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**BANK OF ISRAEL**

Office of the Spokesperson and Economic Information

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**Press release:**

**Remarks by the Governor of the Bank of Israel at the press briefing on monetary policy held today at the Bank of Israel**

Good afternoon.

We are still in the midst of the “Swords of Iron” War. It has been four difficult months for the State of Israel. Beyond security issues, the war brings with it marked economic ramifications as well. It impacts on economic activity overall and on the financial markets, and the uncertainty remains high. However, the economy’s robustness and the rapid recovery it has displayed in recent months have also been reflected in financial markets’ recovery and stability. Israel’s economy rests on solid and resilient foundations. The Israeli economy has known how to recover from more than a few difficult periods in the past, and to return rapidly to prosperity. The economy’s growth drivers, with an emphasis on innovation and technology sectors, in which we are world leaders, help the economy adjust to various situations and to recover from difficult periods.

I will move now to refer to our decision today. The Monetary Committee’s discussions that were held in the past 2 days naturally focused on the economic impacts of the war. The Monetary Committee analyzed the various processes and their impact on economic activity and on inflation, and after the discussions, the Committee decided to leave the interest rate unchanged at 4.5 percent.

The interest rate decision weights several factors, some of which act in opposite directions: inflation moderated to 2.6 percent, slightly below the forecasts at the beginning of the war. GDP was notably adversely impacted in the final quarter of 2023, so that GDP grew by 2 percent in 2023, in line with the Research Department’s forecast in January. In contrast, the economy is showing signs of recovery in several notable indicators: the labor market, credit card activity, the Business Tendency Survey, revenue indicators, the Composite State of the Economy Index for January, and additional activity data. In addition, the uncertainty that persists in the economy remains very high, mainly against the background of the development of the war, and the economy’s risk premium is still at a high level, despite some decline in recent weeks. In addition, the expansionary fiscal policy and its effects, and the limitations on activity in the construction area, still present a risk to the continued moderation of inflation. Expectations for one year ahead also increased slightly recently. The interest rate path will be determined in accordance with the continued convergence of the inflation rate to its target, continued stability in financial markets, economic activity, and fiscal policy.

We entered the war with inflation in Israel still above the target range and encompassing a wide range of CPI components. In recent months, the inflation rate and its dynamics have continued to moderate. The inflation rate for tradable products continues to decline, and is impacted markedly by exchange rate developments. The inflation rate for nontradable goods, made up mainly of the housing component and services industries, remains above the target. Inflation expectations for the coming year increased slightly and are near the upper bound of the target range. Expectations for medium and long terms are anchored within the target range. Despite these developments, there is still uncertainty related to the impacts of the war on inflation processes.

As a small and open economy, we are of course impacted by the global environment as well. Worldwide, the inflation environment moderated in numerous countries, but remains above central banks’ targets. Core inflation, which was “stickier”, is also moderating. Most central banks are still concerned about inflation in services, which remains sticky and weighs on the convergence of inflation to the target, and are thus signaling a later than estimated start to monetary easing.

With the eruption of the war, we took several steps with the goal of ensuring orderly functioning of the markets. These plans have succeeded so far in creating stability in the foreign exchange and other financial markets, as well as support for households and business owners via the frameworks that were put into operation by the banking system. The high level of the Bank of Israel’s foreign exchange reserves, which was about $200 billion just before the war, provides us with maneuvering room to maintain stability in the economy, while reducing the uncertainty. Policy tools that have been activated so far are also consistent with our commitment to returning inflation to the target, and the Monetary Committee assesses that the current monetary policy will continue to support the entrenchment of inflation within the target range.

In parallel, and to provide relief in a focused manner on populations that are going through economic difficulties because of the war, we at the Bank of Israel are working at this time to formulate an additional extension of the banks’ relief framework for customers for an additional 3 months. The extension of the framework will enable the relevant population that needs it to receive additional cash flow relief. We are pleased that the banks chose to adopt the framework with its formulation in October, close to the outbreak of the war. In the coming days, the Banking Supervision Department will publish the full details regarding the continued extension of the framework.

Let me now expand on additional economic data on the agenda. National Accounts data published by the Central Bureau of Statistics indicates that GDP contracted in the final quarter of 2023, and grew by 2 percent for the full year. The decline in GDP was impacted mainly by a decline in the activity of the construction industry and in private consumption, while in contrast, public consumption grew in view of the war. Credit card purchases, which declined markedly in the first weeks of the war, are recovering and their overall level is higher than the average prewar level during the course of 2023.

