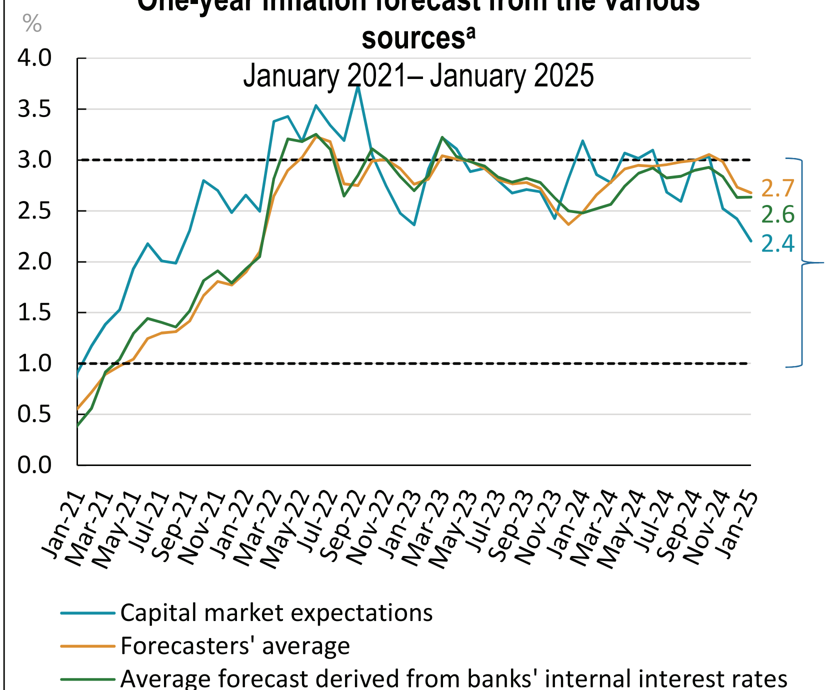
SOURCE: Based on OECD.

Figure 6b
Inflation net of food and energy in Israel and OECD countries
November 2019–November 2024



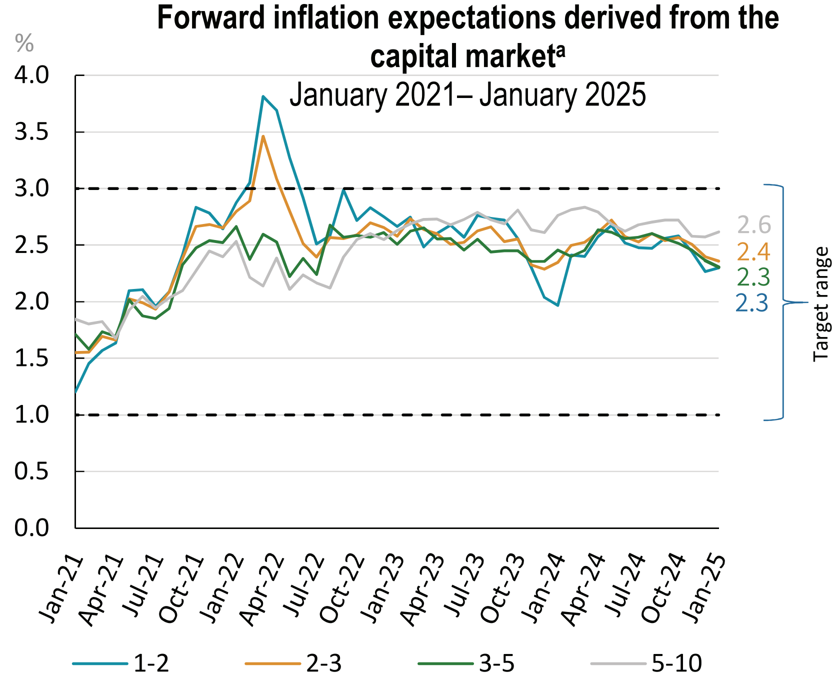
SOURCE: Based on OECD.

Figure 7
One-year inflation forecast from the various sources[a]
January 2021– January 2025



[a] Monthly average.
SOURCE: Based on Bloomberg data.

