BANK OF ISRAEL
Office of the Spokesperson and Economic Information

PRESS RELEASE

July 12, 2010

Report to the public on the Bank of Israel's discussions prior to setting the interest rate for July 2010

The discussions took place on 27 and 28 June 2010

General

Before the Governor makes the monthly interest rate decision, 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 Governor, the Deputy Governor, the directors of the Research and Market Operations Departments of the Bank and economists from various departments who prepare and present the material for discussion. The data, estimates and assessments in these minutes are those that were available at the time of the discussions.

In the narrow forum, the directors of the Research and Market Operations Departments and two other participating members of management present their recommendations regarding the interest rate and, following a discussion, the Governor makes his decision.

A. THE BROAD-FORUM DISCUSSION—THE STATE OF THE ECONOMY

1. Developments on the real side

General assessment

Indicators published in the last month (in the period between the discussions on the June interest rate held on May 24 and the current discussions on June 28) paint a mixed picture with regard to the rate of increase of economic activity. The National Accounts data for the first quarter of the year and initial data from the Bank of Israel's Companies Survey for the second quarter indicate continued expansion. The assessments that the rate of expansion is slowing are based on the monthly indices of private consumption (data for April–May), and on the only modest increase in the

POB 780 Jerusalem 91007 Israel
Tel: 972-2-6552712/3 Fax: 972-2-6528812 www.bankisrael.org.il

composite state-of-the-economy indices for April and May. Concern regarding a slowdown in activity arises from the fall in exports in April and May (in dollar terms), from the data in the Companies Survey relating to export orders for the third quarter of 2010 in the services and manufacturing industries, and from the sharp reduction in the Manufacturing Purchasing Managers Index in May.

National Accounts data for the first quarter of 2010

According to the updated National Accounts estimate, activity continued to expand in the first quarter, with growth based on increases in exports and private consumption. According to this estimate, GDP grew by 3.6 percent in the first quarter of 2010 (annual rate, seasonally adjusted, change from previous quarter—compared with the previous estimate of 3.3 percent). The National Accounts data show an increase of 4.8 percent (annual rate) in business sector product in the first quarter. The figures also show increases of 4 percent in private consumption, 4.1 percent in public consumption, 7.4 percent in goods and services exports, and 3.2 percent in investment in the principal industries.

The composite state-of-the-economy index

The May composite state-of-the-economy index rose by 0.1 percent, following a similar rise in April (each month compared with the previous one). The modest increases in the last two months strengthen the assessments of a slowdown in the pace of economic recovery.

The increase in May reflects, among other things, a 1.7 percent increase in manufacturing production in April, following its 0.3 percent increase in March; a 0.1 percent increase in trade and services revenue in April, following its 1.5 percent increase in March; and a drop of 0.9 percent in the services exports index in May, following its 14 percent jump in April. With regard to foreign trade, see below.

The labor market

The Manpower Survey data show a decline in the rate of unemployment in the first quarter of 2010 to 7.2 percent, from 7.3 percent in the last quarter of 2009 (seasonally adjusted). At the same time the participation rate in the civilian labor force dropped to 56.3 percent, from 56.6 percent in the previous quarter. There was a small increase in employment in the first quarter—an increase of 0.2 percent in the number of employees—with an increase of 8.1 percent in the number of those in part-time jobs and a reduction of 1.6 percent in the number of full-time employees. These changes were reflected in a decline of 0.5 percent in labor input in terms of work-hours in the first quarter compared with the previous quarter.

In March the number of Israeli employee posts fell by 0.2 percent from the number in the February (seasonally adjusted). In the three months January–March the number of employee posts increased by 2.2 percent compared with the number in the previous three months (annual rate, seasonally adjusted).

The nominal wage per employee post in the business sector (Israelis only) increased by 0.3 percent in March compared with the February level. In the three months January–March the nominal wage per employee post increased by 8.7 percent compared with the average in the previous three months, and the real wage increased by 7.1 percent (seasonally adjusted, in annual terms).

