BANK OF ISRAEL
Office of the Spokesperson and Economic Information

December 6, 2010

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

The discussions took place on November 21 and 22, 2010

General

Before the Governor makes the monthly interest rate decision,[1] 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 from the decision on the November interest rate, on October 25, till the current decision, on November 21), showed that economic activity continued to increase in the third quarter of 2010, with a convergence towards full capacity utilization of the production factors.

[1] When the Monetary Committee is appointed, in accordance with the new Bank of Israel Law, interest rate decisions will be made by the Committee.

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Third quarter data show that the rate of growth slowed relative to that in the three previous quarters, when there was rapid growth characteristic of an exit from a recession. The main reason for the slowdown in growth in the third quarter was the decline in foreign trade, against the background of its rapid increase since the middle of 2009, and the slowdown in world trade.

Several indicators point to continued economic recovery. The Purchasing Managers Index increased steeply in October due to the growth in the components of export demand (namely, export **orders** received during October, following the decline in the third quarter) and in production output. The Google search index of the Bank of Israel Research Department shows that the probability of a recession fell to below 50 percent. Labor market data indicate that the economy is approaching a full employment environment.

Negative indicators include October data on foreign trade, and third-quarter data from the Manufacturers Association survey of expectations (see below). Two consumer confidence indices (Globes and Bank Hapoalim) declined slightly in October, but remained at a relatively high level. The composite state-of-the-economy index for October, which increased by 0.1 percent (see details below), also indicates a slower rate of growth than in the first half of the year.

The National Accounts

According to the initial National Accounts estimate for the third quarter of 2010, published on November 16, GDP grew at an annual rate of 3.8 percent, following a growth rate of 4.2 percent in the first half of the year. Business sector product expanded at an annual rate of 3.9 percent in the third quarter, following its 4.9 percent increase (annual rate) in the first half. Goods and services exports fell by 9.6 percent in the third quarter, the first decline after four quarters of rapid growth. Investment continued to grow swiftly in the third quarter, albeit more slowly than in the first two quarters of the year: fixed investment expanded at an annual rate of 9.7 percent, with a 13.2 percent surge in residential investment. A 10.2 percent increase in public consumption also supported GDP growth. Private consumption expanded at an annual rate of 1.3 percent in the third quarter, compared with a rate of 6.7 percent in the second quarter. Imports decreased by 4.6 percent in the third quarter, the first drop after five quarters of rapid increases.

The composite state-of-the-economy index

The October composite state-of-the-economy index increased by 0.1 percent from its September level, and the index for September was adjusted from no change to an increase of 0.1 percent. The indices for July–October reflect a slowdown in the rapid growth that typified the exit from the crisis (from summer 2009).

The moderate increase in the October index was the result of the positive effect of imports (in particular of consumer goods but also of inputs) partially offset by the negative effects of other components—exports (of goods and services), manufacturing production, and trade and services revenue.

The index of consumer goods imports rose at a rate of 15.7 in October, and that of imports of production inputs by 1.8 percent. The index of goods exports fell by 0.5 percent in October, and that of services exports by 3.2 percent. The index of manufacturing production declined in September by 3.8 percent (the October index is not yet available), after dropping in August too. The September index of trade and services revenue fell by 0.7 percent, after rising a bit in August. See below for data on foreign trade.

The labor market

Labor market indicators for the third quarter point to continued improvement and a convergence towards a full employment environment. Central Bureau of Statistics (CBS) data show an unusually steep increase in the number of vacancies in October, 68,200, compared with 55,000 in September. The figures for both months are preliminary, however, and are likely to change.

The total number of business sector employee posts increased by 3.4 percent in June–August, compared with the same period in 2009. Employment increased in many industries; in particular in banking and financial services, business services and transport and communications.

The nominal wage per employee-post in the business sector increased by 4.6 percent in June–August, from its level in June–August 2009, and the real wage by 2.6 percent. Health tax revenue in September shows that total wage expenditure continued to increase rapidly (in September, comparing to August 2010).

The trend data for the monthly unemployment rate showed unemployment at 6.3 percent in the months June–August 2010, similar to but above the rate prior to the crisis. The monthly figures are based on a relatively small sample, however, so that the estimate should be treated with caution.

Foreign trade

In October, goods exports (excluding ships, aircraft and diamonds) increased by one percent in dollar terms (seasonally adjusted) from their September level. In terms of the nominal effective exchange rate, however, they fell by about 2 percent. The changes in exports, an increase from the middle of 2009 to the middle of 2010 and a decline in the last few months, parallel those in world trade.