Figure 8
Forward inflation expectations derived from the capital market[a]
January 2021– January 2025



[a] Monthly averages, annual ranges
SOURCE: Bank of Israel

3. The exchange rate and financial markets

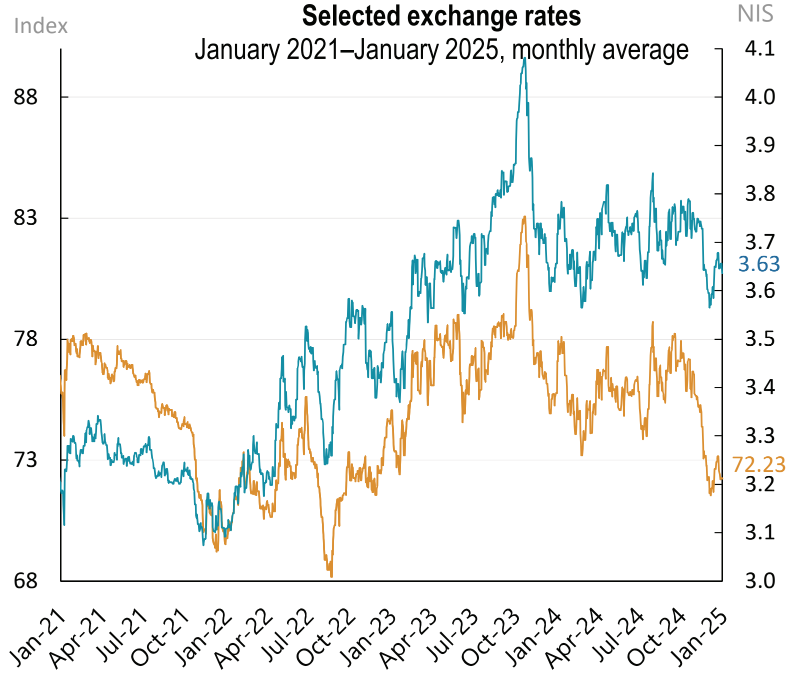
During the second half of 2024, the financial market trading remained volatile, impacted mainly by geopolitical developments. The shekel weakened at the beginning of the period, but later on it strengthened. Similarly, the economy's risk premium increased markedly at the beginning of the period, but toward the end it declined notably—as measured by the CDS and government bond spreads. However, the risk premium remains high relative to the prewar period. The Israeli capital market had a positive year with increases in major equity indices, and was notable compared to leading markets worldwide. In the period reviewed, the Moody's (in September) and S&P (in October) rating agencies again lowered Israel's credit rating and added a negative rating outlook.

During the period reviewed, the risk to economic activity remained at a high level against the background of the security situation and its ramifications on the economic activity, which remained at a level below its long term trend. In parallel, the government's financing needs and their cost grew. As noted, credit rating agencies reduced Israel's credit rating and kept a negative outlook for the credit rating. However, toward the end of the period reviewed, the risk premium and debt financing costs declined, against the background of moderation in assessments of geopolitical risk and improved sentiment toward the local markets. Domestic equity indices increased in the final quarter of the year and partially diminished the underperformance since 2023 that still reflects a low pricing level relative to the companies' profitability and relative to equity indices worldwide. The rates of arrears in credit repayment remained stable, and banks' credit loss provisions declined.

In the fourth quarter of 2024, the shekel strengthened markedly, after maintaining its level in the third quarter. The appreciation trend strengthened with the going into effect of the cease-fire at the end of November (Figure 9, Table 3). It appears that the decline in Israel's risk premium was reflected in the shekel appreciation as well (Figure 10).

Business credit continued to expand in the course of the half year, driven by credit to large companies, and the construction and real estate industry. In the fourth quarter of 2024, there was a sharp increase in the volume of credit to the financial services industry as well. The cost of credit to micro companies increased alongside an increase in arrears by such companies; the share of credit in arrears remained relatively stable in the past half year. The credit raised through corporate bonds also increased during the half year, with the growth accompanied by a prolonged decline in spreads, which reached historically low levels (Table 3).

