BANK OF ISRAEL
Office of the Spokesperson and Economic Information

August 10, 2015

Report to the public on the Bank of Israel's discussions prior to deciding on the interest rate for August 2015

The discussions took place on July 23 and 27, 2015.

General

In the process of making the monthly interest rate decision by the Monetary Committee, discussions are held at two levels—the first in a broad forum, and the second in a narrower one.

In the broad-forum discussion, the relevant background economic conditions are presented, including the real and financial-monetary developments in Israel's economy, and developments in the global economy. Participants in this discussion include the members of the Monetary Committee, senior representatives from the various departments of the Bank, and economists from the economic departments (Research and Market Operations), who prepare and present the material for discussion. The data, estimates and assessments in this document are those that were available at the time of the interest rate decision.

In the narrow forum, which consists of the Monetary Committee and the Director of the Market Operations Department, the Directors of the Research Department and of the Market Operations Department present their recommendations regarding the interest rate. An open discussion follows, which ends with a vote on the level of 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 majority vote of the members of the Monetary Committee who participate in the voting. If the vote is tied, the Chairperson (the Governor) has an additional vote.

A. THE STATE OF THE ECONOMY

1. Developments on the real side

Indicators of the state of the economy

Indicators of economic activity that became available this month point to the economy continuing to grow at the moderate rate of the past few years, with a decline in exports. In the third estimate of National Accounts data for the first quarter, GDP growth was revised slightly downward (from 2.1 percent to 2.0 percent, seasonally adjusted data in annual terms), with a downward revision in exports (a contraction of 2.1 percent compared to a contraction of 1.9 percent in the previous estimate), and an upward revision in private consumption (to 7.9 percent, compared with 7.5 percent). In the Companies Survey for the second quarter, the net weighted balance remained near zero, similar to the first quarter. Goods exports (excluding ships and aircraft and diamonds, in current dollar terms) declined by 5 percent in June, following an increase of 2 percent in May, primarily due to a sharp decline in pharmaceuticals exports following a sharp increase in May. Goods imports (excluding ships and aircraft, diamonds, and fuels) increased by 6 percent in June. Business services exports (excluding startup companies) increased by 5.9 percent in May compared with April, following a prolonged decline in recent months, while the tourism industry continues to recover very slowly—the number of tourist arrivals in the second quarter (seasonally adjusted) was just 2 percent higher than in the first quarter. The Composite State of the Economy Index increased by 0.4 percent in June, positively affected by the increase in imports and in the job vacancy rate. However, the (continued) decline in goods exports and in industrial production were notably negative aspects among the components. The Consumer Confidence Index compiled by the Central Bureau of Statistics increased this month following a decline in the previous month, and the index compiled by Bank Hapoalim has remained stable for the past five months. The Purchasing Managers Index increased to 51.0 points in June.

The labor market

Labor market data continue to indicate a high level of employment and activity. The number of employee posts declined by 0.4 percent in April following an increase the previous month. In February–April, nominal wages increased by 1.5 percent, and real wages increased by 2.3 percent, relative to November–January (seasonally adjusted data). Health tax receipts for April–June were 7.8 percent higher (in nominal terms) than in the corresponding period last year. The job vacancy rate increased in June to 3.3 percent, seasonally adjusted, further to the increase in May.

Budget data

In January–June, the domestic surplus (excluding net credit) in government activity was about NIS 0.6 billion, NIS 1.7 billion lower than the seasonal path consistent with achieving the deficit target of 2.5 percent of GDP. Since the beginning of the year, total tax revenues are about NIS 2.7 billion higher than the seasonal path, and nontax revenues are about NIS 2.5 billion lower than the seasonal path. Since the beginning of the year, gross domestic VAT revenues increased by about 9.2 percent in real terms, compared with the corresponding period in 2014, against the background of growth in private consumption. Since the beginning of the year, government domestic expenditure has been about NIS 4 percent higher (in nominal terms) than in the corresponding period last year.

