BANK OF ISRAEL
Office of the Spokesperson and Economic Information

November 12, 2012

Report to the public on the Bank of Israel's discussions prior to setting the interest rate for November 2012

The discussions took place on October 28 and 29, 2012

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 real, monetary and financial developments in Israel's economy, and developments in the global economy. Participants in this discussion include the three members of the Monetary Committee from the Bank—the Governor, the Deputy Governor and the Senior Advisor to the Governor—and the three members of the Monetary Committee from the public. Other participants in the discussion are the Directors of the Research and Market Operations Departments, and economists from various departments who prepare and present the material for discussion. The data, estimates and assessments in this report are those that were available at the time of the discussions.

In the narrow forum, which consists of the Monetary Committee and the Directors of the Research and Market Operations Departments, the two Departmental Directors 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 the Bank of Israel Law, 5770-2010, (section 18(c)), 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 BROAD-FORUM DISCUSSION—THE STATE OF THE ECONOMY

1. Developments on the real side

General assessment

Indicators of real economic activity that became available this month support the assessment of a moderate growth rate of about 3 percent. These indicators are in line with the Research Department forecast of 3.3 percent GDP growth in 2012. At the same time, expectations from various surveys continue to reflect pessimism regarding the level of activity in the next few months.

Monthly indices of the economic situation

Data on revenue by industry in August indicate an increase in trade and services revenue, which was likely affected by the purchases brought forward ahead of the increase in the VAT rate. The Composite State of the Economy Index for September increased by 0.2 percent, reflecting an increase in nearly all the components of the index, excluding exports of services. Following the Central Bureau of Statistics upward correction of goods exports data for August, the Composite Index data for August were also revised upward. The Industrial Production Index for June-August rose by 14.2 percent in annual terms. Survey figures remained pessimistic with regard to future developments—the Purchasing Managers Index increased slightly this month, but remained at a level indicating sharp contraction in manufacturing activity, and expectations seen in the Bank Hapoalim and the Central Bureau of Statistics consumer confidence indices registered further deterioration, especially in the employment component.

The labor market

Labor market data which became available this month indicate continued moderate growth in employment, though in recent months there has been some stabilization in business sector employment. Employment data for July and August indicate an increase of 1.5 percent (seasonally adjusted) in the number of employed persons, compared with the second quarter, with an increase in the rate of part time positions compared with full time positions. This growth occurred through a continued increase in the employment rate in those months, from 59.1 percent to 59.9 percent, together with a decline in the unemployment rate from 7 percent in the second quarter to 6.9 percent in August. Both the nominal wage and real wage increased by 1 percent in May–July compared with the preceding 3 months, based on seasonally adjusted figures. Health tax receipts indicate continued growth of total nominal wage payments in August and September, at a rate of more than 6 percent, compared with the corresponding period of the previous year.

Foreign trade

Goods exports (in dollar terms, excluding ships, aircraft and diamonds) increased 5.7 percent in the third quarter, following a sharp decline in June. Goods imports (excluding ships, aircraft, diamonds and fuel) registered a slight decline of 2 percent in the third quarter. Goods import and export data continued to maintain stability over time, similar to the trend since the beginning of 2011.

Budget data

Tax receipts for the year to date through September are about NIS 4.5 billion lower than the figure derived from the revised seasonal path. In the past four months there was an improvement in tax collection, and a reduction of the average deviation from the seasonal path. Assuming that government expenditure does not surpass the original amount in the budget, the deficit this year, based on developments to date, is projected to be about 4 percent of GDP. The framework of expenditures expected during the remainder of the year raises some concern of a higher deficit, but it is likely that technical delays due to the bringing forward of elections, will slow or halt the increase in spending. Likewise, bringing the elections forward is expected to have a restraining effect on fiscal developments in the beginning of 2013, primarily in the first quarter, due to the limitation of monthly expenditure to one-twelfth of the previous year's budget until a new budget is passed.

2. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) for September was unchanged. Forecasts projected an increase of 0.5 percent, on average. The main reason for the surprise compared with the forecasts was the decline in the pre-primary education component, which derived from the application of the law mandating free education to 3–4 year olds. This is a one-time factor resulting from policy. The effect was known in advance, but was not accounted for in most forecasts. The development of actual prices indicates the moderation of the inflation environment in the past six months, alongside the continued moderation in the increase in the housing index. The rate of inflation over the previous twelve months was 2.1 percent.

