Bank of Israel

MONETARY POLICY REPORT

January–June 2017

47

August 2017

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According to the Bank of Israel Law, 5770–2010, the Bank of Israel has three objectives: (1) to maintain price stability, as its central goal; it was established that price stability is defined as an annual inflation rate of between 1 percent and 3 percent; (2) to support other objectives of the Government's economic policy, especially growth, employment and reducing social gaps, provided that this support shall not prejudice the attainment of price stability, and (3) to support the stability and orderly activity of the financial system. In order to attain these objectives, the Bank of Israel employs various tools, chief among them the decision on the appropriate level of the short-term interest rate.[1] In addition, the Bank intervenes in the foreign exchange market.

Section 55(a) of the Bank of Israel Law, 5770–2010, establishes the publication of this report, which is submitted to the government and the Knesset Finance Committee twice a year. The report surveys the economic developments that took place during the period covered by the report. It also surveys the policy required, in the view of the members of the Bank of Israel's Monetary Committee—the forum in which monetary policy decisions are reached—for the inflation rate to be within the range set by the government and to achieve the other objectives of the government's economic policy. A survey of financial stability appears in the Financial Stability Report for the period covered.

In accordance with Section 55(b) of the Law, this report explains why the inflation rate deviated from the target range set by the government for more than six consecutive months, beginning with the publication (on July 15th, 2014) of the Consumer Price Index (CPI) for June 2014. The rate of inflation during this period declined to below the lower bound of the target range, and explanations appear in Section A (Policy and Targets) inside.

The Monetary Policy Report for the first half of 2017 was prepared by economists in the Research Department, within guidelines set by the Bank of Israel Monetary Committee.[2] This report is based on data that were published up to July 31, 2017.

[1] As per the decision of the Monetary Committee, the Committee this year moved from 12 decisions per year to a frequency of eight decisions per year instead of 12 decisions per year.

[2] Since November 2014, the Monetary Committee has been operating with a smaller number of members than warranted in the Bank of Israel Law. It currently includes four members.

INTRODUCTION

- **Monetary policy:** During the first half of 2017, the Monetary Committee left the interest rate unchanged and in April it updated its forward guidance policy, from a formulation presenting the assessment that monetary policy would remain accommodative for a considerable time to a statement of the Committee's intention to maintain the accommodative policy as long as necessary in order to entrench the inflation environment within the target range. During the reviewed period (January to June), in view of pressures for appreciation of the shekel, the Bank of Israel increased its foreign exchange purchases, which totaled about $5.9 billion.

- **Actual inflation and inflation expectations:** The annual rate of inflation was positive from January 2017, for the first time since 2014, though it is still below the lower bound of the inflation target range. However, with the publication of the CPI reading for June, the rate fell to -0.2 percent. One-year inflation expectations and one year, one-year forward expectations (that is, second year forward expectations) remained below the lower bound of the inflation target range, while medium and long-term (more than three years) inflation expectations remained solidly within the target range.

- **Real domestic activity:** During the first half of 2017, the Committee discussed the strength of real economic activity, which is reflected in the resilience of the labor market, the growth figures for the second half of 2016 and the first quarter of 2017 and also the indicators of activity in the second quarter. The figures available to the members of the Committee at the beginning of the year showed that private consumption and investment were continuing to lead growth. At a later stage, they showed that consumption had moderated but that the growth rate of exports had increased.

- **The exchange rate:** During the reviewed period, the shekel appreciated by 4.8 percent in terms of the nominal effective exchange rate (the average for June relative to the average for December), primarily as a result of the weakening of the dollar worldwide. Most of the appreciation occurred at the beginning of the period and it was halted against the background of the large-scale intervention by the Bank of Israel in the foreign exchange market. In July, the shekel depreciated by 3.0 percent in terms of the effective exchange rate. The shekel appreciated by 7.7 percent against the dollar and by 1.8 percent against the euro until June, but depreciated by 1.8 percent against the dollar and by 4.5 percent against the euro in July.

- **The global economy:** World trade improved during the period, as did the growth figures of most economies. The Federal Reserve raised the federal funds rate—a trend that is expected to continue—and in Europe the highly accommodative monetary policy continued. Core inflation in the US was near the target while that of the eurozone was still relatively low.

- **The housing market:** The figures for the reviewed period indicate that home prices have stabilized in recent months, alongside more moderate demand and the continuing steady growth in supply.

- **The financial markets:** The domestic share indices rose during the reviewed period. However, some of the indices underperformed the leading indices in Europe, the emerging markets and the US. This is primarily due to the underperformance of the large companies, particularly those in the chemical and pharmaceutical industries. The nominal yield curves shifted downward in the medium and long terms. The spreads between corporate bonds and government bonds for similar duration and indexation declined during the reviewed period, to their lowest level since 2007.

- **Fiscal developments:** The cumulative domestic deficit (excluding net credit provided) totaled NIS 9 billion for January–June, compared with NIS 3.1 billion for the same period last year. The overall deficit for the last 12 months totaled 2.5 percent of GDP, compared with 2.1 percent of GDP at the end of 2016. During the reviewed period, the government decided on several measures to reduce tax rates and expand government expenditure during the years 2017 and 2018, while focusing on families with children up to the age of 6.

- **Research Department staff forecasts:** According to the latest forecast by the Research Department, made in June 2017, GDP is expected to grow by 3.4 percent in 2017 and by 3.3 percent in 2018. Inflation is expected to converge to within the target range during 2018 and the Bank of Israel interest rate is expected to remain at its current level until the second quarter of 2018. Compared with the forecast made in December, the timing of the interest rate increase has been delayed and the forecast inflation is lower.