The housing market is very important to the economy. The security situation led to a negative impact on activity in the construction industry, primarily due to a lack of workers. Supply limitations in the construction industry and the need for alternative housing for those forced to leave their homes are factors that will impact on housing market developments going forward. Beyond maintaining activity in the immediate term, actions should be taken to keep the supply of construction high over time. As I have noted in the past, this is the key to continued moderation of housing prices.

The labor market just before the war was tight and around a full employment environment. Due to the war, the broad unemployment rate, which includes employed people who have been furloughed, soared. This is alongside a decline in the number of job vacancies to levels we saw on the eve of the COVID-19 crisis. After 4 months of war, labor market data have started to show a strong recovery, mainly in view of the increase in the demand for and supply of workers. The broad unemployment rate in January continued its decline and the job vacancy rate increased. The share of absences from work for noneconomic reasons moderated, currently reflecting those in reserves service, after the massive return in November of most employees who were absent for other reasons.

Let me now refer to the credit rating downgrade of the State of Israel’s debt, from A1 to A2, and the publication of a negative rating outlook by Moody’s. As explained by the rating agency, the decision was reached mainly due to the lack of certainty regarding the date and manner of the conclusion of the “Swords of Iron” War, the impact of the war on the government’s and the Knesset’s availability to deal with core economic and social issues, and the change in the fiscal situation. The reason for the negative rating outlook is the uncertainty regarding the expansion of the war to the northern front. Recall that the State of Israel has experienced geopolitical crises in the past, in periods when the debt to GDP ratios were much higher, and it has never been late at all with repaying the government debt. It appears that the risks noted by Moody's have already been priced in by investors, and in the financial and foreign exchange markets, an additional significant impact of the credit rating downgrade has not been seen. To strengthen the trust of the markets and ratings companies in Israel’s economy, it is important that the government and Knesset act to deal with the economic issues raised in the report, which in large part are very similar to the recommendations raised in the past by the Bank of Israel and other entities. These will require structural changes in government ministries and prioritizing growth drivers.

This is the place to recall again that responsible fiscal policy, which led the economy to a debt to GDP ratio of approximately 60 percent at the beginning of the war, is a strategic asset in economic terms. This ratio is supporting us now when the economy has significant expenditures due to the war, defense expenditures, and maintaining support and aid for businesses and households that have been adversely impacted. It is important to continue to conduct responsible fiscal policy, and to broadcast this to the markets, which today are following the activity in Israel more than ever.

The updated government budget for 2024 is particularly challenging. The economic ramifications of the war are broad and significant. Alongside the negative impact on GDP, the war requires a very large increase in budgetary expenditures. This increase stems from expenditures deriving directly from the war effort and from civilian expenditure. In addition to the increase in war-related expenditures, and against the background of the need to strengthen the defense system and its enhanced preparedness against the various threats, a continuous and significant increase in the defense budget for the foreseeable future is likely. This has considerable economic significance. The current budget is an important reference point in strengthening international markets' trust in the Israeli economy. Therefore, it is important that the budget framework presented by the government, which includes notable fiscal adjustments vis-à-vis the consistent growth in defense expenditure, should also be maintained through the end of the legislative process in the Knesset.

I reiterate the need to promptly set up a committee with the participation of defense and civilian entities that will outline Israel’s security needs in the coming years and will formulate an appropriate multiyear budget plan. The committee should discuss the amount and the composition of the defense budget in an informed manner. I hope that the appointment of the committee will be completed soon. The work of such a committee and the implementation of its conclusions will be able to improve Israel’s ability to deal with the defense needs while taking into account civilian needs and the need for fiscal responsibility.

To conclude, the State of Israel is going through a difficult period. We will continue to help the Israeli economy get through the various challenges yet to come. Just as the Israeli economy has been able to recover from difficult periods and to return rapidly to prosperity, it has today the necessary components to continue to realize its growth potential.

I would also like to convey from here that the Bank of Israel and the Monetary Committee want to strengthen the hands of our soldiers and other security forces who are risking their lives for us on the front. We extend our condolences to the families of those killed, we wish for a full recovery for the injured, and we hope for the speedy return of the captives and the missing. Our thoughts are with you.

Thank you.