The monthly unemployment rate according to trend data was 6.9 percent in April 2010, similar to the March level. The monthly data, however, are based on a relatively small sample, so that the figures should be treated with caution.

Foreign trade

Goods exports (excluding diamonds) dropped by about 4.6 percent in May from their April level (in dollar terms, seasonally adjusted). In the three months March–May 2010 these exports expanded at an annual rate of about 6.1 percent (in dollar terms, seasonally adjusted) from their level in the previous three months.

Goods imports (excluding ships, aircraft and diamonds) declined by 0.3 percent in May from their April level (in dollar terms, seasonally adjusted). In the three months March–May these imports increased at an annual rate of 30.2 percent (in dollar terms, seasonally adjusted) from their level in the previous three months.

The Bank of Israel Companies Survey

Initial partial data from the Companies Survey for the second quarter (based on returns from 378 companies out of a total of 600) indicate that total economic activity continued to expand, albeit with some slowdown in the rate of increase. In total, companies that responded expect activity to continue to grow in the third quarter as a result of an increase in orders from the domestic market. In contrast, the returns point to a drop in export orders for the third quarter, particularly in the services and manufacturing industries.

2. Budget data

An analysis performed by the Bank of Israel Research Department shows that under the assumption of a 3.7 percent growth rate in 2010 in Israel, the budget deficit is expected to be significantly lower than the ceiling of 5.5 percent of GDP, at about 4 percent of GDP.

The main reason for the expectation of a deficit below the ceiling is that tax revenues are in excess of the forecasts made when the budget was prepared.

3. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) for May rose by 0.4 percent, close to the average of the private forecasters' predictions and slightly higher than the Bank of Israel's Research Department forecast of an increase of 0.3 percent. The seasonally adjusted index for May increased by 0.4 percent.

Since the beginning of the year the CPI has risen by 0.4 percent.

The 3 percent rise in the CPI in the last twelve months places it at the upper limit of the inflation target range.

The housing component of the CPI increased by 0.7 percent in May, following its 1 percent increase in April. In the last twelve months the housing index increased by a cumulative 4.8 percent (see below for a more detailed reference to the housing market).

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

One-year-forward inflation expectations derived from the capital market ("break-even inflation") increased in June (the average to 24 June) to 2.9 percent, compared with the May average of 2.7 percent.

The Israeli forecasters predict on average that inflation in the next twelve price indices (from June 2010 to May 2011) will be 2.6 percent. They assess that inflation in 2010 measured over the previous twelve months will be 1.9 percent. They expect inflation (over the previous twelve months) to decline gradually to reach 1.6 percent in August, and predict that it will then rise, to reach about 2.8 percent in a year's time.

The Israeli forecasters expect, on average, that the CPI will rise by a total of 1 percent in the three months May to July 2010.

With regard to the interest rate, the Israeli forecasters assess on average that the Bank of Israel's rate will increase in the next three months by a cumulative 0.4 percentage points, and that the rate in twelve months' time will be 3.0 percent.

An analysis of the slope of the *makam* yield curve indicates that the capital market expects the Bank of Israel interest rate one year hence to be about 2.4 percent.

The makam and bond markets

The yield to maturity on CPI-indexed five-year government bonds declined slightly in June (to 24 June) to an average of about 0.9 percent, from an average yield of about 1.1 percent in May. The yield on 5-year unindexed government bonds declined to an average of about 3.6 percent in June, from about 3.8 percent in May. The yield to maturity on one-year *makam* remained unchanged in June at about 2.1 percent, similar to its May level.

The interest rate differential and the yield gap between Israel and abroad

Prior to the current interest rate decision, the Bank of Israel interest rate was 1.25–1.50 percentage points higher than the US federal funds rate, and 0.5 percentage points higher than the ECB rate.

The yield gap between local currency unindexed ten-year bonds and ten-year US Treasury bonds contracted from 163 b.p. on 24 May to 151 b.p. on 25 June.