In accordance with the Bank of Israel Law[3], Section A of this report explains why the inflation rate has deviated from the target range set by the government for more than six consecutive months. In addition, it describes the policy adopted by the Monetary Committee to return the rate of inflation to within the target range, and presents its assessment of the time required to do so. Section B describes the background conditions that prevailed at the time the interest rate decisions were made and presents the perspective of the Committee.

A. POLICY AND TARGETS

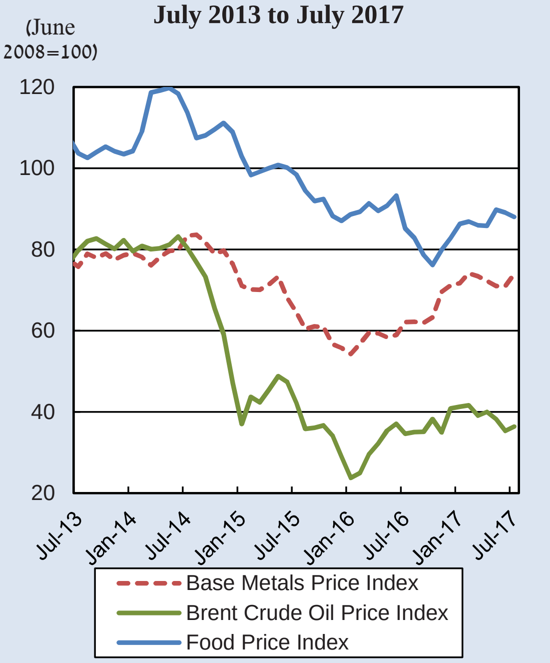
The main considerations behind the decision to leave the interest rate unchanged at its low level of 0.1 percent during the reviewed period: (1) the inflation environment, which remained lower than the price stability target range; (2) the level of the exchange rate and the appreciation of the shekel, and their effect on exports and on inflation, against the background of the continued highly accommodative monetary policy in Europe and most of the advanced economies, even though the Federal Reserve scaled back its accommodative policy during this period; and (3) the entrenchment of the high growth rate, and a labor market characterized by a full employment environment along with wage increases.

During the first half of 2017, in addition to leaving the interest rate at its low level, the Committee continued to provide "forward guidance", a tool it has been using since the interest rate announcement for November 2015. At the beginning of the year, the Committee stated in its announcements its assessment that monetary policy would remain accommodative for a considerable time. In April, the Monetary Committee changed the formulation and announced that it intends to maintain the accommodative policy as long as necessary in order to entrench the inflation environment within the target range. In addition, the Bank purchased foreign currency during the period.

The Committee listed the causes for the low positive rate of annual inflation (not including the June index which was published only after the end of the first half) and the continuing deviation of inflation below the target range during the reviewed half-year: (1) The shekel continued to appreciate in terms of the nominal effective exchange rate, primarily as a result of the weakening of the dollar worldwide. (2) The administrative decisions made by the government with

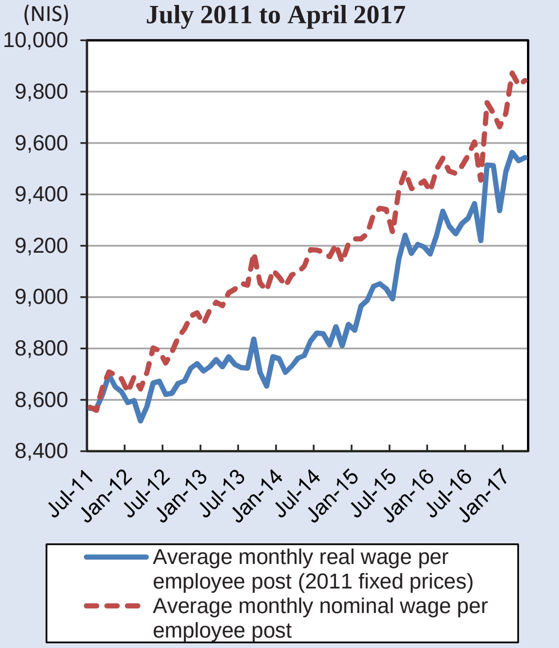
[3] For further details ,see the introduction to the report.

Figure 1
Base Metal, Oil and Food Price Indices, July 2013 to July 2017



SOURCE: Based on Bloomberg.

Figure 2
Nominal Wages and Real Wages in Israel, July 2011 to April 2017



SOURCE: Bank of Israel.

the goal of reducing the cost of living[4] continued to lead to lower prices, which contributed to a decline in inflation during the reviewed period. Net of government interventions, the index for the last 12 months ending in May rose by 0.9 percent. The effect of the government decisions was significantly lower than in the previous six months (in August 2016, it stood at 0.9 percent, in comparison to 0.1 percent in the May index). (3) The increased level of competition in the economy, which was partly the result of the increase in Internet purchases.[5] (4) According to an opinion voiced in the Committee, price levels in Israel may be going through a long-term adjustment to a level that characterizes developed markets in Europe.

The Committee emphasized that despite these factors, annual inflation increased during the reviewed half-year, to 0.8 percent in May. A number of factors led to the increase in prices. Commodity prices were 8.1 percent higher on average than during the previous six months, and oil prices were 7.6 percent higher. These contributed to the increase in the annual inflation rate (Figure 1). An additional cause of the price increases in the economy was global inflation. In May, the annual inflation rate was 2.9 percent in the US and 1.4 percent in the eurozone. These rates affect inflation in Israel through import prices, which indeed were 2.2 percent higher on average during the first quarter of 2017 than in the previous quarter (Figure 1). A possible assessment is that the 1.9 percent increase in the nominal wage during the reviewed period (Figure 2) and the increase in the real unit labor cost during the first quarter of 2017, following somewhat of a decline during the second half of 2016, can also be expected to contribute to future price increases.