Figure 9
Selected exchange rates
January 2021–January 2025, monthly average

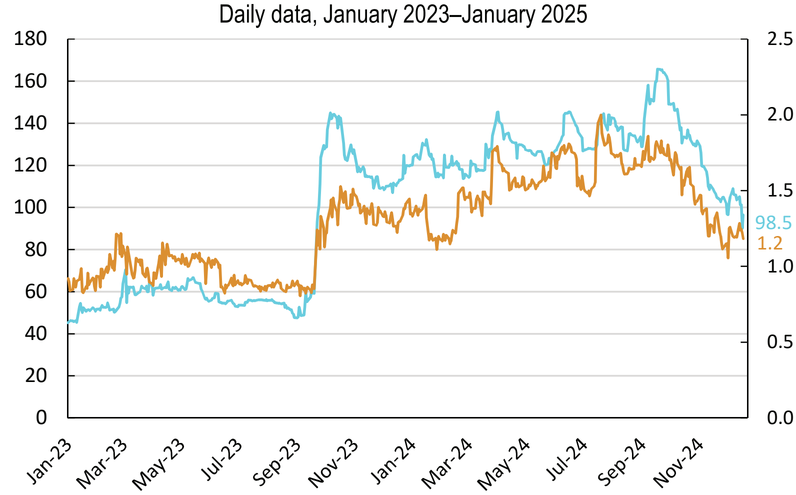


Nominal effective exchange rate (left scale) NIS/$ (right scale)

Nominal effective exchange rate - 12/31/19 = 100

SOURCE: Bank of Israel.

Figure 10
Israel's risk premium as reflected in the difference between nominal yields on Israeli and US dollar-denominated government bonds for 10 years, and the CDS for 5 years.
Daily data, January 2023–January 2025



Israel CDS - 5 years (right scale)

The difference between nominal yields on Israeli and US dollar-denominated government bonds for 10 years

SOURCE: Bank of Israel and based on Bloomberg.

Table 3 | Developments in the domestic asset markets

	07/24	08/24	09/24	10/24	11/24	12/24
Yield to maturity (monthly average, percent)						
3-month *Makam*	4.3	4.3	4.3	4.3	4.4	4.4
1-year *Makam*	4.2	4.1	4.2	4.4	4.3	4.2
5-year unindexed bonds	4.6	4.4	4.6	4.7	4.5	4.3
10-year unindexed bonds	4.9	4.8	4.9	4.9	4.7	4.5
20-year unindexed bonds	5.4	5.2	5.4	5.4	5.1	4.8
1-year indexed bonds	1.5	1.5	1.2	1.3	1.8	1.8
5-year indexed bonds	1.9	1.8	1.9	2.0	2.0	1.9
10-year indexed bonds	2.2	2.1	2.2	2.2	2.2	2.0
Yield spread between government bonds and AA-rated corporate bonds (percentage points)[a]	1.3	1.3	1.3	1.1	1.1	1.2
Equity market (rate of change during the month)						
General Shares Index	3.2	4.4	1.9	5.1	4.0	6.5
Tel Aviv 35	1.4	4.0	1.5	3.8	2.6	5.9
Foreign exchange market (rate of change during the month)						
Dollar/shekel	0.2	-2.9	1.5	0.1	-1.9	0.1
Euro/shekel	1.5	-0.6	2.4	-2.7	-4.7	-1.4
Nominal effective exchange rate	0.8	-1.9	2.2	-1.7	-3.5	-1.0

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

SOURCE: Bank of Israel.

4. Fiscal policy

During the second half of 2024, the deficit target for 2024 was set at 7.7 percent of GDP, and for 2025 at 4.4 percent of GDP, with the allocation of a special reserve supplement of half a percent of GDP that may be used in case there is continued high intensity of fighting. However, the Research Department's forecast is that the deficit in 2025 is expected to be 4.7 percent of GDP. This is against the background of changes in the adjustment measures since the government decision and assessments regarding the supplements that will be given to the defense budget within the framework of the Nagel Committee. In 2026, the deficit is forecast to be 3.2 percent of GDP, mainly due to a decrease in the defense expenditure burden. The debt to GDP ratio is expected to increase to a level of 67 percent in 2024, to 69 percent in 2025, and to decline back to 67 percent in 2026. The Monetary Committee discussions also noted that the budget framework approved by the government with the adjustment measures approved by the Knesset were significant steps that contributed to the markets' confidence in the Israeli economy and led to moderation of its risk premium. However, it is important that the budget framework for 2025 will be approved without additional changes, and that a declining path of the debt to GDP ratio will be adopted beginning in 2026. These steps will contribute to maintaining the markets' confidence and the economy's resilience.