2. Developments on the nominal side

Inflation

The Consumer Price Index for June increased by 0.3 percent, while the average of forecasters' projections was for an increase of 0.2 percent. There was a seasonal increase in the clothing and footwear component and a seasonal decline in the fruit and vegetables component. The rate of inflation as measured by the change in the CPI over the past 12 months was negative 0.4 percent, similar to the change over the 12 months that ended in May. CPI components representing tradable goods declined by 1.8 percent over the past 12 months, and are still affected by the decline in energy prices that occurred prior to the beginning of 2015. The growth rate of components representing nontradable items continues to increase, as prices rose by 0.5 percent over the previous 12 months. In March–June, the rate of increase in the CPI has been consistent with achieving the inflation target, but inflation measured over the preceding 12 months is expected to remain negative for several more months. In addition, the decline in energy prices that resumed in the past month, and the appreciation of the shekel, are liable to defer the return of the inflation rate to within the target range.

Expectations and forecasts of inflation and the interest rate

Short-term inflation expectations from various sources remained around the lower bound of the inflation target range this month. Similar to the previous month, private forecasters' projections for the next 12 CPI readings are for an increase of 1 percent, on average, and expectations derived from banks' internal interest rates are for 0.7 percent. Twelve-month ahead inflation expectations derived from the capital market are currently 1.0 percent, and expectations for 2 years are 1.3 percent. Medium-term (3–5 years) forward expectations remained around 1.5 percent this month, while expectations for longer terms (5–10 years) continued to range around the midpoint of the inflation target range. The Telbor curve indicates some probability of a reduction in the interest rate in the next few months, but most private forecasters do not expect a reduction in the Bank of Israel interest rate. Forecasters project the interest rate in 1 year to be 0.29 percent, on average.

Monetary aggregates

In the twelve months ending in June, the M1 monetary aggregate (cash held by the public and demand deposits) increased by 55.7 percent, and the M2 aggregate (M1 plus unindexed deposits of up to one year) increased by 14.3 percent.

The credit market

Outstanding debt of the business sector remained stable in May, at about NIS 821 billion. Repayments of NIS 2.7 billion were offset by the net raising of debt through nonbank loans and as a result of the shekel's depreciation against the dollar. In June, the nonfinancial business sector issued bonds totaling NIS 3.6 billion, higher than the average over the past 12 months (NIS 2.8 billion), and foreign companies continued to issue bonds at a relatively high pace. There were net withdrawals from corporate bond mutual funds and general bond mutual funds totaling about NIS 3.2 billion in June. Corporate bond market spreads declined slightly in June. Outstanding household debt increased by about NIS 5.8 billion (1.3 percent) in May to about NIS 442 billion, of which outstanding housing debt increased by about NIS 2.5 billion (0.8 percent) to NIS 309 billion.

New mortgage volume continued to increase, reaching NIS 7 billion in June. In parallel, the volume of mortgage refinancings—a process by which borrowers improve the terms of their loans against the background of low interest rates and yields—increased to NIS 2.7 billion (most of which is not included in the volume of new mortgages taken out.) In June, mortgage interest rates increased on all indexation tracks, particularly on the variable-rate CPI-indexed track (which increased by 0.2 percentage points), and on the fixed-rate unindexed track (which increased by 0.18 percentage points).

The housing market

The housing component of the CPI (based on residential rents) increased by 0.4 percent in June, and has increased by 2.2 percent over the past 12 months. In April–May, home prices declined by 0.4 percent, and in the 12 months ending in May, they increased by 3.2 percent, compared with 4.0 percent in the 12 months ending in the previous month. Preliminary data indicate an increase in the number of transactions in May, among all buyer categories, following a seasonal decline in April. However, the annual pace of transactions is not exceptional compared to previous years. The number of new homes sold in May remained high—about 2,400, similar to the number in April—and the stock of homes available for sale remains relatively high.

3. The foreign exchange and capital markets

The foreign exchange market

From the monetary policy discussion on June 21, 2015, through July 24, 2015, the shekel strengthened by about 0.25 percent against the dollar, and by about 3.5 percent against the euro. The shekel strengthened by about 2.5 percent in terms of the nominal effective exchange rate.

The capital market

From the monetary policy discussion on June 21, 2015 through July 24, 2015, the Tel Aviv 25 Index remained essentially unchanged (a decline of 0.1 percent). Yields in the government bond market increased by up to 12 basis points on the nominal curve and by up to 20 basis points on the CPI-indexed curve. The yield on unindexed bonds with 10 years to maturity increased from about 2.33 percent to around 2.41 percent. There were slight changes along the *makam* yield curve, and most of the curve was trading at a yield similar to the Bank of Israel interest rate. Israel's sovereign risk premium, as measured by the five-year CDS spread, remained virtually unchanged, at about 70 basis points.