Expectations and forecasts of inflation and of the Bank of Israel interest rate

Forecasts of the inflation rate over the next twelve months based on the average of forecasters' inflation predictions, and inflation expectations based on over-the-counter CPI futures contracts offered by banks, declined after the publication of the CPI for September, from around 2.5 percent to around 2.1 percent. In contrast, expectations calculated from the capital markets (break-even inflation) remained high throughout the month, at 2.5 percent, although it is likely that those expectations are biased upward this month. According to forecasters, prices are expected to increase by 0.3 percent over the next three months. This is against the background of, in the short term, expectations of imminent food price increases, and, in contrast, the recent declines in commodity prices worldwide. Inflation expectations for two years and longer remained stable at around 2.5 percent. Expectations for the Bank of Israel interest rate one year from now derived from the Telbor (Tel Aviv Inter-Bank Offered Rate) market as well as expectations based on the average projection of forecasters, are for an interest rate of 2.1 percent. Most forecasters who provide projections to the Bank of Israel predict that the Bank will keep the interest rate for November unchanged.

The makam and bond markets

Yields declined on government bonds—both unindexed and CPI-indexed—by up to 30 basis points, in contrast to government bond markets in advanced economies, which traded with only minor changes. *Makam* yields also declined along most of the curve, by up to 10 basis points, with one-year yields declining to 2.15 percent during the period.

The interest and yield spreads between Israel and abroad

The yield gap between 10-year Israeli government bonds and equivalent 10-year US Treasury securities decreased by about 30 basis points, to about 250 basis points. Israel's sovereign risk premium as measured by the five-year CDS spread increased slightly this month to 150 basis points, in contrast to CDS spread declines in most countries.

The monetary aggregates

In the twelve months ending in September, the M1 monetary aggregate (cash held by the public and demand deposits) increased by 14.2 percent, and the M2 aggregate (M1 plus unindexed deposits of up to one year) increased by 7.4 percent.

The credit market

The outstanding debt of the business sector was stable in August at NIS 792.7 billion; since the beginning of the year the debt has increased by 1.6 percent. Total outstanding credit to households increased in August by 0.8 percent, to NIS 381 billion. The total volume of new mortgages granted in September was NIS 3.2 billion, compared with NIS 5.8 billion in August. Part of the decline in new mortgage volume can be attributed to there having been fewer business days in the month due to the Jewish holidays, and to the fact that some transactions were brought forward ahead of the VAT increase which came into effect in September. The balance of housing debt was NIS 272 billion at the end of August, an increase of 6.9 percent since August of 2011. Mortgage interest rates on new CPI-indexed mortgages granted in September remained essentially unchanged, while interest rates in the unindexed variable rate segment again increased by about 0.1 percentage points, following a similar increase in August.

The housing market

The housing component of the CPI (representing rents) declined by 0.1 percent in September. In the twelve months ending in September it increased by 2.8 percent, compared with an increase of 3.8 percent in the twelve months to August. Home prices, which are published in the Central Bureau of Statistics survey of home prices but are not included in the CPI, increased in July–August by 0.6 percent, after increasing by 0.8 percent in June–July. In the past 6 months, home prices have risen by 2.9 percent, and in the twelve months ending in August, home prices increased by 1.4 percent, compared with an increase of 1 percent in the twelve months to July.

Activity in the construction industry is strong compared with its levels in the past decade. The number of building starts remains high and is expected to continue to be reflected in an increased stock of homes. At the same time, the level of building starts remains below the record level of mid–2011, and there is a decline in the rate of properties marketed by the Israel Land Administration. There were 40,554 building starts in the twelve months to July, compared with 42,462 in the twelve months to June.

The Bank of Israel Research Department assessment (staff forecast)

The Bank of Israel Research Department's macroeconomic forecast for 2012 and 2013 was updated last month. The forecast (which was published as a separate press release together with the previous interest rate notice) projected GDP growth of 3.3 percent in 2012 and 3 percent in 2013. According to the forecast, the Bank of Israel interest rate is expected to remain unchanged until the end of 2013, and the inflation rate over the four quarters ending with the third quarter of 2013 is expected to be 2.6 percent. With an upward revision in the number of building starts and building completions, the Research Department projects that the increase in the housing component of the CPI (representing rents) will moderate from an annual rate of 3.5 percent in 2012 to 0 percent in 2013, and by the middle of 2014 will reach negative 1.5 percent, which should contribute to the moderation in the increase of general price levels.