It is worth mentioning that the CPI for June, which was published in July 2017 (and did not influence the interest rate decisions during the reviewed half-year) led to an inflation rate of -0.2 for the past 12 months, the only negative figure during the reviewed period. The government interventions contributed -0.2 percentage points to this index. The main causes for the sharp drop in the index for this month were the seasonal drop in the prices of fruits and vegetables and the prices of clothing and footwear, and the decline in prices of transportation.

The Committee members agreed that the macroeconomic data for Israel indicate that the low rate of inflation is primarily the result of supply-side factors. Annual inflation

[4] The institutional changes since February ,2016 which affected the annual rate of inflation during the half-year ,included price reductions in food ,electricity and water ,taxis and public transportation ,and vehicle insurance .Likewise ,tariffs and purchase taxes on imported goods were cancelled.

[5] For further discussion of the increase in competition and Internet purchases, see the Bank of Israel Annual Report for) 2016 Chapter.(3

in Israel was, as mentioned, affected by the appreciation of the shekel in terms of the nominal effective exchange rate, the price reductions initiated by the government, and also, apparently, the increased level of competition in the economy, all factors that are not related to the demand side. The contribution of another factor on the supply side—the price of energy—became positive during the reviewed half-year, following a long period in which its contribution had been negative. Furthermore, against the background of accommodative monetary policy, the economy was characterized by positive developments: the labor market remained strong; wages and the employment rate increased; private consumption increased, primarily at the beginning of the period, according to figures available to the Committee members; and export data started to increase later in the period. Long-term inflation expectations continued to indicate that the financial markets are expecting that monetary policy will eventually lead to the achievement of the inflation target.

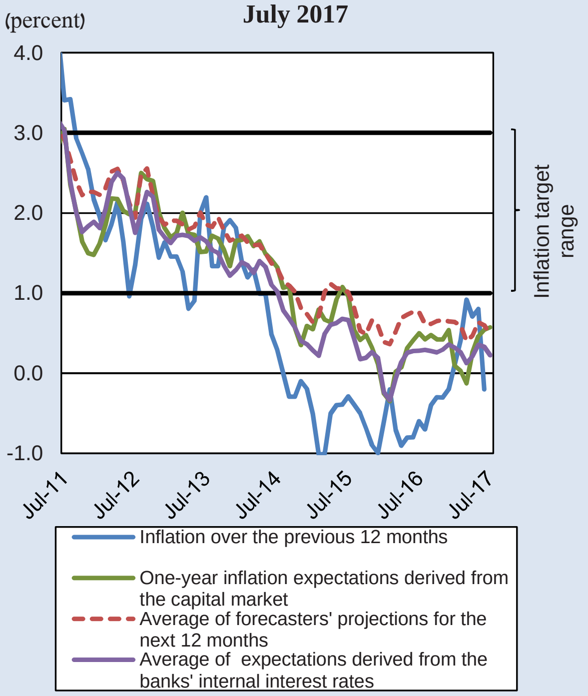
Monetary policy remained accommodative during the reviewed half-year: The interest rate is at an historic low and the Bank of Israel's intervention in the foreign currency market continued. In all of the interest rate discussions during the reviewed period, the Monetary Committee decided not to change the interest rate and continued to guide expectations by changing the text of the forward guidance. The new formulation states the Committee's intention to maintain the accommodative policy as long as necessary in order to entrench the inflation environment within the target range. This is in contrast to the previous formulation, which reflected the Committee members' assessment that monetary policy would remain accommodative for a considerable time.

The Committee felt that the accommodative monetary policy that it has adopted—a very low interest rate over time and the foreign exchange purchases—will contribute to returning inflation to within the target range.

In summary, the Committee members believe that leaving the interest rate at its current level, alongside the economic forces that are at work—continued economic growth, the low unemployment rate, the increase in energy and commodity prices, wage increases and global inflation—will work to return inflation to within the target range during 2018. As mentioned, the Committee intends to continue the accommodative monetary policy until the entrenchment of the inflation environment within this range.

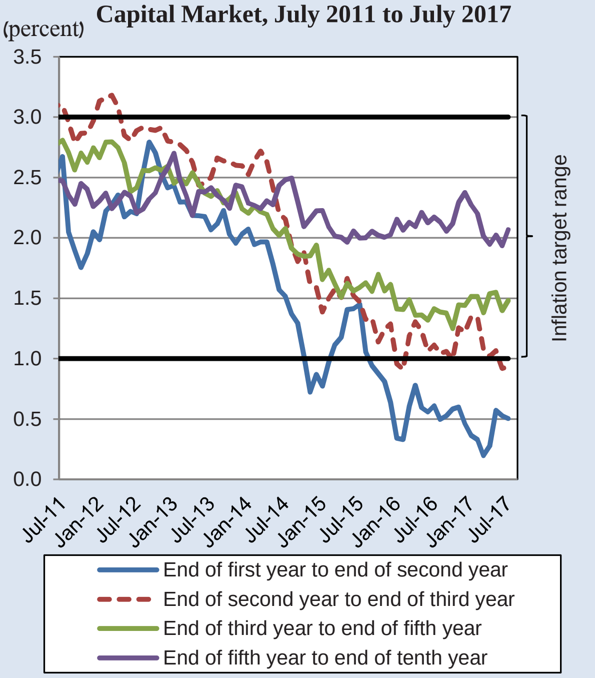
B. BACKGROUND CONDITIONS AND THEIR EFFECT ON INTEREST RATE POLICY

Figure 3
Inflation and Inflation Forecasts, July 2011 to July 2017



SOURCE: Based on Central Bureau of Statistics.