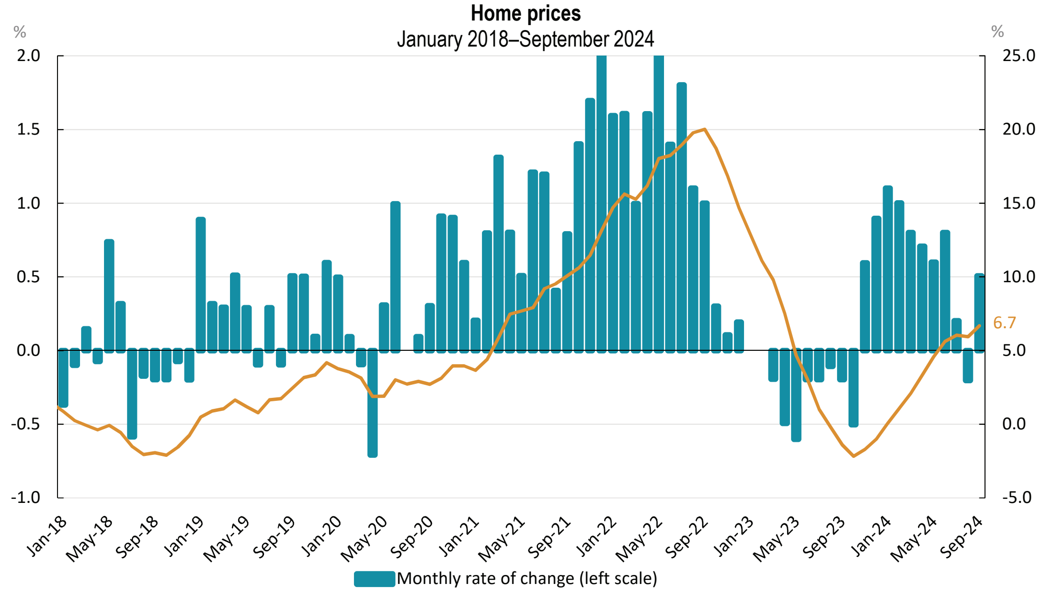
The budget deficit in the past 12 months (December 2023—November 2024) totaled 7.7 percent of GDP. In September, the accumulated deficit reached a record of 8.5 percent of GDP, as it included for the first time 12 months of heightened expenditures of the war. In October, the accumulated deficit began to decline due to the recovery of the revenues component back to its prewar level alongside stabilization of the accumulated expenditure in terms of GDP. The accumulated expenditure net of the war's expenses was stable over the course of the year. The accumulated deficit excluding the expenses of the war ranged around 3 percent of GDP and declined in recent months to around 2 percent of GDP. However, the Nagel Committee's recommendation to increase the security budget has not yet been reflected.

5. The housing market

Activity in the construction industry is recovering gradually, but there are still considerable limitations, mainly workforce constraints, on activity due to the war. Home prices continued to increase during the reviewed half year, and the pace of annual increase remains high, at 6.7 percent (though September-October). The rate of increase of the housing component in the CPI was 4.1 percent at the end of the half year reviewed. Central Bureau of Statistics third quarter data show an increase compared to the previous quarter in building starts, building completions, and number of permits granted. However, compared to the corresponding quarter of last year, before the war—there was a decline. The Committee members reiterated the importance of maintaining a high stock of construction supply over time, above its current level, to support the stabilization of housing prices.

The monthly rate of increase in home prices during the half year moderated in comparison to the previous half year. Home prices returned to increase in the September-October Home Price Index, which increased by 0.5 percent, after two near-zero readings. Over the past 12 months, the increase in home prices totaled 6.7 percent (Figure 11). A Research Department analysis indicated that the increase of second-hand home prices is what drove the home price increase in the past year. Recovery could be seen in the quantity of home sales from the low it reached with the outbreak of the war, and it is slightly below its trend.

