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, everyone.

Yesterday and today, the Monetary Committee of the Bank of Israel held discussions in order to decide on monetary policy. As announced at the conclusion of its discussions, the Committee decided to leave the interest rate unchanged at 3.25 percent.

Inflation in Israel remains slightly below the midpoint of the target range. At the same time, the Israeli economy remains resilient and robust. Third-quarter data indicate continued growth, following the rapid recovery in the second quarter. Nevertheless, uncertainty remains elevated in view of geopolitical developments. During the reviewed period, the shekel depreciated, and Israel's risk premium increased slightly, although it remains close to the levels that prevailed prior to the October 7 war. Globally, inflationary pressures have intensified, reflecting higher energy prices, supply chain disruptions, and continued geopolitical tensions.

I would now like to elaborate on the principal considerations underlying our decision and to review the main economic developments in Israel and abroad.

In recent months, inflation in Israel has moderated and is now slightly below the midpoint of the target range. In September, inflation over the previous twelve months stood at 1.6 percent. According to forecasters' projections, inflation is expected to remain around this level in the coming months, return to near the midpoint of the target range at the beginning of 2027, and remain around that level thereafter. The development of the inflation environment partly reflects the monetary policy we have pursued in recent years—a data-driven policy that responds to evolving conditions and is guided by our commitment to returning inflation to the target range.

Looking ahead, several factors may influence the path of inflation in opposing directions. The inflation environment will be shaped to a considerable extent by geopolitical developments and their implications for economic activity, energy prices, Israel's risk premium, and the exchange rate; by the evolution of demand alongside supply constraints; and by fiscal developments.

Current indicators suggest that economic activity continued to expand in the third quarter, alongside persistent supply constraints. This follows the rapid recovery in the second quarter

after the sharp decline during Operation Roaring Lion. Credit card expenditure data remain volatile and are close to their long-term trend. The aggregate balance in the Central Bureau of Statistics' Business Tendency Survey for September increased and returned to its level from before Operation Roaring Lion. Capital raised in the high-tech sector in the third quarter totaled approximately US$ 5 billion, a level similar to that recorded in the earlier quarters of the year.

The labor market remains tight, and labor supply constraints are still significant. The unemployment rate is low, and the job vacancy rate remains high, while participation and employment rates are still below the prewar levels. The pace of nominal wage growth in the economy moderated after accelerating due to temporary factors, and stood at 4.3 percent in June through August compared with the corresponding period a year earlier. In the business sector, wage growth in May through July stood at 5.3 percent relative to the same period last year.

Activity in the construction industry remains high. According to CBS data for the second quarter of the year, the pace of housing starts declined slightly compared with the second quarter of last year, but remains high. Building permits and housing completions are also at high levels. The seasonally adjusted volume of housing transactions moderated in July and August, following an increase in May and June, but overall has remained stable over the past year. The inventory of unsold homes is stable and remains high. In July and August, home prices declined by 0.6 percent, and in annual terms they fell by 1.8 percent. In this context, and as I have emphasized on many occasions, it is important to maintain a high level of housing supply over time. In the September CPI, the annual rate of increase in the housing component was 3.8 percent. The rate of price increases in renewed rental contracts is at 2.4 percent, while the annual rate of increase in contracts involving a change of tenant rose to 5.3 percent.

Business credit continued to expand at a rapid pace, as interest rates on new business credit declined. Household credit continued to grow, and delinquency rates are low.

In the financial markets, since the previous monetary policy decision, the shekel has depreciated by approximately 3.1 percent against the US dollar. Israel's risk premium, as measured by CDS spreads, increased slightly, but remains close to its prewar level. Domestic equity indices rose during the reviewed period, albeit with volatility, following their outperformance over the past two years.

The Research Department has updated its macroeconomic forecast. Before presenting the forecast, I would like to explain a change we have made this time in the presentation of growth data. This change was made necessary following recent CBS revisions to the National Accounts with regard to the significant volume of exports produced abroad and its rapid growth. In the past two years, overseas production by Israeli companies has accounted for a rapidly growing share of GDP. This component contributes in part to government tax revenues, but it does not utilize domestic capital or labor, and most of the income it generates does not accrue to Israeli households. As a result, its rapid growth may create a distorted picture of the pace of real domestic economic activity. Accordingly, in this forecast we also present growth excluding the separately estimated component of production abroad. This measure more accurately reflects the internal economic dynamics of the Israeli economy: domestic demand, the supply constraints it faces, the degree of tightness in the labor market, and related developments. I would note that supplementary reporting of GDP excluding foreign activity is also used in

several other advanced economies where there is a material difference between domestic production and total production including output abroad.