Figure 4
Forward Inflation Expectations Derived from the Capital Market, July 2011 to July 2017

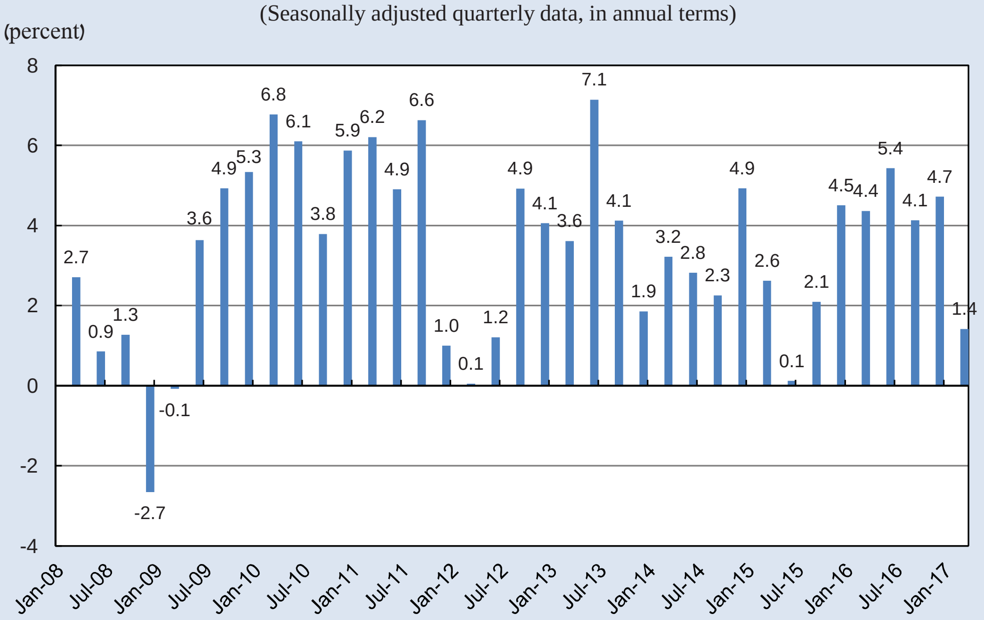


SOURCE: Bank of Israel.

During the reviewed period, the upward trend in inflation, which began in the second half of 2016 (Figure 3), continued. One-year inflation expectations and one year, one-year forward expectations (that is, second year forward expectations) remained below the lower bound of the target range. Medium-term expectations were above the lower bound and long-term forward expectations (5–10 years) remained near the center of the target range. From January until the index for May 2017, annual inflation was positive, for the first time in about three years. Between January and May, annual inflation increased from 0.1 percent to 0.8 percent, continuing the upward trend that began in the second half of 2016. This was partly due to the declining effect of the fall in energy prices and the institutional interventions (Figure 3). One-year inflation expectations during the period were relatively stable compared with their levels during the second half of 2016, and were below the lower bound of the target range. One-year expectations derived from the capital market stood at 0.5 percent at the end of the first six months of 2017. Short- and medium-term forward expectations (2–3 years) during the period fluctuated in the vicinity of the lower bound of the target range (Figure 4) while longer-term forward expectations remained stable around the center of the target range. The assessment of Committee members was that there are several factors that can support a continued increase in inflation back and its return to the target range: (1) the prices of some commodities, particularly oil, were higher than during the preceding six-month period; (2) the GDP figures during the reviewed period indicate continued strong growth of economic activity; (3) wages increased; and (4) global inflation increased and in many countries inflation approached the target range.

The national accounts figures for the first quarter of 2017 indicate a stabilization of growth at a high level. The low level of GDP growth reported for the first quarter of the year (1.4 percent) was a result of the sharp drop in the release of vehicles from customs due to the shift of imports to the end of 2016 based on tax considerations (Figure 5). As implied by early indicators, the GDP growth net of vehicles was over 4 percent in the first quarter and was slightly higher than growth in the previous quarter and in 2016. These growth rates are higher than the estimated growth potential (about 3.2 percent) and are accompanied by a strong labor market. Initial indicators show that the high growth rate continued at the beginning of the second quarter of the year. Table 1 presents the growth figures that were available to the Committee members during the interest rate discussions.

Figure 5
GDP Growth Rates, January 2008 to March 2017
(Seasonally adjusted quarterly data, in annual terms)



SOURCE: Based on Central Bureau of Statistics.