4. Global economic developments

Two developments in the global economy were the focus of attention this month—the crisis in Greece and the sharp stock price declines in China—but in both situations there was some stabilization toward the end of the period, and financial market volatility remained limited mainly to those two economies. The IMF revised its 2015 global growth projection slightly downward, and its 2016 projection remained unchanged. World trade has been uncharacteristically contracting for several months. In the US, there was a moderate recovery in the second quarter, and assessments are that it did not compensate for the low growth in the first quarter. Nonfarm payrolls increased by more than average for the year to date, and unemployment declined to 5.3 percent, though the labor force participation rate declined and salaries increased only moderately. Housing market indices point to vigorous growth, while personal consumption expenditure increased moderately, exports weakened against the background of the strengthening of the dollar, and industrial production expanded moderately. The Fed Chair repeated the assessment that the Federal Reserve is likely to increase the interest rate this year. In the eurozone, the deterioration of the crisis in Greece did not have a marked negative impact on economic activity or on financial markets. The weakening of the euro and the accommodative monetary policy support exports and demand for credit; purchasing managers indices were relatively positive, and consumer confidence indices remained at high levels relative to recent years. Industrial production contracted in May, and unemployment remained high, at 11.1 percent. The agreement with Greece led, for now, to some calm, though it is still not clear to what extent it is sustainable. Japan's economy is showing signs of slowing: industrial production contracted in May and retail sales grew moderately. The Bank of Japan reduced its growth and inflation forecasts, and there is a growing assessment that it will accelerate its expansion plan. China's stock market, which had increased by about 150 percent in the past year, declined sharply this month, and only stabilized, at a level 20 percent below its high, after various government actions. In contrast, indicators of real economic activity were positive, relative to previous months. In emerging markets, generally, a slowdown continues. Inflation remains low in major economies, and interest rates were reduced by several central banks, including those in Sweden, Canada, and China. The price of a barrel of oil declined this month to $56, from $63 in the previous month, and prices of industrial metals declined to a multiyear low.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR AUGUST 2015

Main points of discussion

The members of the Monetary Committee participating in the discussion decide on the appropriate rate of interest for the economy. After the discussion on the interest rate for August 2015, it was decided to keep the interest rate at 0.1 percent. The decision was unanimous.

The discussion focused on several main issues: (1) inflation; (2) real economic activity; (3) the development of the exchange rate; (4) the global picture; (5) the housing market, and (6) fiscal policy.

Committee members noted that the inflation rate derived from the price increases over the past four months is consistent with achieving the range defined as price stability. The Committee discussed the factors that could lead to another slowdown in the inflation rate—renewed oil price declines and shekel appreciation—and the factors that may support continued price increases—mainly an acceleration in nominal wages. Committee members agreed that the risks of a renewed slowdown in the inflation rate are greater than the risk of acceleration in price increases, and that those risks may defer the return of the inflation rate to within the target range.

The Committee discussed the causes for the continued moderate growth in the economy, as seen in, among other things, National Accounts data and the Companies Survey. Members noted that several of the factors that further moderated growth in the beginning of the year are likely to be temporary. First, the slowdown in public consumption is likely to be transitory if the government in fact approves a new and expansionary budget by the end of the year. Second, the decline in goods exports from Israel was affected by temporary labor disruptions in the chemicals industry. In addition to this temporary factor, Committee members agreed that the decline in goods exports derives mainly from the contraction of world trade in recent months. Finally, the Committee discussed the composition of growth and several members expressed concern that this composition is increasingly less reliant on the growth of exports, which is a growth driver in a small and open economy. Such a change in the composition is liable to negatively impact the increase in productivity in the economy, a development that will slow GDP growth, particularly when the economy is near to exhausting the increase in employment.

The Committee discussed the continued appreciation of the shekel in the past month, and the impact of the appreciation on activity and employment in export industries, and in the tradable sector overall.

