BANK OF ISRAEL
Office of the Spokesperson and Economic Information

March 8, 2021

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

The discussions took place on February 21 and 22, 2021.

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 Markets), who prepare and present the material for discussion.

In the narrow forum—which consists of the Monetary Committee and a representative of the Markets Department—the Research and the Markets 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 February 22, 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 0.1 percent. Five Committee members supported the proposal to keep the interest rate unchanged, and one Committee member supported the proposal to reduce it to 0 percent.

The discussion focused on the adverse impact of the crisis on GDP and on employment noting the heterogeneity of industries regarding the magnitude of the impact, the more rapid than expected path of recovery of economic activity in Israel and abroad against the background of the vaccination campaigns, the inflation environment, the developments regarding the exchange rate, and the financing limitations in the credit market.

Main points of discussion

The effect on aggregate economic activity of the third lockdown, despite its length, was apparently more moderate than expected, and than that of the previous lockdowns. This can be seen in several rapid indicators of activity—mobility data, credit card purchases, and labor inputs. This moderate negative impact is apparently a direct result of the adjustment by the public and businesses, seen in, among other things, the rising trend of online purchases between each lockdown as indicated by credit card data. This is alongside the Israeli economy's comparative advantage in the area of services exports for which global demand during the coronavirus crisis even increased (except for tourism), and particularly in the high tech industry which has continued to grow during the crisis. Despite the lockdown, GDP grew in the fourth quarter of 2020 by 6.3 percent (2.9 percent net of the effect of vehicle imports)—growth that reflects strong activity in several industries, and in the full year of 2020, GDP contracted by 2.4 percent, a smaller than expected contraction, which mainly reflected the adverse impact on private consumption (-9.4 percent). However, the relatively moderate negative impact in aggregate activity blurs the gaps in the effects of the crisis among the various sectors and industries in the economy, between those that were directly or indirectly negatively impacted by the limitations, and those less affected. The negative impact is not uniform across the firms, and as can bee seen in a CBS real time survey, larger firms are more resilient while the smaller are more vulnerable.

In parallel, a gap opened between GDP data, which are relatively encouraging compared internationally, and the state of the labor market, where the broad unemployment rate in recent months has been very high; during the course of the second lockdown it was about 23 percent, declined to about 14 percent between the lockdowns, and at the beginning of the third lockdown it climbed to about 20 percent. This gap points to most of the unemployment in Israel being concentrated in industries that are characterized by low labor productivity and wage conditions, and emphasizes the differential adverse impact on different labor market industries at the height of the crisis. In view of this, the Committee members expressed concern over the effects of the crisis on inequality in the economy.

Despite the low level of annual inflation, -0.4 percent, the inflation environment continues to increase, driven by global oil and commodity prices. The Committee members discussed the increase in inflation expectations, against the background of the accommodative policy and the rise in the global inflation environment, and in particular the increase in inflation expectations in the US. One-year inflation expectations from all sources increased and are around the lower bound of the target range. Expectations derived from the capital market for the first and second years forward increased markedly, and expectations for medium and longer terms remain anchored within the target range. The Committee members noted that despite the increase in inflation expectations for the short term, the expectations are still low, as is actual inflation. Therefore, the monetary policy will have to remain accommodative in order to support economic recovery.

In terms of the forecast for continued recovery in Israel and worldwide, the high pace of vaccination as well as the effectiveness of the vaccines, increase the probability for a rapid recovery of the Israeli economy and the realization of the optimistic scenario in the Research Department's forecast that was published in January. The IMF revised upward its growth and trade forecasts for advanced economies against the background of the vaccination process—in 2021, the global economy is expected to grow by 5.5 percent. Global economic data indicate continued recovery in view of the decline in the scope of morbidity worldwide—GDP data for the fourth quarter surprised to the upside in most countries, sentiment indices indicate continued recovery, purchasing managers indices in January continued to point to expansion in global activity, and world trade continued to grow. At the same time, in some countries the level of morbidity remains high; in Europe the morbidity level and continued lockdowns led to a marked contraction in GDP in 2020. The monetary policy in the main economies continued to be very accommodative and governments put additional fiscal programs into action. Equity prices continued to rise on global capital markets, while in the Israeli market prices rose strongly relative to other countries. The Committee members were of the opinion that these signs could indicate the desired exit from the global crisis, even if it is expected to be gradual.