3. The foreign currency and stock markets

The foreign currency market

From the previous monetary policy discussion held on September 23, 2012, through October 26, 2012, the shekel appreciated against the dollar by 1.1 percent, in contrast with most major currencies, which weakened against the dollar. The shekel appreciated by 0.8 percent against the euro. In terms of the nominal effective exchange rate the shekel appreciated by about 1.2 percent.

The capital market

From the previous monetary policy discussion held on September 23, 2012, through October 26, 2012, the Tel Aviv 25 Index increased by about 5.3 percent, in contrast to the declines in stock markets worldwide, primarily in advanced economy countries. With that, the Tel Aviv Stock Exchange (TASE) closed the gap which had opened this year between its return and global stock market returns. The Tel-Bond 20 Index and the Tel-Bond 40 Index increased by 1.4 percent and 1.5 percent, respectively.

4. Global economic developments

The debt crisis in Europe continues to be the main risk to the global economy. Macro data released this month in the US and in Europe were mixed, but for the most part included positive surprises (compared with already low forecasts). This month, the IMF lowered its global growth forecast for 2012 and 2013 to 3.3 percent and 3.6 percent, respectively, compared to 3.5 percent and 3.9 percent in the previous forecast. In its announcement, the IMF wrote that this forecast relies on optimistic assumptions—that the eurozone would succeed in solving the problems of the countries in crisis within a reasonable amount of time, and that the United States would succeed in dealing with its budget problems (the "fiscal cliff") and would outline a credible policy for returning to a path of sustainable debt. In addition, the IMF estimated that the banks in Europe would need to markedly lower their leverage, which is liable to harm credit and growth. This month, global financial markets continued the relatively optimistic behavior that has characterized them since the ECB and the Fed declared new programs of large scale asset purchases. The yields and CDS spreads of the countries at the heart of the crisis continued to decline. In contrast, central banks and governments around the world continued to lower growth and inflation forecasts. Inflation remains low worldwide, and it continued to moderate in emerging economies. Commodity prices, which declined this month—and based on market assessments are expected to continue to decline—will also support this trend. A number of central banks lowered their interest rates this month. Disappointing corporate results were reported recently in the US, particularly in the high tech sector, and the sentiment among companies and analysts has deteriorated significantly in the past month.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR NOVEMBER 2012

Main points of discussion

The six 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 November 2012, four of the Committee members voted in favor of lowering the interest rate by 0.25 percentage points to 2 percent, while two Committee members voted in favor of keeping the interest rate unchanged.

The discussion focused on three main issues: (1) developments in the domestic economy; (2) developments in the global economy; and (3) developments in the housing market and the decision by the Supervisor of Banks.

Committee members were divided in their assessment of developments in the Israeli economy, with some identifying a further slight decline in the rate of growth in recent months. The pessimism seen in the various surveys (such as the Business Tendency Survey, the Purchasing Managers Index, and the Consumer Confidence Index) raises concerns of a further slowdown. At the same time, the effect of the fiscal restraint expected until the State Budget is approved is liable to have a negative impact on growth rates during the next few months. Other Committee members assess that following the slowing of the growth rates that took place a year ago, there has not been further slowing, despite the negative developments in the global economy. In their assessment, looking at the whole of 2013, they do not expect significant fiscal restraint.

The Committee members discussed developments in the global economy. In their assessment, the risk of financial crisis, primarily in the eurozone, has recently diminished. However, growth forecasts by the IMF, among others, regarding most countries, were lowered. At the same time, some of the Committee members noted that developments in the global financial markets did not indicate further worsening. In order to support their growth, various countries have reduced their interest rates, and other countries have adopted quantitative easing measures. The effective interest rate gap has therefore widened, which supports exchange rate appreciation. However, it was noted that in the past week, the shekel's appreciation has been halted.

In light of the increase in home prices in recent months and the increase in the number of transactions and volume of new mortgages against the background of the low interest rates in the mortgage market, the Committee members expressed their concern over a renewed upward trend in home prices, and discussed possible steps. In this framework, the Bank of Israel's Supervisor of Banks notified the members of the Monetary Committee of his decision to issue a directive limiting the loan-to-value (LTV) ratio in order to support the stability of the banking system. The Monetary Committee assessment is that the Supervisor of Banks' directive will serve to moderate the effects of lower interest rates on the home prices.