The expected real interest rate

The current Bank of Israel interest rate (in June) *minus* twelve-months-forward inflation expectations derived from the capital markets in June, prior to these discussions, averaged *minus* 1.3 percent, compared with *minus* 1.2 percent in May.

The monetary aggregates

In the twelve months up to and including May 2010 the monetary base measured by the M1 monetary aggregate (cash held by the public and demand deposits) increased by 12.2 percent; in May it decreased by about 0.2 percent. In the last twelve months the M2 aggregate (M1 plus unindexed term deposits of up to one year) increased by 4.2 percent, and in May it decreased by 0.2 percent. The rapid increase in M1 in the last year was mainly due to the public's switching from term deposits to demand deposits in light of the low level of the interest rate on term deposits.

The credit markets

The outstanding balance of bank credit to the business sector increased in April by 1.1 percent, after declining by 0.1 percent in March. Outstanding bank credit to households increased in April by 0.2 percent following its 1.3 percent increase in March.

The housing market

Based on the survey of house prices, housing prices (these are not included in the CPI, which measures the costs of housing rentals) increased in March by 0.9 percent, and in the twelve months to March (inclusive) by 21 percent, due both to the low rate of interest and to the slowness of the response of the supply of housing to higher prices.

Outstanding housing credit (mortgages) increased by 0.4 percent in April.

The Research Department estimate

This is the first time that in the course of the discussions on the interest rate, the Research Department presented a quarterly forecast that combines various indicators derived from models for forecasting inflation and real developments with discretionary assessments incorporated in an expanded DSGE (dynamic stochastic general equilibrium) model that brings together the information to obtain a consistent forecast.

The basic assumptions of the scenario presented were that world trade will increase by 7.4 percent in 2010 and by 6.0 percent in 2011, that interest rates in the major economies will not increase before the beginning of 2011, and that inflation around the world will remain low.

The Research Department assessment based on the above analytical framework was that inflation in the next twelve months will be close to the midpoint of the target inflation range, at 1.8 percent. Inflation is expected to be 1.3 percent in 2010, and 2.1 percent in 2011. This, based on a derived increase in the Bank of Israel interest rate to an average of about 1.8 percent in the third quarter of 2010, and to 2.5 percent in a year's time.

4. The foreign currency market and the share market

The foreign-currency market

During the period from 24 May to the current discussions (25 June), the shekel weakened against the dollar, with the exchange rate rising from NIS 3.81 to the dollar to NIS 3.86, a depreciation of 1.3 percent. In this period the shekel depreciated by 1.1 percent against the euro, from NIS 4.71 to the euro to NIS 4.76. Measured by the nominal effective exchange rate of the shekel, calculated as the trade-weighted average shekel exchange rate against 28 currencies (representing 38 of Israel's trading partners), the shekel depreciated by about 1.9 percent.[1]

The share market

The Tel Aviv 25 share price index on 24 June was about 2.6 percent lower than on 24 May. The Dow Jones index rose by about 1 percent in that period.

[1] The weight of the dollar in the effective exchange rate is about 25 percent, and that of the euro, about 33 percent.

5. Israel's financial risk, the sovereign risk premium

Israel's risk premium, as measured by the five-year credit default swap (CDS) spread, decreased between the previous and the current interest rate discussions, from 1.24 percentage points to 1.13 percentage points. CDS spreads around the world followed a similar trend of contraction, including those of the peripheral European countries (except for Greece, whose CDS continued to widen).

6. Global economic developments (see Appendix for further details)

In the month between the previous interest rate discussions and the current ones, growth figures for the first quarter of 2010 became available that indicated that the global recovery was continuing and that it had even accelerated compared with the rate in the previous quarter. However, for many advanced economies data relating to the second quarter point to a slowdown in the rate of expansion in the global economy. Investment houses around the world expect the global rate of growth to slow in the second half of 2010, against the background of the ending of the positive effects of the fiscal aid programs and continuing monetary expansion in some countries, and against the background of the expected slowdown in growth in Europe.