Figure 11
Home prices
January 2018–September 2024

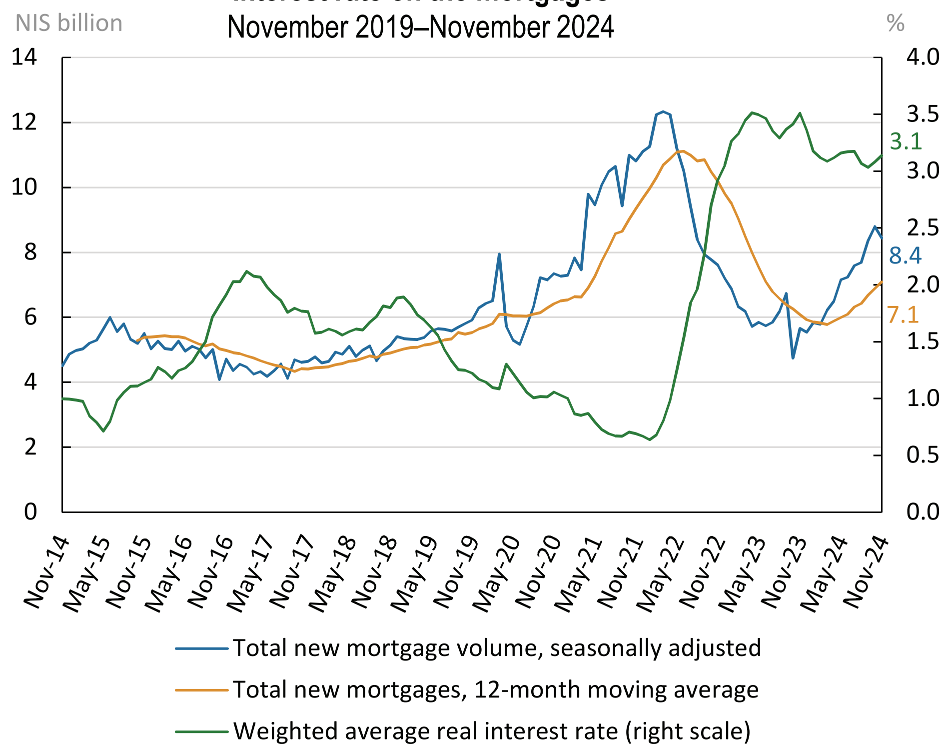


SOURCE: Bank of Israel.

There was an increase in new mortgage volume with an increase in the interest rate on most tracks. The most popular track is the unindexed, fixed-rate track (about 30 percent of transactions). Weighting the various tracks, the average nominal interest rate on mortgages is about 5.1 percent. Risk indices of new mortgages continued to be high—the share of mortgages with an LTV greater than 60 percent and a PTI above 30 percent reached a record in November of about 25 percent of transactions. Bullet loans continued to increase and their share in total new mortgages reached about 18 percent in November (Figure 12).

The housing component of the CPI—reflecting rent costs—increased at a relatively moderate pace during the half year reviewed, but the annual rate of increase of the Owner-Occupied Dwellings Index jumped in November (from 2.9 percent to 4.0 percent), mainly due to an effect of the removal of a low reading of -0.7 percent from it. Comparing its rate of increase in the past 3 months to its rate of increase in the past half year, stabilization can be seen.

Figure 12
New mortgage volume and the weighted average real interest rate on the mortgages
November 2019–November 2024



SOURCE: Bank of Israel, Banking Supervision Department.