Goods imports (excluding ships, aircraft and diamonds) increased by a buoyant 9.2 percent in dollar terms (seasonally adjusted) in October, from their September level. In terms of the nominal effective exchange rate they increased 5.9 percent. This was partly due to an exceptional 50 percent surge in car imports. The increase in imports of current consumer goods was preceded by several months when they decreased: as noted above, in the third quarter imports fell at an annual rate of 4.6 percent (in real terms, seasonally adjusted).

The "Expectations of manufacturing-sector survey" of the Manufacturers' Association

The trends evident from the "Expectations of manufacturing-sector survey" of the Manufacturers' Association carried out in the third quarter are consistent with those reported in the Bank of Israel Companies Survey. The Manufacturers' Association survey shows that growth in manufacturing output continued, and even accelerated somewhat in the third quarter. The growth reflected a sharp increase in activity on the domestic market, with a reduction in exports. The increase in output was based on greater equipment utilization, with continued recruitment of labor at a rate similar to that in the first half of the year. Recruitment efforts met with greater difficulty in finding skilled staff: about eighty percent of manufacturers reported encountering such a difficulty, a rate similar to that noted prior to the crisis.

Manufacturers also reported, however, on a marked slowdown in the rate of increase in export orders in the third quarter, and expectations of a further slowdown in the fourth quarter.

2. Budget data

Tax revenues increased at a faster pace in August–October, except for gross receipts of VAT on domestic production, which remained steady. Tax revenues in the three months August–October, seasonally adjusted and allowing for changes in tax legislation and nonrecurring receipts, were 2.5 percent higher than in May–July.

The domestic deficit in October, excluding credit, was NIS 2.1 billion, NIS 0.5 billion less than the deficit implied by the seasonal path consistent with the budget. The deviation from the expected seasonal path derived from tax revenues that exceeded the expected amount by NIS 2.3 billion, partially offset by expenditure that exceeded the planned amount by NIS 1.8 billion.

Since the beginning of the year, the domestic deficit (excluding credit) has totaled NIS 12.9 billion, 1.6 percent of GDP. This is lower than the deficit according to the seasonal path, mainly because of higher than expected revenues (about 5 percent in excess of the budget), but also due to under-expenditure of the budget (by 1.6 percent). The under-expenditure was the result of the over-estimate of interest expenditures. For purposes of comparison, the deficit (excluding credit) in the same period last year, January–October 2009, was NIS 21.8 billion.

Based on developments to date and on the assumption of almost complete expenditure of the budget, and assuming the upward trend in tax revenues will persist until the end of the year, the total deficit (excluding credit) in 2010 is expected to amount to less than 4 percent of GDP (compared with the ceiling of 5.5 percent of GDP).

3. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) for October increased by 0.3 percent. Although the overall index was in line with expectations, this was the net result of surprising changes in the individual components of the index: the housing index declined by 1.1 percent, while the index excluding housing "compensated" by an increase of 0.7 percent.

Since the beginning of the year, the seasonally adjusted CPI has increased by 1.9 percent, consistent with an annual rate of inflation of 2.1 percent. In the last twelve months the CPI has increased by 2.5 percent, within the target inflation range.

Despite the surprising decline in the housing rental component of the index in October, the increase in the overall index since the beginning of the year has been led by the increase in house rentals, with the other components increasing only moderately. The housing index has risen by 4.5 percent since the beginning of the year, while the index excluding housing has increased by only 1.5 percent. Since the unexpected changes in October—the decline in the housing index and the increase in the index excluding housing—relate to a single month, it is too soon to consider it as a turning point.

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

Market-based one-year-forward inflation expectations ("break-even inflation") increased to about 3.2 percent in November (the average to November 18), compared with an average of 3.0 percent in October.

The Israeli forecasters predict on average that inflation in the next twelve price indices (from November 2010 to October 2011) will be about 2.9 percent. On average they expect that inflation measured over the previous twelve months will be 2.5 percent in 2010, and 2.8 percent in 2011.

The forecasters expect, on average, that in the three months November 2010 to January 2011 the CPI will rise by a total of 0.2 percent.

About half of the forecasters had expected the Bank of Israel interest rate to increase by a quarter of a percentage point for December, while the other half had expected no change. On average they expect that in twelve months' time the interest rate will be 3 percent.

