

BANK OF ISRAEL

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Press Release

Global Challenges and Inflation Targeting

The case of Israel - Comments by Deputy Governor Nadine Baudot-Trajtenberg

In my introduction I mentioned briefly the relatively calm and favorable performance of the Israeli economy during the past 5 years and in fact even slightly longer than that. This may give the impression that it has been an easy period in which to conduct monetary policy. And yet let me suggest that positive economic developments, and positive shocks such as for instance the discovery of large natural gas reserve here in Israel, or the more vigorous price competition in certain industries, can bring about challenges to monetary policy which are as complex and difficult as those presented by negative shocks.

Let me briefly remind ourselves of the developments: as you can see in the first slide, GDP indeed kept growing throughout the period, yet the quarterly fluctuations often painted a much more uncertain future than annual figures indicate, as the headwind, particularly of the European economic slowdown, was felt. The second slide shows us that the labor market continued to show remarkable resilience, with rising participation rate – particularly of Arab women, but not only – and falling unemployment rate. That, combined with rising nominal wages, supported a consumption led economic growth, while for most of the period, exports faltered compared to, at time, feeble world trade expansion. Yet inflation in Israel fell to lower levels even than crisis wounded regions, well below its inflation target of a 1% to 3% range, and in fact was in negative territory for almost 3 years.

This unusual constellation of economic facts presented the MPC with a new challenge, one shared by some other SOE like those presented just before me, the Czech, the Swedish, also the Swiss economies. In fact, I’d often start a presentation with the sentence *“I never thought I would be making comparison between the Swiss and Israeli economies”*. For those who may think that the MPC meetings might have been boring, let me assure you that it gave rise to intense and vigorous discussions, which are still going on til this day.

So we pondered greatly on understanding inflation, inflation dynamics, the transmission mechanism, the elusive figure of the equilibrium exchange rate and the dynamics of the FX market, the costs of being “behind the curve” or in front of it, structural changes that may affect pricing power and dynamics, the power or lack thereof of words and other open mouth operations are amongst the many issues we debated. Our “tolerance” with the low inflation surprised some, exasperated others and now often these same pundits wonder at our patience with rising rates in the US.

There is little doubt that the fact that the real economy was performing well allowed us to study and ponder on these issues without adopting a much more aggressively expansionary monetary policy as occurred in some other countries. Our financial system had weathered the GFC pretty much unscathed, and the sensible level of leverage of both the corporate and household sectors combined with a declining public sector debt gave us comfort as to the overall financial stability in the economy.

Let me drill down on some of some of the issues related to the mentioned puzzle.

First, to what extent was the very low inflation due to transitory elements, or to external “supply shocks” such as the falling oil prices. We dissected the CPI every which way possible, but let me show you here one of my preferred observation. By the way, we do not have a core measure of inflation as in some other countries, and excellent work had been done in the past by Sigal Ribon of the research department at the BoI, that could not identify a core measure that would be superior for understanding inflation dynamics. But if you exclude from the CPI some of the most obviously volatile supply shocks, such as fruits and vegetables (for which there is limited imports in Israel and thus exhibit wide monthly volatility), energy prices in light of the dramatic fall in oil prices at the time, and reduction in regulated prices such as electricity, water and others as well as a 1% reduction in the VAT in 2015, then the underlying inflation never reached negative territory though it did, and still does, remain below our inflation target range of 1% to 3%. More work was done on the importance of external factors by Itamar Caspi also of the research department, which also showed that a large part of the “deflation” was in fact imported from abroad or part of a more global phenomenon.

Clearly the strengthening of the shekel was also contributing to the subdued price environment, I will soon return to this, thorny, issue.

On the financial side we were very much facing the headwinds of the aggressive monetary stance taken in the large economic blocks such as the US, Europe, Japan which not only had low CB interest rates but also undertook QE while many SOE were aggressively intervening in their FX market in order to avoid excessive appreciation of their currencies. The effectiveness of our historically low short term interest rate was also partly undermined by a historically steeper yield curve than in most other countries as can be seen in the following graph.