Table 1
National Accounts - data available during the reviewed half-year*
(Seasonally adjusted data, quantitative rates of change compared to previous period, in annual terms)

Month		January	February	March	April	May	June	July
GDP	2016:Q3	3.4	3.6	4.2	4.1	4.3	4.1	4.1
	2016:Q4			6.2	6.5	6.3	4.7	4.6
	2017:Q1						1.4	1.2
Business sector product	2016:Q3	4.0	4.2	5.0	5.1	5.2	4.6	4.6
	2016:Q4			7.8	8.0	7.8	5.7	5.6
	2017:Q1						0.6	0.3
Private consumption	2016:Q3	3.5	3.4	3.1	3.3	3.4	2.9	3.0
	2016:Q4			3.5	3.8	3.0	1.1	1.1
	2017:Q1						-1.6	-1.7
Fixed capital formation	2016:Q3	15.3	15.3	12.8	13.2	12.8	11.6	11.8
	2016:Q4			7.4	8.0	7.8	1.8	3.1
	2017:Q1						-5.6	-3.1
Exports excluding diamonds and startups	2016:Q3	-2.6	-0.8	0.0	-1.0	-0.5	-1.2	-1.2
	2016:Q4			8.0	7.3	7.2	7.6	7.9
	2017:Q1						8.0	8.6
Civilian imports excluding ships, aircraft, and diamonds	2016:Q3	10.7	10.7	7.6	6.7	6.7	5.6	5.9
	2016:Q4			-0.5	-1.2	-1.4	-3.3	-1.7
	2017:Q1						-5.3	-1.5

* The data include vehicle imports, which had a marked impact during the reviewed half.
SOURCE: Based on Central Bureau of Statistics.

The data available to the Committee members during the reviewed half-year indicate that the composition of growth has changed: Imports increased and the rate of increase in private consumption, which had been characterized by particularly high rates of growth at the beginning of the year, became more moderate. In contrast to the first three quarters of 2016, GDP growth during the last quarter of 2016 and the first quarter of 2017 were characterized by balanced growth that was not based only on a high growth rate in current private consumption, but also on growth in exports, which was supported by the expansion in world trade. Table 2 presents the development of GDP, imports and uses. Growth in the export of services was particularly high, although the export of goods also increased during the last two quarters. However, it is difficult to determine whether the improvement in the goods exports continued in the second quarter of the year as well.

The employment rate apparently stabilized during the reviewed period at close to full employment. During the first quarter of 2017, the participation and employment rates among the prime working ages (25–64) stabilized at a high level. During the past year, the unemployment rate fell by one percentage point (to 3.9 percent) and to an even greater extent among those with relatively low levels of education. The average number of hours per employee has been in a clear upward trend for about two years and the rate of increase in the nominal wage has accelerated. The job vacancy rate was stable at a high level during the first four months of 2017. Taken together, these elements attest to the strength of the labor market, which is responding to domestic demand for labor-intensive goods and services. The shortage of professional workers, as indicated by the Companies Survey

Table 2

Development of GDP, imports and uses

(Seasonally adjusted data, quantitative rates of change compared to previous period, in annual terms)

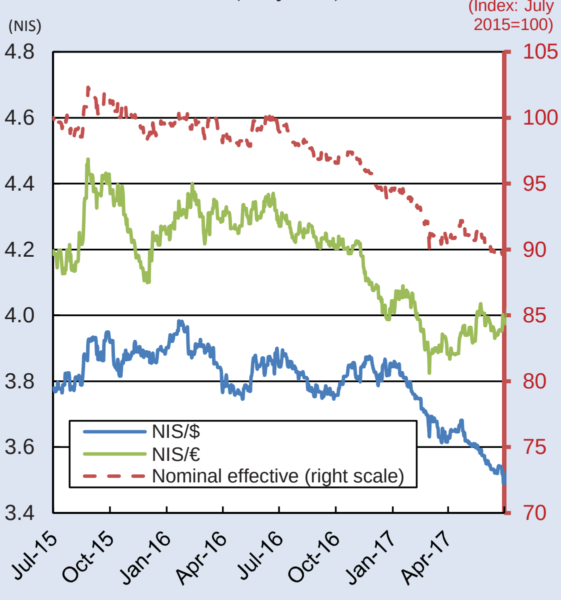
	2014	2015	2016	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4	2017Q1
GDP	3.2	2.5	4.0	4.5	4.4	5.4	4.1	4.7	1.4
Business sector product	3.1	2.3	4.3	4.9	4.0	5.9	4.6	5.7	0.5
Imports excluding defense, ships, aircraft and diamonds	4.2	1.4	8.1	20.5	-3.9	28.0	5.9	-1.8	-1.6
Private consumption	4.3	4.3	6.3	6.5	7.6	9.2	3.0	1.3	-1.1
of which : private consumption excluding durable goods	3.7	4.7	5.1	4.8	5.8	7.2	4.0	1.0	2.7
Public consumption	3.7	3.3	3.8	12.4	-1.6	7.1	2.7	3.5	2.6
of which : public consumption excluding defense imports	3.3	4.0	3.8	11.4	-1.1	5.3	2.1	3.3	7.1
Gross domestic investment	3.5	3.0	7.2	17.0	13.4	-8.8	31.1	7.9	-20.3
of which : in fixed assets	0.0	0.1	11.2	12.3	22.8	7.5	11.7	3.0	-3.4
Exports excluding diamonds	2.5	-2.6	2.8	0.1	6.6	6.2	-2.8	10.0	13.9
of which : exports excluding diamonds and startups	4.7	-2.7	1.5	0.0	-1.6	9.2	-1.0	8.3	9.7

SOURCE: Based on Central Bureau of Statistics.

for the first two quarters of 2017, is one of the most significant constraints on the continuing expansion of activity in all industries. The Job Vacancy Survey indicates that the ratio of the supply of labor to the demand for labor remains low after a major decline in 2016 and in more than a few occupations the ratio is even less than 1.