Many forecasters in investment houses around the world this month reduced their growth forecasts for 2011, in particular for Europe. At the same time, the weakness of the euro against most currencies is expected to help Europe's economy.

There is considerable concern among investors regarding countries with high public debt and/or large budget deficits, and in several European countries, including the UK, the authorities announced fiscal measures to reduce their budget deficits. That said, the need for fiscal consolidation in several leading economies and for regulatory reforms and changes leaves the markets with a large measure of uncertainty. Active participants in the global financial markets remain very sensitive to any indication of weakness.

Expectations regarding interest rates in the major central banks in 2010, reflected in the conduct of financial market traders, are that interest rates in the US, Europe and Japan will not change before the end of the year. In other words, compared with the assessments at the beginning of the year, the expected timing of increases in interest rates by the leading central banks has been postponed.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR JULY 2010

In the narrow-forum discussion, four members of management make recommendations to the Governor regarding the appropriate rate of interest for the economy. In the discussions on the interest rate for July, all the participating members of management recommended that the Governor hold the rate unchanged at 1.5 percent.

As stated in the reports of previous interest rate discussions, the Bank of Israel's policy is to continue with the gradual process of bringing the interest rate back to a more "normal" level intended to position inflation firmly within the target range, and to contribute to the further recovery of economic activity, while supporting financial stability. The path of the interest rate will be determined in accordance with the inflation environment, the entrenchment of growth in Israel and globally, the rate at which the major central banks increase their interest rates, and in light of developments in the exchange rates of the shekel. At the current level of the interest rate, monetary policy continues to be expansionary.

In the discussion, participants noted that according to the Bank of Israel assessments and those of the private forecasters, inflation measured over the previous twelve months will continue to decline, and in the next few months it will be around the midpoint of the target inflation range or even below it. It was noted that in the basic scenario of the Research Department assessment, which combines discretionary assessments and the results of several models, inflation a year hence is expected to be close to the midpoint of the target inflation range. The assessments of the private forecasters and inflation expectations derived from the capital market are that inflation in a year's time will be in the upper part of the inflation target range. The range of expectations, given the current data, is that the Bank of Israel's interest rate will increase by between 1 and 1.5 percentage points in the next twelve months.

It was noted in the discussion that inflation expectations one year forward calculated from the capital market increased in June (average for the month) and were close to the upper limit of the target range. Some of the participants interpreted this as a rise in expected inflation, while others stressed the possibility that technical factors unrelated to changes in inflation expectations a year ahead had affected CPI-indexed bond prices (according to this view, a drop in the supply of short-term CPI-indexed government bonds caused a liquidity problem in the CPI-indexed bond market, and led to a decline in the yield on these bonds relative to the yield on unindexed bonds with a one-year horizon).

Data published since the previous interest rate discussions indicate that the expansion in real economic activity in Israel is continuing, with increased uncertainty regarding the continuation of the rapid rate of growth. Participants noted in particular the greater uncertainty regarding exports in light of global developments and their implications for Israel's economy. In addition, the weakness of the euro against the shekel reduces the profitability of Israel's exports to the eurozone and makes it more difficult for Israeli exporters to compete with European competitors.

The timing of increases in the interest rate in Israel relative to those in the leading economies affects the shekel exchange rate. Participants in the discussion noted that as a result of economic data from around the world published recently and concern over the debt crises in several European countries, the timing of increases in interest rates in Europe and most advanced economies will be delayed, and increases in their interest rates are not expected before the end of 2010.

Taking into consideration the various points made in the discussion, the Governor decided to keep the interest rate for July unchanged at 1.5 percent.

In its announcement of the decision, the Bank of Israel stressed the following conditions that led to the decision to leave the interest rate unchanged for July:

- The inflation environment: inflation measured over the previous twelve months is falling, and is expected to continue to do so, and in the next few months is expected to be close to the midpoint of the target range or even below it. Inflation expectations, both of forecasters and those calculated from the capital market, are that in another year the inflation rate will return to the upper part of the inflation target range, with a cumulative interest-rate increase of between 1 and 1.5 percentage points in the next twelve months.