The main argument in favor of lowering the interest rate for November is that this could serve to encourage growth in the economy, and to help the economy deal with any further growth rate moderation in the future, as shown by various surveys, taking into account the delayed influence of monetary policy. Furthermore, since actual inflation as well as inflation expectations for the next year are near the midpoint of the inflation target range, lowering the interest rate would not endanger price stability.

The main argument in favor of leaving the interest rate unchanged is that since there has been no significant change in the economy's growth rate over the past few months, and primarily in light of the weakness of the global economy, the interest rate, after having been reduced by half a percentage point since the beginning of the year, appears appropriate for the economy. Those in support of leaving the interest rate unchanged believe that no evidence of a further slowdown in economic activity has accumulated thus far, and noted the negative effects that may develop in the economy from a low interest rate over an extended period.

Following the discussion, the six members of the Monetary Committee voted on the Bank of Israel's interest rate for November 2012. Four of the Committee members voted in favor of lowering the interest rate by 0.25 percentage points, and two Committee members voted in favor of leaving the interest rate unchanged.

In its announcement, the Bank highlighted the following main considerations underlying the decision to lower the interest rate for November by 0.25 percentage points to 2 percent:

- Indicators which became available this month continue to strengthen the assessment that there has been some moderation in the growth rate to about 3 percent. These indicators are consistent with the Research Department's forecast which was published last month. Expectations seen in consumer surveys and the Business Tendency Survey are pessimistic and indicate predictions of further moderation in activity. Economic activity in the first few months of 2013 is expected to be affected by the fiscal restraint inherent in the monthly expenditure limitation until a new budget is approved.
- The inflation environment moderated in the past six months, with the continued slowing of the increase in the housing index (primarily representing rents). The rate of inflation over the previous twelve months was at the midpoint of the inflation target range. Most inflation expectations for the coming year are also at the midpoint of the target range, against the background of the decline in commodity prices and, in contrast, the expected increases in food prices.
- Against the background of the debt crisis in Europe, the level of economic risk from around the world remains high, and with it the concerns over negative effects on the local economy. Macro data published this month in the US and in Europe were mixed, and for the most part surprised to the upside, but this was relative to already low forecasts. This month the IMF reduced its global growth forecast for 2012 and 2013. Inflation worldwide continues to be low, and it continued to

moderate in emerging market economies. Commodity prices, which declined this month, are also expected to support this trend. Central banks in major economies are continuing with quantitative easing programs, and several central banks reduced their interest rate this month.

- Home prices, as measured over the past 12 months, increased by 1.4 percent. However, home prices increased by 0.6 percent in the past month, and by 2.9 percent over the past 6 months. The increases in home prices in recent months and the continued growth in housing credit raise concerns of a continued increase in home prices.

Against the background of the necessity to provide further support for economic activity and in the absence of inflationary pressure, the Monetary Committee decided to lower the interest rate by 0.25 percentage points.

In light of the increases in housing prices in recent months and the continued growth in housing credit against the backdrop of low interest rates in the mortgage market, the Supervisor of Banks decided to issue a directive limiting the loan-to-value ration in order to support the stability of the banking system.

The Bank of Israel will continue to monitor developments in the Israeli and global economies and in financial markets, particularly in light of the continuing high level of uncertainty in the global economy. The Bank will use the tools available to it 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 keep a close watch on developments in the asset markets, including the housing market.

The decision was reached and announced on October 29, 2012.

Participants in the narrow-forum discussion:

Members of the Monetary Committee
Prof. Stanley Fischer, Governor of the Bank of Israel, Chairperson
Prof. Reuben Gronau, Member of the Monetary Committee
Mr. Barry Topf, Senior Advisor to the Governor on Monetary Policy Issues
Prof. Rafi Melnick, Member of the Monetary Committee
Dr. Karnit Flug, Deputy Governor of the Bank of Israel
Prof. Alex Cukierman, Member of the Monetary Committee

Other participants in the narrow-forum discussion:
Mr. Andrew Abir, Director of the Market Operations Department
Prof. Nathan Sussman, Director of the Research Department
Mr. David Zaken, Supervisor of Banks
Mr. Eddy Azoulay, Chief of Staff to the Governor
Dr. Yossi Saadon, Advisor to the Governor and Bank of Israel Spokesperson

Adv. Tida Shamir, General Counsel
Ms. Ziv Naor, Economist in the Research Department
Ms. Esti Schwartz, Monetary Committee Secretary