The shekel appreciated in terms of the nominal effective exchange rate during the reviewed period, primarily due to the shekel's appreciation against the dollar. The shekel appreciated by a smaller amount against the euro. The appreciation in terms of the nominal effective exchange rate during the reviewed period (the average in June relative to the average in December) was about 4.8 percent, primarily the result of the weakening of the dollar worldwide (Figure 6). Most of the appreciation occurred at the beginning of the period, and it was halted against the background of the large-scale intervention by the Bank of Israel in the foreign exchange market. In July, the shekel depreciated by 3.0 percent in terms of the nominal effective exchange rate. The shekel appreciated by 7.7 percent against the dollar and by 1.8 percent against the euro through the end of June, but depreciated by 1.8 percent against the dollar and by 4.5 percent against the euro in July.

Figure 6
Selected Exchange Rates, July 2015 to July 2017
(daily data)



SOURCE: Bank of Israel.

The Committee's assessment was that the shekel is over-appreciated, and throughout the period, the Committee members emphasized that the level of the exchange rate and the appreciation of the shekel are liable to hinder the export and tradable goods sectors and delay the return of inflation to within the target range. Therefore, the Bank of Israel continued to purchase foreign exchange in accordance with the policy of intervention, i.e. to intervene when the exchange rate shows excessive fluctuations that are not justified by fundamental economic conditions or when the foreign currency market is not functioning appropriately, and according to the policy to offset the effects of natural gas production. These purchases are an integral part of monetary policy. During the reviewed period (figures for January to June) and in view of the pressures for appreciation, the volume of purchases increased to about $5.9 billion. Of that, $0.9 billion was purchased as part of the policy to offset the effect of the production of natural gas on the exchange rate.[6]

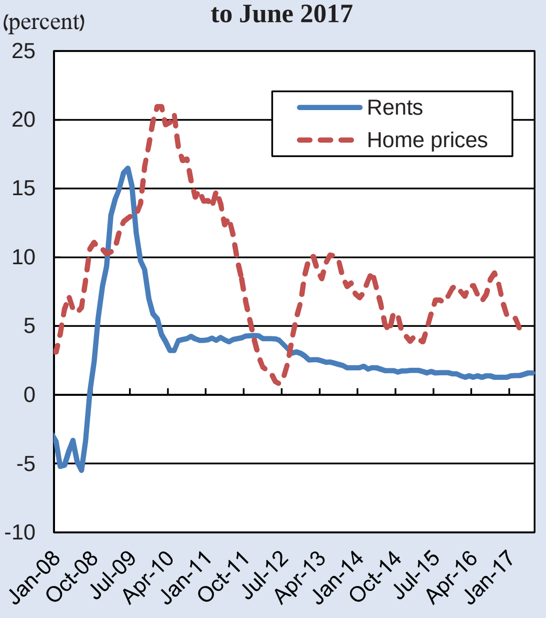
Housing market data indicate the stabilization of prices in recent months, along with a cooling off of demand and the continuing increase of supply at a stable rate. This assessment is supported by the low number of new home sales

[6] A box that appeared in the Monetary Policy Report for the second half of 2016 provides a more detailed discussion of the Bank of Israel's exchange rate policy and surveys the reasons, the results and the decision-making process.

and a significant contraction in the activity of investors. These developments were accompanied by a decline in the volume of new mortgages and an increase in mortgage interest rates relative to the previous half-year, though there has been some decline in recent months. The increase in mortgage interest rates during the reviewed period relative to the preceding half-year is also apparently contributing to the cooling off of demand.

Total new mortgages continued to decline during the reviewed period, a trend that began in the preceding half-year. At the beginning of the period, the total was about NIS 4.5 billion per month and at the end of the period it was about NIS 4.2 billion per month (seasonally adjusted figures). The interest rates on mortgages in all tracks increased during the reviewed period relative to the previous half-year, inter alia against the background of measures taken by the Banking Supervision Department in the past to reduce the risk to borrowers and the risk of the banking system's housing credit portfolio, the banks' internalization of the risk, and the need for the banks to reach the capital adequacy ratios. The risk in the housing market remained high, but did not increase during the reviewed period. At the end of the period, mortgage rates declined slightly. In the past few months there has been an apparent slight moderation in activity and in the pace of price increases, and if this continues, it may reduce the risk. During the reviewed period, there was an increase in the size of the average mortgage and in the length of the average term to maturity of fixed-rate mortgages.[7] Nonetheless, the loan-to-value (LTV) ratio and the payment to income (PTI) ratio remained almost unchanged during the reviewed period, following a prolonged downward trend in recent years.

Figure 7
Rates of Increase in Home Prices and Rents over the Preceding 12 months, January 2008 to June 2017



SOURCE: Based on Central Bureau of Statistics.

During the reviewed period, home prices stabilized. This was reflected in, among other things, the drop in the annual rate of increase in home prices during the 12 months ending in April to 4.5 percent, compared with 5.7 percent at the end of the preceding six-month period (Figure 7). Rents increased by about 1.6 percent during past 12 months, and in recent years there has been relative stability in their rate of increase (Figure 7).

During the reviewed period, there was an improvement in world trade and in the growth of most of the economies. The positive momentum in the global economy continued and the IMF is expecting an acceleration in growth and world trade, based on a recovery of the manufacturing sector and global investments. The US experienced a weak first quarter that is partly explained by temporary factors and, according to most indications, a recovery

[7] A discussion of the risk implicit in the housing market and the increase in the interest rates on mortgages can be found in the Financial Stability Report for the first half of.2017

is expected later in the year. Contracts continue to reflect the probability of an additional increase in the federal funds rate. The likelihood of a 0.25 percentage point increase in the interest rate in September is about 4 percent and the likelihood of such an increase in December is about 36 percent.