The program that the Bank of Israel announced on January 14, to purchase $30 billion in 2021, led to an immediate and relatively sharp depreciation of the shekel, but since then the shekel has strengthened slightly. From the Monetary Committee's previous decision until January 14, the shekel strengthened by 3.2 percent in terms of the effective exchange rate. Following the Bank of Israel's announcement regarding the scope of its intervention in the foreign exchange market in 2021, the shekel weakened by 5.2 percent, so that at the end of the period, the shekel had weakened by about 1.8 percent in terms of the effective exchange rate, by about 2 percent against the US dollar, and by about 0.6 percent against the euro. A continuation of this trend is expected to support export performance, the exit from the crisis, and a return of inflation to the target range.

Most of the Committee members were of the view that the current extent of monetary accommodation, through its various tools, is sufficient for now, particularly in view of the additional tools used in the credit market, such as the payment deferral framework. They noted that the financial system is functioning in an orderly fashion, and that the various indicators do not point to severe credit distress. However, they noted that the small and micro business segment has encountered greater difficulty in raising credit. The Committee members noted that the interest rates in the economy have remained at low levels, despite the increase in credit risk, partly due to the policy measures taken by the Bank of Israel and the Ministry of Finance.

Five of the Committee members were of the opinion that the interest rate should be left unchanged at 0.1 percent. These five Committee members thought that the low level of the interest rate supports a recovery of economic activity and a gradual return of inflation to the target range, particularly in view of the fact that the Bank of Israel is using other tools in the credit market and in the foreign exchange market. One Committee members voted in favor of lowering the interest rate to 0 percent. He believed that an interest rate lower than 0.1 percent is more appropriate due to the intensity of the crisis and the unusually intense impact on the employment level. He added that he does not rule out the possibility that a more accommodative policy and a move to a negative interest rate may be necessary in the future. The Committee decided to leave in place the other policy measures decided upon in the past.

The Committee noted that the fast pace of the inoculation process in Israel increases the optimism regarding a rapid return of the economy to a path of growth in the coming year. However, the risks to economic activity remain high—mainly in view of the risk of additional morbidity waves due to the spread of the various mutations—and the adverse impact on the economy, and particularly on the labor market, is expected to be prolonged.The Committee will therefore continue to utilize a range of tools in order to increase the extent of monetary policy accommodation and to ensure the continued orderly functioning of the financial markets. The Committee will expand the use of the existing tools, including the interest rate tool, and will operate additional ones, to the extent that it assesses that it is necessary in order to achieve its monetary policy goals and to moderate the adverse economic impact resulting from the crisis.

Participants in the narrow-forum discussion:

Members of the Monetary Committee:
Prof. Amir Yaron, Governor of the Bank and Chairperson
Mr. Andrew Abir, Deputy Governor of the Bank of Israel
Prof. Reuben Gronau
Prof. Moshe Hazan
Prof. Zvi Hercowitz
Prof. Michel Strawczynski

Other participants in the narrow-forum discussion:

Ms. Dana Orfaig, Research Department
Mr. Tal Biber, Head of the Markets Division, Markets Department
Dr. Golan Benita, Chief of Staff to the Governor
Mr. Uri Barazani, Spokesperson of the Bank
Mr. Arad May, Secretariat of the Monetary Committee
Ms. Shulamit Nir, Research Department
Mr. Yoav Soffer, Advisor to the Governor
Mr. Daniel Shlomiuk, Spokesperson's Office