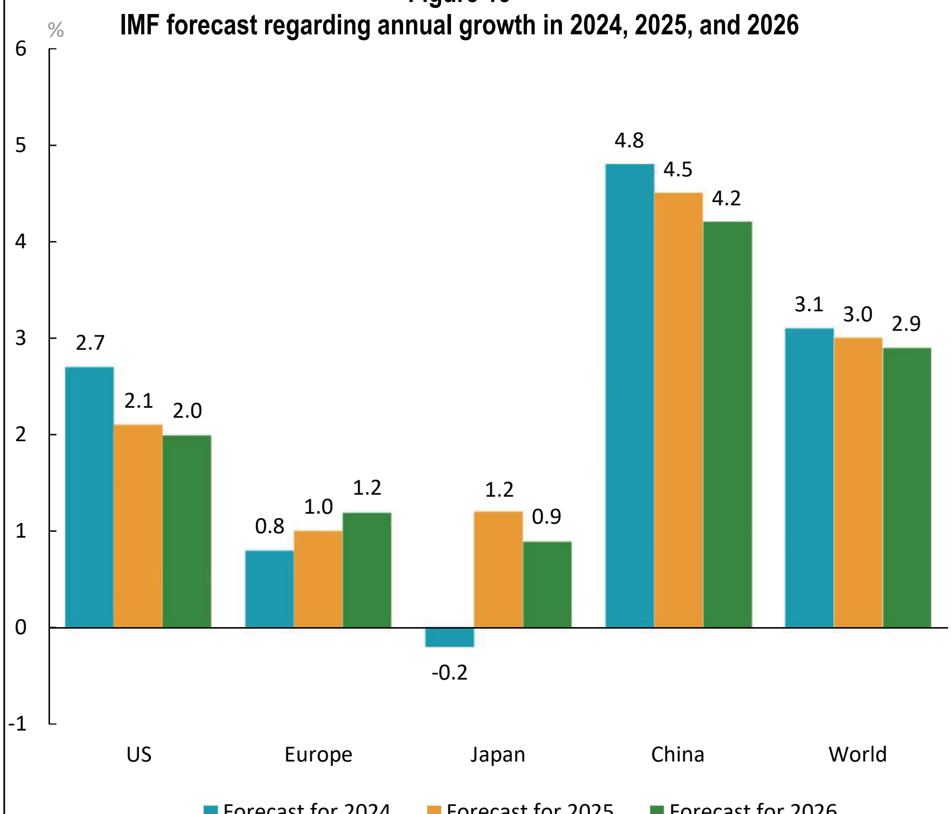
6. The global economy

Economic activity in the US remained robust, driven by personal consumption. In the eurozone, third quarter growth surprised to the upside, but looking forward the recovery in the eurozone is expected to remain moderate. Third quarter growth in China surprised to the upside as well, but the most recent data are still relatively weak. Inflation trends worldwide showed moderation in the reviewed period, but in the US the inflation rate remains stickier. In the reviewed period, the US Federal Reserve began a round of interest rate reductions that totaled one percentage point, but at the end of the period the expected interest rate path rose. The ECB continued its round of interest rate reductions.

The trend of inflation in Israel during the half year is different from its trend worldwide—while the year over year inflation rate in Israel increased, the inflation rate around the world moderated. In the US, the annual rate of change of the CPI was 2.7 percent at the end of the half year, and in the eurozone it was 2.2 percent.

Most central banks, including of major economies—the US, eurozone, UK, and China, reduced their interest rate in the current cycle of interest rate reductions worldwide. However, Brazil and Japan increased the monetary interest rate, while India, Norway, and Australia did not change the interest rate, though they are expected to do so (Figure 13).

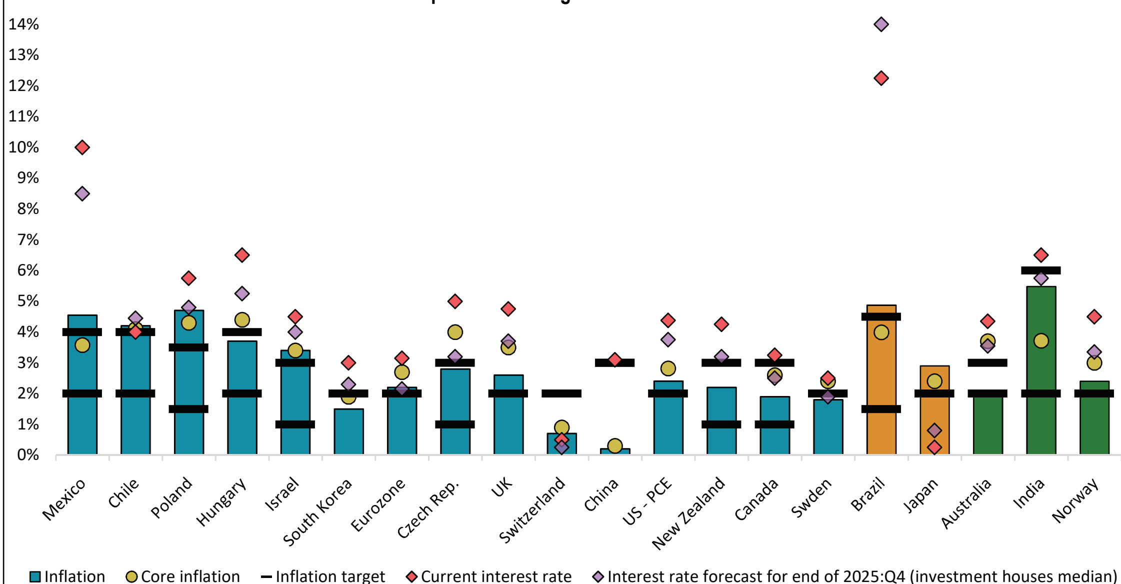
Figure 13
IMF forecast regarding annual growth in 2024, 2025, and 2026



SOURCE: Based on Bloomberg.