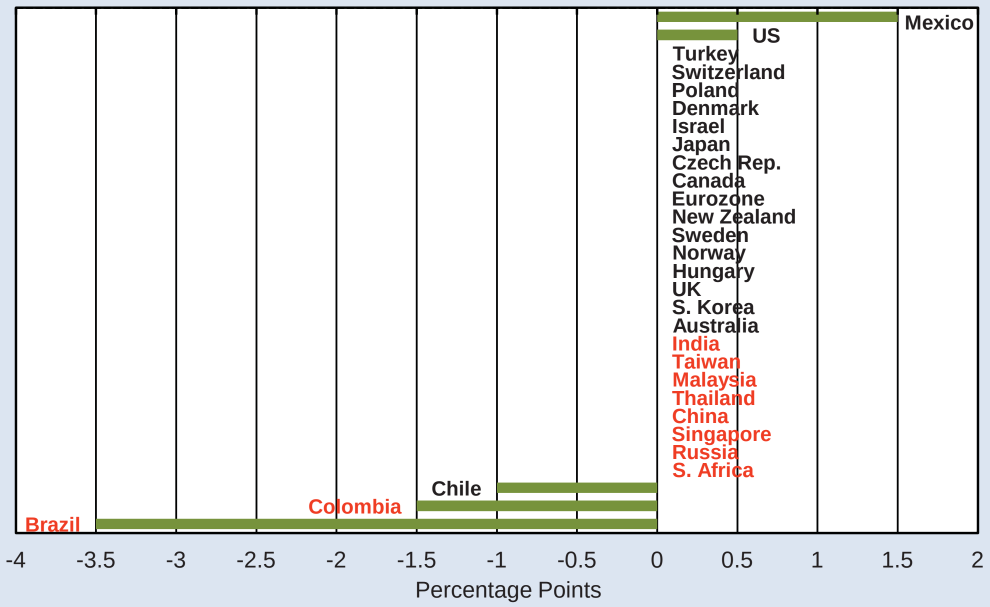
Growth continued in Europe and the output gap narrowed for the second quarter in a row. The confidence indices are at record highs, employment is increasing and the risk of the breakup of the eurozone has declined as a result of the elections in France. Core inflation is still lower than the target and the ECB's quantitative easing policy is continuing, despite pressure from some of the eurozone countries to scale it back.

In Japan, expansion continued at a high rate, growth continued for the fifth quarter in a row and according to the BOJ, the Japanese economy has recently achieved a positive output gap. Nevertheless, wages and prices have been slow to respond to the improvement in the economy and the BOJ is continuing its very accommodative policy. The growth forecasts for China were revised upward and reflect the strengthening of economic activity in the first quarter of 2017 and expectations of continued fiscal accommodation. Positive sentiment continued in the stock markets, despite the uncertainty surrounding the policies of the Trump administration which led to volatility in the short run. The positive economic and political developments in Europe led to a strengthening of the euro worldwide, while the dollar weakened.

In most of the leading economies, monetary policy remained accommodative while the Fed continued to increase its interest rate (Figure 8). Monetary policy in most of the major economies remained highly accommodative during the reviewed period. The interest rate in the eurozone (the interest rate on excess balances of the commercial banks) has remained at -0.4 percent for a long period, and several other countries have also maintained negative interest rates. The ECB is maintaining its quantitative easing program, in accordance with its announcement in December that it would continue at least until the end of 2017, in view of the relatively low level of inflation. The results of the quantitative easing could be seen in the negative nominal yields in the intermediate terms (3–5 years) in most of the countries. In the UK, the interest rate has been 0.3 percent since the second half of 2016. The Fed raised the federal funds rate last December from 0.5 to 0.75 percent, in March to 1 percent, and in June to 1.25 percent (Figure 9).[8] In contrast, the interest rate in Japan has remained negative for a long period at -0.1 percent and the central banks in Chile, Columbia and Brazil have lowered their interest rates (Figure 8).

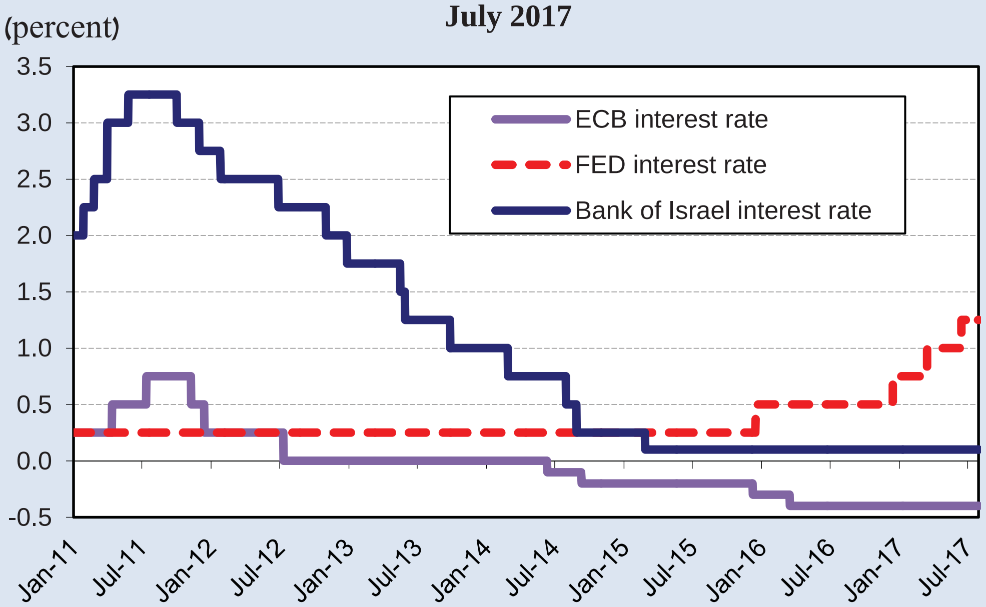
[8] The federal funds rate is published in a range of 0.25 percentage points .In this document ,the upper bound is used ,in line with common practice.