The makam and bond markets

From the beginning of the month to November 18, yields on 5-year CPI-indexed government bonds were, on average, about 0.7 percent, similar to the average in October. The yield to maturity on unindexed 5-year government bonds increased slightly in November, to an average of 3.7 percent, from 3.6 percent in October. The yield to maturity on one-year *makam* was about 2.4 percent, similar to the average level in October.

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 1.75–2.0 percentage points higher than the US federal funds rate and 1 percentage point higher than the ECB rate.

The yield gap in shekel terms, between ten-year unindexed Israeli and US government bonds, contracted slightly to 1.7 percentage points from the time of the previous interest rate decision to the current one.

The expected real interest rate

The Bank of Israel interest rate—*deflated* by the twelve-months-forward inflation expectations derived from the capital markets—averaged *minus* 1.2 percent in November (to the date of the current discussions), below the level of *minus* 1 percent in October.

The monetary aggregates

The marked slowdown in the rate of increase in the monetary aggregates continued, against the background of the increases in the interest rate in the last few months. In the previous twelve months up to (and including) October, the monetary base measured by the M1 monetary aggregate (cash held by the public and demand deposits) increased by 4.6 percent. In October it decreased by about 1.2 percent relatively to the previous month. In the last twelve months the M2 aggregate (M1 plus unindexed term deposits of up to one year) increased by only 0.9 percent, while in October it declined by 0.2 percent relatively to September.

The credit markets

The outstanding balance of credit to households continued to increase (data up to September), and since the beginning of the year it has increased by about 7 percent, with a similar increase in total outstanding mortgages. In September households' total debt increased by 0.3 percent, with outstanding mortgages increasing by 0.7 percent.

The total outstanding balance of bank and nonbank credit to the business sector has increased by 2.7 percent since the beginning of the year; in September it increased by only 0.2 percent.

The housing market

The housing component in the CPI, which reflects the costs of housing rentals and accounts for about 20 percent of the total CPI, has increased by 4.5 percent since the beginning of the year, but in October it declined, by 1.1 percent. However this decline relates to only one month, and thus cannot be considered the start of a turnaround in the trend of the price of housing services. One possible explanation, for the sharp change in the housing component in October, is the characteristic seasonal factor, with price changes in the winter months generally lower than average. From December 2009 to February 2010, for example, there was a cumulative fall of 2.1 percent in this component, followed by renewed sharp increases.

House prices, however, which are not included in the CPI and which are taken from the Central Bureau of Statistics (CBS) survey of house prices, continued to increase, and on average increased by 1.9 percent in August–September, giving a cumulative increase of 19.7 percent in the past twelve months. In this case there are conflicting data: Treasury data, based on the median transaction, suggest that house prices have been declining for a few months, while the CBS data suggest that house prices continue to increase at a rapid rate.

The volume of new mortgages granted in October increased by a steep 11 percent compared with the level in September, to NIS 3.58 billion. All types of mortgage showing increases, but the most prominent increase, of 27 percent, occurred in CPI-indexed mortgages at floating interest rates. It should be noted that in September there was a sharp decline compared with the previous month, due in part to the period of the Jewish High Holydays and to the high volume of mortgages in the summer months. The flow of new mortgages granted in October was similar to the levels in the summer months. With regard to the different types of mortgages, the sharp increase in the flow of indexed floating interest mortgages took place against the background of the reduction in interest on mortgages of that type, alongside increases in the interest rate on the other two types—unindexed floating interest, and fixed interest.

The Research Department assessment

Prior to the interest rate discussions, the Research Department prepares an assessment of expected economic developments and an analysis of various risks. The assessment is formulated using a medium-scale DSGE (Dynamic Stochastic General Equilibrium) model, which helps to integrate the Department's views into a single, coherent, staff forecast.[2]

According to the staff forecast, inflation in the next twelve months is expected to be 2.5 percent, and the Bank's interest rate is expected to increase gradually to reach about 3.0 percent in a year's time. The main reason for the forecast being above the midpoint of the inflation target range is the housing component (rentals), which is expected to continue increasing relatively quickly, and energy and commodity prices which have increased considerably in the last few months. Factors acting in the opposite direction, to slow the rate of price increases, include the low rate of inflation around the world and the appreciation of the shekel in the last few quarters.

The main risks to real economic activity and inflation in Israel derive from developments abroad. Nevertheless, a renewal of massive capital inflows into Israel, should that occur, with the pressures towards appreciation that they cause, would have a moderating effect on growth and inflation, and a slowing effect on the pace of interest rate increases.