The Bank of Israel was among the first in the world that decided to reduce the monetary interest rate, in January 2024, and since then has kept the interest rate unchanged at 4.5 percent—while other central banks decided at a later stage in 2024, but were able to reduce the interest rate more times, and are expected to continue reducing it. This is different from the Bank of Israel, where the expectations for reducing the interest rate declined over the course of the half year reviewed, due to the unique background conditions of the Israeli economy (Figure 14).

Figure 14
The inflation level compared to the target and to the central bank's interest rate



Blue: Countries that decreased the interest rate in the current cycle; Orange: Countries that increased the interest rate; Green: Countries that didn't change the interest rate.
The interest rate forecast in Israel is the average interest rate of forecasters for the year ahead. SOURCE: Based on Bloomberg.

C. The macroeconomic forecast and the Committee's assessment regarding the expected path

1. The Research Department's macroeconomic forecast

The Research Department updated its macroeconomic forecast during the period. The Research Department forecast that was published in January 2025 was compiled under the assumption that the direct economic effect of the war will continue at a moderate level of intensity until the end of the first quarter of 2025. The Department assumes that during the period of the forecast, the existing limitations on the supply side will gradually recede, and domestic demand will recover first at a pace slightly more rapid than that of supply. The forecast also considered the expected impact of the budget adjustments on economic activity. In the Department's assessment, geopolitical developments since the October forecast reduced the risks to the downside in the growth forecast. According to the Department's forecast, GDP grew by 0.6 percent in 2024, and will grow by 4.0 percent in 2025, and by 4.5 percent in 2026. According to the forecast, the annual inflation rate at the end of 2025 will be 2.6 percent and the rate will be 2.3 percent in 2026 (Table 4).

Table 4 | Research Department forecasts

(Rates of change in percent, unless noted otherwise)

Forecast for the year	2024			2025			2026
Forecast date	07/24	10/24	01/25	07/24	10/24	01/25	01/25
GDP	1.5	0.5	0.6	4.2	3.8	4.0	4.5
Private consumption	2.0	3.0	4.0	5.0	7.0	7.5	5.5
Fixed capital formation (excl. ships and aircraft)	-9.0	-10.0	-7.5	8.0	12.0	8.0	15.0
Public consumption (excl. defense imports)	8.0	13.0	12.0	-5.5	-4.0	-1.5	2.0
Exports (excl. diamonds and startups)	-1.5	-6.0	-5.0	4.5	4.0	4.5	5.5
Civilian imports (excl. diamonds, ships and aircraft)	-5.0	-6.0	-2.0	3.5	11.5	12.0	13.0
Unemploument rate - annual average (ages 25–64)	4.0	3.5	3.5	3.8	3.2	3.1	3.1
Government deficit (percent of GDP)	6.6	7.2	7.0	4.0	4.9	4.7	3.2
Debt to GDP ratio	67.5	68.0	67.0	68.5	69.0	69.0	67.0
Inflation[a]	3.0	3.8	3.4	2.8	2.8	2.6	2.3
Forecast date	07/24	10/24	01/25				
Inflation in the coming year[b]	3.2	3.2	2.6				
Interest rate in one year[c]	4.25	4.5	4.0/4.25				

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

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

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

SOURCE: Bank of Israel.

2. The expected paths of inflation and growth

The Committee members discussed the development of the supply constraint and pace of recovery of demand, and the potential ramifications of these processes on inflation and growth. The Committee assesses, similar to the Research Department's forecast, that during 2025 the existing limitations on the supply side will gradually recede, and domestic demand will recover first at a slightly more rapid pace than that of supply.

The inflation rate is expected to increase during the first half of 2025, against the background as well of the changes in taxation, particularly the VAT increase, alongside continued supply constraints, together with excess demand, and later it is expected to moderate to within the target range in the second half of the year. In the Committee's assessment there are several risks for a possible acceleration of inflation: the geopolitical developments and their impacts on economic activity, prolonged supply constraints, shekel volatility, and fiscal developments. Therefore, the Committee's assessment is that the balance of risks for inflation tend to the upside.

Similar to the Research Department, the Monetary Committee assesses that the growth rate in 2025 will be approximately 4 percent, under the assumption that the direct economic impact of the war will only continue until the first quarter. The geopolitical developments since the October forecast reduced, in the Committee's view, the downside risks of the growth forecast.

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.