The forecast for overall GDP was constructed using a bottom-up approach in two main stages. In the first stage, we applied our regular forecasting tools and models to produce a forecast for GDP excluding production abroad, based on the data series that the Central Bureau of Statistics has only recently begun to publish. In the second stage, we used the data on output generated by production factors located abroad and applied a range of relevant tools and projections in order to forecast its path of development. The forecast for overall GDP is therefore the sum of the forecast for the portion of output produced in Israel and the forecast for the portion produced by production factors abroad. Naturally, and in view of the uncertainty surrounding developments in the technology and artificial intelligence sectors more broadly, the estimate for the portion of GDP produced abroad is characterized by a high degree of variability.

The baseline assumption underlying the forecast assumes that the intensity of the fighting will remain low, similar to the current level, which may contribute to some easing of the supply constraints facing the economy, and that the geopolitical environment will remain tense. The forecast does not incorporate possible fiscal legislation measures that may be adopted by the government formed after the elections.

According to the Research Department's baseline scenario, GDP is expected to grow by 5.6 percent in 2026 and by 7.5 percent in 2027. However, much of this revision reflects the substantial contribution of production abroad. The forecast for GDP excluding production abroad stands at 3.4 percent in 2026 and 5.1 percent in 2027. Inflation is expected to average 1.5 percent in 2026, and 2.1 percent in 2027. The Department estimates that the government budget deficit will amount to 4.4 percent of GDP in 2026 and 4.6 percent in 2027. The debt-to-GDP ratio is expected to be approximately 68 percent at the end of 2026 and 66.5 percent at the end of 2027. Excluding production abroad, the debt-to-GDP ratio is expected to be 70 percent at the end of 2026 and 70.5 percent in 2027. The Department projects that the policy rate will be 3 percent in approximately one year.

The forecast is subject to several risks: uncertainty regarding geopolitical developments; significant fiscal uncertainty, on both the revenue side and the expenditure side; uncertainty regarding the size of the defense budget and its implications for the deficit and inflation; and uncertainty and risks related to developments in technology and artificial intelligence and their possible effects on the global and Israeli economies.

More broadly, the heightened geopolitical uncertainty facing Israel makes it all the more important to preserve adequate fiscal policy space. The importance of maintaining fiscal resilience has become even clearer in recent years. Israel's ability to cope with the COVID-19 crisis and with the war that began in October 2023 relied to a large extent on the fact that the economy entered those crises from a relatively strong starting position, reflected in a relatively low debt-to-GDP ratio of 60 percent. This policy space made it possible to support economic activity and the needs of the economy during those periods while preserving market confidence. The rise in yields globally, and to some extent in Israel as well, in recent months further underscores the importance of maintaining a low debt-to-GDP ratio, given its potential implications for the cost of financing public debt, which is already high in Israel relative to other advanced economies.

Looking ahead, the main challenge for economic policy—one to which I have referred repeatedly in recent years—has three dimensions: achieving a sustained decline in the debt-to-GDP ratio, financing essential security needs, and investing in growth engines, particularly human capital and infrastructure. Implementing all three dimensions is by no means straightforward and requires decisions that will ensure their sustainability over time. Achieving this objective will, in part, require reducing expenditures that impair growth, improving the efficiency of public spending, and broadening the tax base through higher employment rates and productivity. The greater the share of the population that participates in the labor market and increases its earning capacity, the more it will be possible to support fiscal policy objectives while reducing pressure for further tax increases.

Global geopolitical developments also remained at the center of attention during the reviewed period. Energy prices continued to rise, with the price of Brent crude increasing by approximately 15 percent to around US$ 110 per barrel. In addition, natural gas prices in Europe continued to rise to their highest levels since the outbreak of Operation Roaring Lion. At the same time, inflation in the major economic blocs increased. In their most recent decisions, both the Federal Reserve and the European Central Bank raised interest rates by 25 basis points, and the market-implied interest rate path moved higher during the reviewed period, now incorporating roughly three rate hikes over the coming year.

To conclude, the Israeli economy continues to operate in an environment characterized by high geopolitical and fiscal uncertainty. Inflation has moderated and remains slightly below the midpoint of the target range, while economic activity continues to recover. The full effects of the monetary policy measures we have already taken have not yet been fully reflected in the economy, and at this stage it is appropriate to continue monitoring their cumulative impact. The Monetary Committee will continue to act in accordance with the data and in line with economic developments. The interest rate path will be determined in accordance with the development of inflation, economic activity, geopolitical uncertainty, and fiscal developments.

The Bank of Israel and the Monetary Committee stand with the soldiers and all members of the security forces who are fighting bravely for us on the various fronts. We extend our condolences to the families of those who have fallen, and wish the wounded a full and speedy recovery.

Thank you.