- Uncertainty regarding the continuation of rapid growth has increased. Global economic developments, mainly those in Europe, are likely to have a negative impact on Israel's growth, and in particular on Israel's exports.

- Interest rates of the central banks of the leading advanced economies are very low, and are expected to remain so longer than originally anticipated. In addition, the ECB has reintroduced some of the special instruments of monetary accommodation.

The Bank of Israel will continue to act to achieve its objectives of price stability, the encouragement of employment and growth, and support for the stability of the financial system.

The decision was made and published on June 28, 2010.

Those participating in the narrow-forum discussion:
Prof. Stanley Fischer, Governor of the Bank of Israel
Prof. Zvi Eckstein, Deputy Governor of the Bank of Israel
Dr. Karnit Flug, Director of the Research Department
Dr. Edward Offenbacher, Member of Management and Head of the Monetary and Finance Division, Research Department
Ms Irit Mendelson, Assistant Director of the Market Operations Department
Dr. Ohad Bar-Efrat, Advisor to the Governor and Head of the Information and International Affairs Division

Mr. Eddy Azoulay, Chief of Staff to the Governor
Dr. Yossi Saadon, Advisor to the Governor and Bank of Israel Spokesperson

Appendix: Major Global Economic Developments

US

The leading indicators of economic activity point to a slowdown in growth in the second half of 2010, but not a return to recession. The slowdown is expected against the background of the ending of the effect of fiscal expansion domestically and abroad and the increase in stocks in the first half of the year.

The US economy grew by 3 percent, annual rate, in the first quarter of 2010, led by manufacturing activity and supported by the global recovery and the weakness of the dollar, which helped US exports, and by the continued rebuilding of stocks and investment in equipment. Foreign investment houses expect on average that growth will accelerate in the second quarter to a rate of 3.7 percent , and that it will then ease to between 2.8 percent and 3.2 percent (annual rates) in the next three quarters.

Some of the economic indicators continue to point to a recovery in economic activity. The first manufacturing surveys published for May, however, including the Empire State Manufacturing Survey of the Federal Reserve Bank of New York and those of the Federal Reserve Banks of Philadelphia and Richmond, indicate signs of a slowdown. In addition, the New York Fed's survey notes that in May the level of optimism regarding future business conditions declined, and the Chicago Purchasing Managers Index showed a slowdown in business activity in May. Moreover, the level of activity remained below the pre-crisis levels, and reflect a slower recovery in consumer and business spending than had been expected.

Concern over the risks facing the US economy because of the European debt crisis and its implications also cast a cloud over the recovery. The planned fiscal cuts in countries in the eurozone are expected to have a negative impact on US exports to Europe, and the strengthening of the dollar against the euro too is expected to have a negative effect on US exports to Europe and to the rest of the world.

Moreover, the growth is not creating a real increase in employment, and the economy is still confronted by a weak labor market. The number of claims for unemployment benefit remains high, and the rate of utilization of production capacity increased to 74.7 percent, which is still below the average level of the last four decades.

The weakness in the housing market also persists, and continues to keep growth down. The latest housing market data show a sharp drop in activity following the ending of the tax benefit for first-time house buyers, indicating that the market is still dependent on government support. Thus, the number of building starts fell in May. The number of mortgage applications also declined.

Against the background of the weakness in the labor market, the low level of utilization of production capacity, the slow recovery of consumer spending and the high level of stocks in the housing market, inflation indices remain low, and the risk of deflation is higher than the risk of inflation. The CPI continued to decline and dropped by 0.2 percent in May, following a fall in fuel prices. The investment houses on average expect a decline in the inflation rate in 2010 from 2.3 percent in the first quarter to 0.9 percent in the fourth quarter.