Committee members were updated on developments in the Chinese economy and regarding the debt crisis in Greece, and agreed that despite the stabilization seen recently in those economies, the developments in those countries are still a risk to global economic recovery. The Committee discussed assessments regarding the date of initial increase in the federal funds rate and also discussed the continued monetary expansion in Europe. Members emphasized that Bank of Israel policy in the future depends on developments in the inflation environment, in growth in Israel and abroad, and in the exchange rate of the shekel. Interest rates abroad, alongside other data, impact on the policy to the extent that they impact on these developments and on the domestic economy.

Committee members discussed the vigorous activity in the housing market and the elevated volume of new mortgages extended to home buyers. The Committee also discussed the positive effect of mortgage refinancing activity on the risk profile of existing mortgages.

The Committee was updated on the government's steps to formulate a new budget, and on concern that the deficit target in this budget will be high, and lead to an increase in the debt to GDP ratio.

In conclusion, all Committee members supported leaving the interest rate unchanged, and they concurred that the current interest rate environment continues to support continued growth and the return of the inflation rate to the target range within a year. At the same time, the Committee's decisions take developments in asset markets into account as well.

Following the discussion, the five members of the Monetary Committee voted on the Bank of Israel interest rate for August 2015. All members supported keeping the interest rate at 0.1 percent.

The main considerations behind the decision

The decision to keep the interest rate for August 2015 unchanged at 0.1 percent is consistent with the Bank of Israel's monetary policy, which is intended to return the inflation rate to within the price stability target of 1–3 percent a year over the next twelve months, and to support growth while maintaining financial stability. The path of the interest rate in the future depends on developments in the inflation environment, growth in Israel and in the global economy, and the exchange rate of the shekel, as well as on monetary policies of major central banks.

The following are the main considerations underlying the decision:

- The rate of increase in the CPI over the preceding four months has been consistent with the inflation target. Short-term inflation expectations from various sources are around the lower bound of the target range. Expectations for medium and longer terms remain entrenched near the midpoint of the target range. However, the decline in energy prices, which resumed in the past month, and the appreciation of the shekel, may defer the return of the inflation rate to within the target range.
- Indicators of real economic activity that became available this month point to the economy continuing to grow at its moderate rate of recent years, led by private consumption and with a decline in exports. The second quarter Companies Survey supports this assessment. The Composite State of the Economy Index increased by 0.4 percent in June, and was positively affected by an increase in imports and in the job vacancy rate, but declines in goods exports and in industrial production were notably negative components. Labor market data continue to indicate a high level of employment and activity.
- Developments in China’s economy and the debt crisis in Greece, despite their recent stabilization, continue to pose risks to a global economic recovery. Moderate recovery continues in the US and Europe. While in the US the probability increased of an interest rate rise beginning this year, in Europe the monetary expansion continues, and in several economies the interest rate was reduced.
- The shekel strengthened by 2.5 percent in terms of the nominal effective exchange rate this month, and has appreciated by 7.1 percent for the year to date, primarily as a result of the weakening of the euro. The appreciation, and the moderation in growth of world trade, weigh on the growth of exports and of the tradable sector.
- Robust activity in the housing market, both on the supply side and on the demand side, continued this month, and was reflected in a record level of new mortgage volume, and an especially elevated level of new home sales. In the past 12 months, home prices have increased by 3.2 percent.

The Bank of Israel will continue to monitor developments in the Israeli and global economies and in financial markets. The Bank will use the tools available to it and will examine the need to use various tools to achieve its objectives of price stability, the encouragement of employment and growth, and support for the stability of the financial system, and in this regard will continue to keep a close watch on developments in the asset markets, including the housing market.

The decision was reached and published on July 27, 2015.

Participants in the narrow-forum discussion:

Members of the Monetary Committee
Dr. Karnit Flug, Governor of the Bank and Chairperson
Dr. Nadine Baudot-Trajtenberg, Deputy Governor
Prof. Alex Cukierman
Prof. Reuben Gronau
Prof. Nathan Sussman, Director of the Research Department

Other participants in the narrow-forum discussion:
Mr. Andrew Abir, Director of Market Operations Department
Mr. Daniel Hahiashvili, Chief of Staff to the Governor
Mr. Eran Politzer, Economist in the Research Department
Ms. Esti Schwartz, Secretary of the Monetary Committee
Mr. Yoav Soffer, Spokesperson of the Bank of Israel