The transitory nature of the elements mentioned were affecting short term inflation expectations as can be seen in the next graph, though those never reached the negative territory, and only lately have they returned to within the target range of price stability. However, medium and longer term inflation expectation remained well anchored within that range and thus reassured us that we were not being pulled into a deflation dynamics that would have warranted more firm action on our part.

An additional back drop of the social and economic tapestry was the fact that the cost of living in Israel is significantly higher than in comparable countries. The loud and persistent social outcry encouraged the successive government to undertake reforms in notably concentrated sectors in order to increase competition and thus generate price reductions. That technological revolution leads to both internet shopping and easier price comparison apparently were a welcome structural development and pushed prices down. Clearly, the MPC did not see a reason to counter these positive developments.

The monetary policy, in a nutshell, was to keep an expansionary stance by holding interest at the lowest level ever, o.1% for over 3.5 years. We intervened in the FX market and used forward guidance to better explain to the market how we view developments.

Let me return to FX intervention, an issue very much debated both within and outside the BoI. There are mainly two types of arguments against intervention: The first basically says that FX intervention is ineffective. Central Banks are not capable of combating long term trends and large real flows. We agreed that so long as the strengthening of the shekel reflected fundamental forces, indeed there was no place for FX intervention. However, the issue we hotly debated, was can we identify excessive strengthening, excessive in the sense that is substantially overvalued compared to an estimate of the real equilibrium exchange rate. The second argument is that markets know better and will always deliver the appropriate exchange rate.

We benefited from excellent work by Amit Friedmann, Sigal Ribon and Itamar Caspi that addressed the short term effectiveness of out FX interventions. They found a definite impact that would wane over a period of a few months. This meant that our FX intervention could be used to break what traders call "a momentum" in the market. Those could have been triggered by various events, including for instance a misunderstanding of a new piece of information published, such as national accounts data or others, that would be followed by a herd-like behavior.

The Research Department also spent a fair amount of time and energy in trying to identify the range within the equilibrium exchange rate should lie. Also, Prof. Nathan Sussman, then head of the Research Department, provided his own model, which more recently he has published with Yosi Saadon, in which they have attempted to asses to what extent PPP and UIP approaches explain the fluctuations in the exchange rate in Israel. We thus have evidence that the shekel was often excessively overvalued, which pushed prices to an artificially low level.

We introduced Forward Guidance when the Fed's rate started to rise in the US, as there were expectations in Israel that the BoI would soon follow suit. We thus found it important to express more clearly that our focus is on the developments in Israel, albeit influence by what happens abroad, and that we would change our stance when pertinent data convinces us that it is time to do so.

With the recent rise in inflation, and at the last interest rate decision of Governor Flug, some thought that the BoI would deviate from that stance. Again Governor Flug remained true to herself, guided only by professional integrity, and lead the discussion in exactly the same way she had done during the previous 56 decisions (except for the cake…).

Looking forward to normalization we mentioned that not all conditions were yet met to justify a change in interest rate. Some fear that the BoI may not have the necessary tools to mitigate the down cycle when it comes around, and would like to see perhaps a more rapid rise in interest rates in order to "build ammunition" were the harder times to appear. To those I'd like to stress two things: First, the level of the nominal interest rate does not constitute ammunition, it is the real level of interest that counts, in which case a higher inflation level is what would provide ammunition, not a higher nominal rate. We are now on the road to higher inflation, it has been a long and bumpy one, and may not be smooth ahead either. We will respond in a way that does not jeopardize the continued path to the target range. Second, the interest rate is not the only tool in the BoI toolkit, and there is no reason to narrow it only to that.

Finally, I mentioned that positive developments have presented exciting challenges for the BoI, and an important one has been how to explain that holding the interest rate constant was the appropriate policy to hold. It takes as much work, integrity, and at times courage (a husband who keeps asking what have you been doing for the past 3.5 years), as to change interest rates just to get a headline.