Against this background, the Fed is expected to leave the interest rate at a low level at least till the beginning of next year. The investment houses revised their interest rate predictions, and now expect on average that the interest rate will start to rise only in 2011. Futures contracts price in a similar trend.

Europe

The euro bloc economy grew by 0.8 percent (annual rate) in the first quarter of 2010, with marked differences between the different countries, with Germany and France showing the strongest growth. On the one hand, the sharp depreciation of the euro against most other currencies is expected to help Europe's exports. On the other hand, the consumer confidence index remains low in light of rising unemployment and the persistent fiscal crisis.

Growing uncertainty over the debt crisis, the stability of the European banking system and the possible effects of the budget cuts introduced in most countries continue to cast a shadow over the European economy. The reduction in Greece's credit rating by Moody's, who reduced Greek bonds to the Ba1 junk rating (Ba1) following the downgrading by Fitch and S&P, and Germany's announcement prohibiting selling financial assets short, similar to the announcement by the new government in Hungary that the fiscal situation was more serious than reported previously, added to the uncertainty and concern. The reduction of Spain's debt rating by Fitch from AAA to AA+ and the announcement of the nationalization of a small regional bank in Spain while four regional banks had to merge caused concern that the crisis in Spain's banking system was becoming more severe, and led to apprehension of contagion affecting other European countries. Rumors that Spain would receive support from the EU and the IMF caused a steep jump in yields on Spanish government bonds, but following the successful bond issue by the Spanish government the yields fell again, with the government managing to raise €3.5 billion with a yield of 4.86 percent, lower than the market yield prior to the issue.

Many governments reacted by announcing programs of cuts and reforms, including Italy, Spain, France, Germany, Greece and Switzerland. The UK also announced deep budget cuts that incorporated reduced expenditure, increased taxes and surcharges on banks, in an attempt to reduce the large budget deficit. In addition, to calm the markets the Spanish government announced that it would publish the results of banks' stress tests (measuring banks' resilience), which was followed by a German government announcement that it would also publish stress test results on the German banks by the end of July.

The expected reduction in consumer spending in light of increased unemployment and the budget cuts, in conjunction with the global slowdown expected later in the year and the effect of the continuing financial pressure related to the debt crisis, are expected to lead to a slowdown in European growth. The investment houses on average expect growth of 2.5 percent (annual rate) in the second quarter, slowing to 1.8 percent in the third quarter and 1.5 percent in the fourth.

The investment houses on average base their calculations on the expectation that the ECB will leave the interest rate unchanged till the end of the first quarter of 2011, and will then start to increase the rate gradually. Futures contracts price in the probability of an increase in the interest rate as early as in the fourth quarter of 2010, with an increase to 1.25 percent by the end of the second quarter of 2011.

Japan

Economic growth in Japan accelerated in the first quarter of 2010, mainly due to the export sector. The investment houses on average predict deflation in the coming year.

This led policy makers to take several measures. As expected the central bank left the interest rate unchanged at 0.1 percent, and it announced a program of one-year loans to growth-supporting industries totaling ¥3 trillion ($33 billion), and 0.1 percent interest, in an attempt to avoid deflation and support the recovery of the Japanese economy.

The government introduced growth-supporting measures, including cuts in the rate of corporate taxes and means of opening the economy to foreign companies. It also announced a program to halt the increase in public debt.

The emerging markets

China's economy grew at an annual rate of 11.9 percent in the first quarter of 2010. The data on activity in May indicate increased consumer spending and exports. However, there are now signs that the policy measures taken to cool the economy, particularly in the housing market and public sector investment, are starting to have an effect. The Purchasing Managers Index declined in May, and manufacturing production rose by less than expected.

Slower growth in China is likely to have an effect on other Asian economies which have till now shown high rates of growth.

At the same time, inflation in China accelerated against the background of the rise in real estate prices. The announcement that China would allow flexibility in fluctuations in the exchange rate of the yuan is likely to help restrain inflation in China.