4. The foreign currency market and the share market

The foreign-currency market

During the period from October 24 to November 19, the shekel appreciated by about 0.5 percent in terms of the nominal effective exchange rate.[3] This reflected, among

[2] For an explanation of the model and its use see the Bank's Inflation Report No. 31, for April–June 2010.

[3] Calculated as the trade-weighted average shekel exchange rate against 28 currencies (representing 38 of Israel's trading partners). The weight of the dollar in the effective exchange rate is about 25 percent, and that of the euro, about 33 percent.

other things, shekel appreciation of 1.4 percent against the euro, and deprecation of 0.1 percent against the dollar. During this period the Bank of Israel bought foreign currency.

The share market

Since the previous interest rate discussions, the Tel Aviv 25 share price index was steady—after a few days of reductions, the index increased again to the peak level it had reached in October following the upward trend that started in the middle of the year. This was similar to the trends in most stock markets around the world in that period.

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 slightly to 111 basis points (b.p.), from 116 b.p in the previous month. This contrasted with the trend in CDS spreads around the world, which showed increases with the indications of the renewed debt crisis in Europe.

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

This month's economic data (the data becoming available between the meeting on October 24 and that on November 22) present a mixed picture, with the US standing out with its positive performance, and Europe with a negative one. Assessments, both of the investment houses and of international institutions, are that the process of recovery of the global economy from the trough it had reached was continuing, and the probability of another recession had fallen. Some investment houses increased their forecasts of growth for the coming months; the OECD, in contrast, revised its forecast downwards. There is great uncertainty regarding the rate of growth of the global economy, which constitutes a central risk factor for the Israeli economy. Uncertainty remains high against the general background of the debt crisis in some European countries, in particular Ireland.

Inflation in the advanced economies remains low, mainly due to their output gaps. In the emerging market economies, however, inflationary pressures grew, mainly due to the increases in commodity prices.

Intervention in the foreign currency markets continued in several countries this month. This included the imposition of restriction on capital movements. Monetary policy continued to be expansionary in the leading economies, and in the US another quantitative easing program was launched, known as QE2. The Fed program is expected to affect the monetary policies of other central banks around the world, mainly those that have started moving to tighter monetary policies, and to present a challenge regarding the persistent appreciation of domestic currencies, increasing capital flows, and increasing inflation. Several central banks, in economies that have already started growing relatively rapidly, continued increasing interest rates—India, Sweden, Australia, Chile and South Korea increased their interest rates this month—against the background of positive macroeconomic performances and the increase in commodity prices (mainly metals and agricultural commodities). Thereafter, in light of concern over a possible increase in the interest rate in China, there was a sharp correction to commodity prices.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR DECEMBER 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 current discussions on the interest rate for December, all the participating members of management recommended that the Governor leave the interest rate unchanged, at 2.0 percent. They also recommended that, as part of the process of normalizing monetary policy, the interest rate corridor around the Bank's interest rate in the credit window and the commercial banks' deposit window be widened to ±0.5 percent (during the crisis it had been reduced to ±0.25 percent).

Leaving the interest rate at 2 percent is consistent with the process of gradually restoring a more normal interest rate environment—a process aimed at stabilizing inflation within the target range, and supporting further growth of economic activity while maintaining financial stability. The pace of interest rate increases is not predetermined, but is set in accordance with the inflation environment, growth in Israel and globally, the monetary policies of the major central banks, and in light of developments in the exchange rates of the shekel. At the current rate of interest, monetary policy continuous to be expansionary.

Several issues were discussed, in particular the global economic environment, real economic activity, developments in the credit and assets markets and the inflation environment.

In the discussion it was noted that data published in the month since the previous interest rate discussions (since the decision on interest rate for November, on October 24, till the last one, on November 21) show that the expansion in economic activity is continuing, albeit at a slower pace. Special attention was drawn to the decline in exports in the last few months, following their rapid expansion in the first half of the year—a decline which was also due to the weakness in world trade. Participants in the discussion spoke of the risks to economic growth arising from the slowdown in the recovery of demand in the industrialized countries.

One-year-forward inflation expectations derived from the capital market (break-even inflation) increased again in November, and averaged (until November 18) 3.2 percent. Private forecasters' expectations for the increases in the next twelve CPIs (the indices from November 2010 to October 2011) averaged 2.9 percent. The Bank of Israel Research Department twelve-month inflation forecast, however, is about 2.5 percent. There was discussion of the factors exerting upward pressure on inflation: the housing market, the approach toward full capacity utilization—as reflected in labor market data and in investment in fixed assets—and the rise in world commodity prices. Against this, however, the risks to global growth and the moderating influence of developments around the world on Israeli inflation in the coming months were also discussed.

