BANK OF ISRAEL
Office of the Spokesperson and Economic Information

January 21, 2019

Report on the Bank of Israel's discussions prior to deciding on the interest rate

The discussions took place on January 6 and 7, 2019.

General

The Monetary Committee sets the interest rate in a process that includes two discussions—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.

In the narrow forum—which consists of the Monetary Committee and the Director of the Research Department—the Research and the Market Operations Departments present their views of the main considerations that should guide the setting of the monetary policy. An open discussion on monetary policy 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.

A summary view of the economic situation available at the time of the Committee's discussion is presented in the notice regarding the interest rate decision, which was published on January 7th, and in the data file that accompanied the notice.

THE NARROW-FORUM DISCUSSION

The members of the Monetary Committee participating in the discussion decide on the appropriate rate of interest. After the discussion, it was decided to keep the interest rate unchanged at 0.25 percent. The decision was unanimous.

The discussion focused primarily on real economic activity, recent developments in financial markets, the inflation environment, and the expected path of monetary policy.

Main points of discussion

The Committee assessed that the slowing in economic activity this year reflects a combination of transitory factors and supply constraints, and looking forward it appears that the economy is converging to its potential growth rate. This assessment is mainly supported by the tight labor market—a low unemployment rate alongside a high job vacancy rate (demand for workers) and a high employment rate; these are reflected in wages that continue to accelerate, primarily in the business sector. The Committee members noted that the growth in imports also supports the assessment that the slowing rate of growth reflects a supply constraint, as the increase in domestic demand is satisfied by imports and less so by domestic production.

The Committee discussed the potential for declines in financial markets and the lack of stability seen in them in recent weeks to impact on the domestic economy. The members assessed that the developments to date will impact directly on the real economy to only a small extent. They assessed that an adverse impact in the value of the public's assets portfolio has a relatively small effect on private consumption (the wealth effect), among other reasons because a notable part of the public's financial wealth is held in pension funds and private consumption is not especially sensitive to their current returns. The Committee members were of the opinion that a greater risk to real activity is incorporated in the possibility that the lack of stability will contract companies' funding sources and make them more expensive, particularly in the high tech industry, though at least for now significant signs of that occurring are not seen. They were of the opinion that to date, it appears that the declines in financial asset prices are not anomalous in view of the prolonged period of rises that preceded it, and therefore their effect on domestic real activity is expected to be limited. In contrast to the above, the concern was raised that if the capital market declines abroad lead to a slowdown in advanced economies, it would negatively impact demand for Israeli exports.

The Committee members were of the opinion that the main risk from abroad derives from the real channel. The global economy is losing momentum, and it appears that the main drag on advanced economies is from Europe and Japan, while the US is growing at a reasonable pace. The global slowdown, the uncertainty regarding financial markets and regarding the ramifications of the trade war between the US and China, as well as the slowing pace of monetary policy normalization in advanced economies are liable to adversely impact demand for domestic output, also because they can lead to renewed appreciation pressures on the shekel.

Regarding the housing market, the Committee was of the opinion that the risk it poses to financial stability decreased, as described in detail in the Financial Stability Report published by the Bank of Israel in December. With that, the Committee emphasized that in order to support continued moderation in home prices, the pace of building starts needs to be accelerated, after it declined markedly in the past year.

Regarding the inflation environment, the Committee members noted that it is around the lower bound of the target range. Inflation expectations derived from the capital market, for all terms, are within the target range. However, the Committee noted that forward expectations for long terms (five-year, five year forward inflation) declined to below the midpoint of the target. Some of the Committee members claimed that the increase in the inflation rate is losing momentum, both looking backward and in terms of expectations, and that it derives from, among other things, the halt in the shekel's depreciation, the decline in energy prices, and from the slowing, to an extent, in activity in Israel and abroad. In contrast, other Committee members noted that the inflation rate appears relatively stable, and that the tight labor market and wage increases will ultimately be expressed in higher prices as well. In this regard, some of the Committee members claimed that the increase in demand for workers and the wage increases derive to some extent from enhanced competition, alongside the moderation of the inflationary pressures that it brings. Therefore, it is reasonable to expect that the pass-through from the wage increases to prices will be only partial. The Committee members noted that the government's efforts to reduce the cost of living are welcome. They agreed that although these moderate the measured inflation rate, but they noted that in order to set monetary policy the development of prices excluding their effects should be examined as well.

In the discussion on the monetary policy path, the Committee members assessed that in view of the robust state of the economy, while in contrast the enhanced risks, the process of raising the interest rate is expected to be gradual and cautious, so that it will support the increase in inflation to around the midpoint of the target range. They noted that the challenge of the policy is in the need to support inflation so as to return it to around the midpoint of the target range, while gradually reducing the level of monetary accommodation.

Participants in the narrow-forum discussion:

Members of the Monetary Committee:
Prof. Amir Yaron, Governor of the Bank and Chairperson
Dr. Nadine Baudot-Trajtenberg, Deputy Governor
Mr. Andrew Abir, Director of the Market Operations Department
Prof. Reuben Gronau
Prof. Moshe Hazan
Prof. Zvi Hercowitz

Other participants in the narrow-forum discussion:
Eddy Azoulay, Chief of Staff to the Governor
Yoav Soffer, Bank of Israel Spokesperson
Uri Barazani, Deputy Spokesperson of the Bank
Prof. Michel Strawczynski, Director of the Research Department
Dr. Yossi Yakhin, Economist in the Research Department
Ari Kutai, Economist in the Research Department
Esti Schwartz, Secretary of the Monetary Committee