Figure 8
Changes in the Central Bank Interest Rates in the OECD Countries (in black) and in the Developing Economies (in red), January–June 2017



SOURCE: Bloomberg.

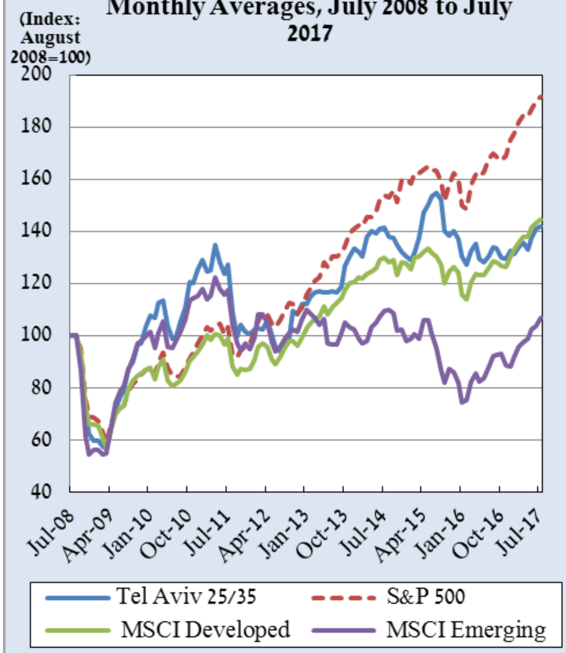
Figure 9
Central Bank Interest Rates: Israel, US and ECB[a], January 2011 to July 2017



[a] The interest rate on surplus balances of the commercial banks.
SOURCE: Bank of Israel.

The domestic share indices rose during the reviewed period, but some of them underperformed the leading indices in Europe, the emerging markets and the US. This is primarily due to the underperformance of the large companies, and in particular the companies from the chemical and pharmaceutical industries. The Tel Aviv 25/35 index increased during the reviewed period by 6.4 percent; the S&P index continued its upward trend from the previous six-month period, rising by 8.3 percent; while the share indices of the developed markets rose by 10 percent and those of the developing markets increased by 17.9 percent (Figure 10). The nominal yield curves showed declines in the intermediate and long terms. The spreads between similar corporate and government bonds declined during the reviewed period to their lowest level since 2007. The narrowing of spreads was a result of both the decline in yields on corporate bonds and the rise in yields on CPI-indexed government bonds.

Figure 10
Global Share Indices in Dollar Terms, Monthly Averages, July 2008 to July 2017



SOURCE: Bloomberg.

The cumulative domestic deficit (excluding net credit provided) totaled NIS 9 billion from January to June, in contrast to NIS 3.1 billion during the same period last year. The deficit up to this point is similar to the seasonal path consistent with achieving the deficit target for 2017, i.e. 2.9 percent of GDP. Nevertheless, part of the deficit increase reflects usage of the budget at an earlier stage of the year relative to previous years. Tax revenues during the first half of the year were 4 percent higher than in the same period last year. However, when one-time receipts and, in the other direction, the retroactive addition of credit points for parents of children up to the age of 6, which will be reflected in the figures for next month, are taken into account, the rate of increase is about 3 percent. The increase in tax revenues was significantly more moderate than in 2016 due to the decline of about NIS 2.5 billion in revenues from the taxation of vehicles during the first half of the year relative to the same period last year, and also due the halt in the increase of revenues from the real estate market. However, net of legislative changes, tax revenue is slightly higher than forecast in the budget, due to growth that is more rapid than forecast.

During the first half of the year, the government announced the "Net Family" plan, which included tax reductions and additional expenditure of about NIS 2.5 billion in 2017 and about NIS 4 billion in 2018. The plan focuses on parents of children up to the age of 6. At this stage, some of the plan's components have been approved only as a temporary order for 2017 and 2018, due the constraint of the fiscal rules for coming years.

According to the Research Department's staff forecast from the beginning of April 2017, GDP was expected to grow by 2.8 percent in 2017 and by 3.3 percent in 2018, which is a downward adjustment for 2017 (relative to the December 2016 forecast). According to this forecast, inflation was expected to converge into the target range in the second quarter of 2018, reaching a level of 1 percent, and the Bank of Israel interest rate was expected to increase to 0.25 percent in the second quarter of 2018 and to 0.5 percent in the fourth quarter of 2018. Relative to previous forecasts, the timing of the interest rate increase has been delayed and the forecast rate of inflation has decreased.

According to the Research Department's staff forecast from June 2017, GDP will grow by 3.4 percent in 2017 and by 3.3 percent in 2018, compared with 2.8 percent and 3.3 percent, respectively, in the April forecast. The growth forecast for 2017 was revised upward because National Accounts data for the first quarter and initial activity data for the second quarter indicate that exports and investment increased more rapidly than the assessment at the time of the previous forecast. The path of inflation was revised downward relative to the April forecast. During the four quarters ending with the second quarter of 2018, inflation is expected to be 0.8 percent (in contrast to 1 percent for the same period in the April forecast). The interest rate path remained unchanged from the April forecast.