In this discussion, housing featured high on the list of inflationary pressures discussed. In the last year the housing component of the CPI (based on rentals) was the main inflationary factor. In the last twelve months the CPI increased by 2.5 percent, and the index excluding housing went up by only 1.4 percent. The point was made that the sharp and surprising decline of 1.1 percent in the housing component in October does not give grounds for concluding that there has been a turnaround in the price of rentals. If anything, it is still the other way around: in light of the gap that has arisen between the increase in house prices (19.7 percent in the twelve months to September) and the increase in rentals (4.7 percent in the twelve months to October) rentals may continue to increase. The (rentals) housing component is the main reason that inflation is expected to be above the midpoint of the target inflation range in the coming year.

With regard to financial stability, the contribution of the low interest rate to developments in the credit markets – especially its contribution to the increase in asset prices, particularly real estate prices – was discussed. House prices continued to increase rapidly in the last year, due partly to the slow adjustment of the supply of apartments, but also due to the fast increase in housing credit arising from the low rate of interest. In the discussion emphasis was given to the sharp increase in house prices which itself—and not its indirect effect on inflation—made the Bank introduce macroprudential measures which were taken recently. Other, even stricter, measures were discussed, which would be taken as necessary. The need to cool the rapid expansion of mortgage interest was stressed again, not primarily from the inflation aspect, but rather from the financial stability aspect.

Developments worldwide were reviewed, including the quantitative easing in several leading economies (and especially the QE2 program in the US), and their low interest rates. These present a challenge to monetary policy makers in economies with relatively buoyant demand, such as Israel's; the challenge of dealing with the combination of domestic demand and capital inflows on one side, and the weakness of world trade on the other. The difficulty becomes more acute in light of the interest rate differentials, the result of the process of increasing interest rate that has started in countries recovering relatively rapidly, Israel among them.

In light of the indications of a slowdown in the growth rate of the Israeli economy, led by a decline in exports against the background of greater uncertainty about world growth, and in light of the macroprudential measures introduced by the Bank of Israel and their implications for inflation, the Governor decided to keep the rate of interest unchanged for December, at 2 percent.

In its announcement of the decision, the Bank of Israel emphasized the following points:

- Inflation in the last twelve months is within the target range, and according to assessments of the private forecasters and of the Bank of Israel Research Department it is expected to be slightly above the upper limit of the inflation target range in the first half of 2011, and then to return to within the target range. Inflation expectations derived this month from the capital market for one year ahead were slightly above the upper limit of the target range.

- Most of last month's economic indicators support the assessment that economic activity continued to expand in the third quarter and in October. The decline in exports, however—reflecting the effect of the weakness of world trade—following the rapid increase in exports in the first half of the year, also featured prominently in the data. The lack of certainty regarding the rate of domestic growth, deriving from uncertainty about global demand, still constitutes a significant risk factor.

- Interest rates of the leading advanced economies' central banks are low, and are expected to remain low for a long time; the Fed reintroduced instruments of quantitative easing. Against this background, the differentials between interest rates in countries with relatively rapid rates of growth, including Israel, and those in the advanced economies present a serious challenge for policy makers in the rapidly growing economies, who need to strike a balance between domestic pressures to increase the interest rate on the one hand, and the effect such an increase may have with regard to appreciation of their currency and, in turn, on exports and economic activity, on the other.

As part of the process of normalizing monetary policy, the Bank of Israel decided to widen the interest rate corridor around its interest rate in the credit window and the commercial banks' deposit window from ±0.25 percent to ±0.5 percent.

The Bank of Israel stated that it will continue to use the instruments available to it in order to achieve its objectives of price stability, the encouragement of employment and growth, and support for the stability of the financial system, including keeping a close watch on developments in the housing market, and especially on house prices.

The decision was made and published on November 22, 2010.

Participants 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
Mr. Barry Topf, Director of the Market Operations Department
Mr. Rony Hizkiyahu, the Supervisor of Banks
Mr. Eddy Azoulay, Chief of Staff to the Governor
Dr. Yossi Saadon, Advisor to the Governor and Bank of Israel Spokesperson
Mr. Alon Binyamini, Economist, Research Department

Appendix: Major Global Economic Developments

The US

The macroeconomic data for last month show a faster rate of recovery than that in the last few months. The improvement was noted in problematic sectors as well (real estate, employment and credit), with surprisingly positive developments in various confidence indices. Against this background investment houses revised their forecasts of US growth upwards. Nevertheless, in the labor market the broad unemployment rate still stood at about 17 percent, and the Case-Shiller index real estate index dropped again in August for the second consecutive month. Thus, even after the upward revision of the forecasts, the expected rate of recovery remains slow, with some concern over deflation (the Core PCE index for September was 0 percent, and the PPI for October was *minus* 0.6 percent).

