Jan 11, 2026

Strong market reaction to the rate decision

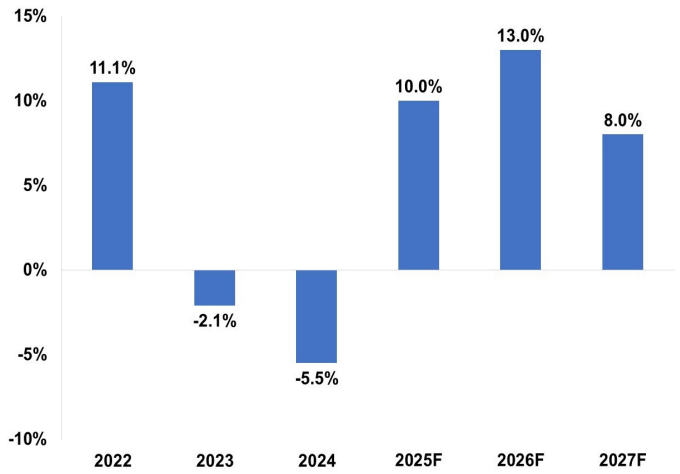
- **The Bank of Israel's decision to cut the interest rate for the second consecutive time did not surprise us, but it does signal the path ahead. Markets reacted by pricing in one additional rate cut this year beyond the level priced in before the decision, to a level of 3.25%, and by recording gains of about 3% in the equity market.**
- **It is likely that the window of opportunity for cutting interest rates will be limited in time and will close at some point; therefore, the market reaction, which currently is pricing in slightly lower interest rate by the end of the year, seems reasonable to us.**
- **The impact also filtered through to longer maturities, and the yield on 10-year bonds declined to around 3.8%, compared with 4.17% in the U.S.**
- **The Bank of Israel estimates that over the next two years imports will continue to grow more rapidly than exports. If we add to this the reduction in US military aid, it is quite possible that the current account surplus will gradually shrink, and there may even be years with a current account deficit.**

The Bank of Israel's decision to cut the interest rate for the second consecutive time did not surprise us, but it does signal the path ahead. Markets reacted by pricing in one additional rate cut this year beyond the level priced in before the decision, to a level of 3.25%, and by recording gains of about 3% in the equity market. The markets had assigned a very low probability for a rate cut last week, in light of previous BoI policy and rhetoric that supported a cautious and gradual approach.

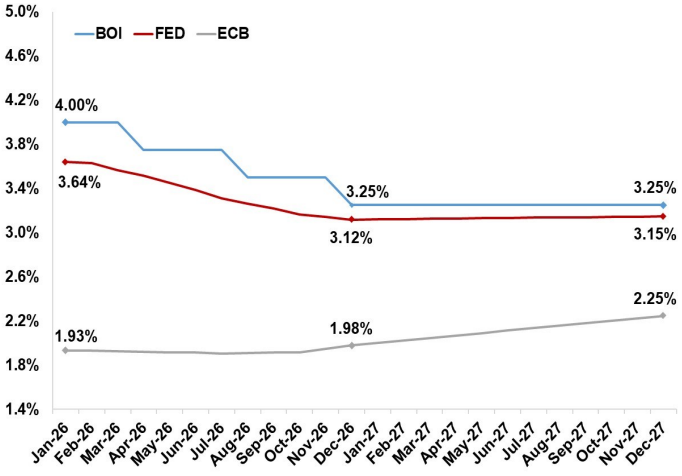
Regarding economic data, the economy continues to grow at a rapid pace, and the labor market remains tight. The relationship between the labor market and inflation is elegant in theory, but in practice we have been at low unemployment rates for nearly a decade, during which we experienced both near-zero inflation and elevated inflation. The differences between these periods stemmed from other factors whose impact on inflation was far more significant than the stage of the business cycle. Weakness in the real estate market and the strengthening of the shekel likely carried substantial weight in this rate decision, as did the fact that short-term real interest rates have risen due to the sharp decline in inflation expectations.

Monetary policy includes a significant element of opportunism. Although we tend to present economic trends and monetary decisions using models, in practice background noise plays a considerable role in decision-making. Therefore, it is difficult to define a long-term equilibrium interest rate (R*), since it is not possible to fully neutralize the impact of such noise. In addition, the timing of rate cuts may influence the

The Bank of Israel expects a surge in investments over the next two years
Investments, % of change, 2025-2027 BOI forecast
Source: CBS, BOI



Markets have shifted to pricing in three more rate cuts in 2026
Implied interest rates,
Source: Bloomberg



level at which policy rates ultimately stabilizes. **It is likely that the window of opportunity for cutting interest rates will be limited in time and will close at some point; therefore, the market reaction, which currently is pricing in slightly lower interest rate by the end of the year, seems reasonable to us.**

The impact also filtered through to longer maturities, and the yield on 10-year bonds declined to around 3.8%, compared with 4.17% in the U.S. If we take into account that the State of Israel is still raising capital abroad in dollar terms at a cost of about 90 to 100 basis points above the U.S. government, then at least technically this implies expectations for continued appreciation of the shekel to below 3 shekels per dollar over the long term. In practice, this spread does not necessarily reflect only genuine expectations of shekel appreciation, but also a strong home bias among local investors toward shekel-denominated assets.

The Bank of Israel has updated its growth forecast for 2026 to 5.2%, compared with 4.7% in the previous forecast a quarter earlier. Among the components of GDP, a 13% increase in investment in fixed assets stands out, following a 10% increase in 2025. When examining planned infrastructure projects and residential construction (based on permits granted in recent years), this estimate appears reasonable. The major test will be whether there is sufficient manpower to carry out these projects. The labor supply expected to increase as a result of a reduction in military reserve duty is not a substitute for workers in the construction sector, and as long as Palestinian workers do not return to working in Israel, the realization of this forecast appears to depend to a large extent on the entry of additional foreign workers into the country.

The Prime Minister expressed in an interview with The Economist the need to gradually reduce U.S. military assistance over a decade until it is fully eliminated. Official aid has so far amounted to 3.8 billion dollars per year, but in practice recent the sums and munitions received in recent years were significantly higher. Weaning off U.S. military assistance means making purchases through Israel's regular fiscal budget, which will have an impact on the fiscal deficit as well as reduce the current account surplus. In the third quarter of 2025, Israel moved into a current account deficit, and **the Bank of Israel estimates that over the next two years imports will continue to grow more rapidly than exports. If we add to this the reduction in US military aid, it is quite possible that the current account surplus will gradually shrink, and there may even be years with a current account deficit.**

BOI Rate and CPI Forecast			
BOI Rate		CPI	
December 2026	3.50%	Dec 2025	0.0%
12M Forecast	3.50%	Jan 2026	-0.2%
		12M Forecast	1.8%