Against this background, the Fed introduced another quantitative easing program, QE2. Unlike the original QE1 program, which was intended to prevent financial collapse, QE2 is directed towards dealing with the problem of the slow rate of growth. Some commentators expect the program to be augmented in 2011. Others, however, do not expect the Fed to implement the program in full. On the fiscal side, in light of the Republican majority resulting from the congressional elections, President Obama may encounter difficulties in trying to continue with the plan to boost the economy.

Most forecasts do not expect the Fed to start increasing the interest rate before 2012.

Europe

The EU continues to confront the problems of the imbalance between member countries, high deficits, and high unemployment (an average of 10.1 percent, with about 21 percent in Spain). Quarterly growth in the third quarter was 0.4 percent, slightly below the expectations which were 0.5 percent. This low growth occurred against the background of tight fiscal measures and the strengthening of the euro that impacted negatively on exports. The monthly indicators for October also fell short of expectations, mainly in Germany, with weak manufacturing production and a steep drop in retail sales. Inflation in October was 0.1 percent, and in the last twelve months was 1.9 percent. In most of the other member countries, the trend of broad fiscal cuts continued. The markets reflect expectations of no increase in the ECB interest rate before the third quarter of 2010.

The crisis in Ireland continues to stand out, alongside the crises that the PIGS countries (Portugal, Italy, Greece and Spain) are contending with. Bond yield in the PIGS countries, as well as in Ireland, rose sharply in the last month, in light of the persistent crisis in the banking sector (the yield gap between Germany and Ireland widened to 550 basis points). This was followed by some improvement, against the background of Ireland's announcement that it agreed to accept aid from the EU rescue fund.

In the UK, growth in the third quarter was 0.8 percent, surprising in light of the expectations of 0.4 percent. The Bank of England expects growth in the next quarters to exceed the long-term trend, but to be moderate compared with the rate in 2010. Thus the chances of a second quantitative easing program in the UK in the near future have receded significantly. Inflation is expected to remain above 2 percent next year, with the expected increase in VAT and the continued increase in commodity prices.

Japan

Third-quarter growth in Japan exceeded expectations—0.7 percent compared with 0.4 percent, mainly due to the increase in domestic demand. There are signs, however, of a slowdown in the next few months, particularly in light of the continued strengthening of the yen (exports made a zero contribution to growth in the third quarter), and the assessment that the steep increase in domestic demand was a one-off occurrence that derived from the ending of certain tax reliefs (on vehicles and cigarettes) in October, and that was known in advance.

China

China's rapid growth continued this month, and various indicators suggest that it will continue in the coming quarters too.

China's government continues to introduce tightening measures. The central bank imposed additional capital adequacy requirements on various investments, with the largest four banks ceasing to grant credit to the real estate sector till the end of the year. The interest rate is expected to continue to increase in the near future, in light of the acceleration in inflation. The increased in the interest rate is expected to contribute to the appreciation of the yuan. China's foreign trade data for October, that indicate a continued widening of the trade balance, are expected to add weight to the international pressure on the Chinese government to enable significant appreciation of the yuan.

Moody's rating agency raised China's credit rating from A+ to AA.

The emerging markets

Strong growth continued in the emerging markets in East Asia. The World Bank slightly raised its 2010 growth forecast for the Far Eastern economies, from 8.7 percent to 8.9 percent. The forecast also emphasizes the risks arising from the continued capital inflow into those countries, together with the gradual rise in inflation.

One of the factors contributing to growth in these markets is the increase in inter-zone trade and the increase in domestic demand. In light of the confirmation of the US QE2 program, the probability of further regulatory and monetary measures to slow the inflow of capital increased this month. Thus, in the course of the month, Taiwan imposed restrictions on investment by nonresidents, also on trade in long-term government bonds (restrictions on short-term assets are already in force). Turkey increased the reserve requirement on deposits to 6 percent (its level prior to the crisis), in light of the persistent inflow of capital, having already raised it once in September. In India the interest rate was increased (the sixth rise since the beginning of the year), and also in South Korea and Chile, against the background of increased indications of faster inflation.