Bank of Israel

Report to the public of the Bank of Israel's discussions prior to setting the interest rate for May 2007

The discussions took place on April 18 and 22, 2007

7 May 2007

General

Before the Governor makes the monthly interest rate decision, discussions are held at two levels. The first discussion takes place in a broad forum, in which the relevant background economic conditions are presented, including real and monetary 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 various economic departments of the Bank (the Research, Monetary, Foreign Currency, and Foreign Exchange Activity departments) and economists from various departments who prepare and present the material for discussion.

In the narrow forum, the directors of the economic departments 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

Various economic indicators, such as data from the latest quarterly Companies Survey received in April, the number of employee posts and tax revenues, all reinforce the assessment that rapid growth persisted in the first quarter of 2007. The Bank of Israel forecasts GDP growth of 5.1 percent in 2007.

The Bank of Israel Companies Survey

The Companies Survey shows that rapid growth continued in the first quarter of 2007, and that companies expect a further expansion of activity in the second quarter. Most sectors of the economy reported expanded activity, including manufacturing, commerce, business services, transport and communications. Construction companies report on a positive change and increased activity since the last quarter of 2006.

The labor market

The number of employee posts rose by 4.4 percent in the last twelve months (calculated from November 2006–January 2007 compared with the equivalent period a year earlier). The nominal wage per employee post rose by 3.1 percent in that period. The rate of unemployment declined from 8.3 percent of the civilian labor force in 2006:III to 7.7 percent in 2006:IV.

Foreign trade

The data of goods imports (excluding diamonds, ships, airplanes and energy products), seasonally adjusted, indicate a rise of 5.6 percent from 2006:Q4 to 2007:Q1.

The data of goods exports (excluding ships, airplanes and diamonds), seasonally adjusted, show a rise of 6 percent in the same period.

Tourist entries

In January–March 2007, about 450,000 tourist entries into Israel were recorded, 4 percent below the figure in the first three months of 2006.

2. Budget data

The domestic government budget surplus in the first quarter of 2007 (excluding credit) totaled about NIS 7.5 billion, NIS 6 billion (about one percent of GDP) higher than the seasonal path consistent with meeting the budget target—a deficit ceiling of 3 percent of GDP. The source of the surplus was mainly the increase in tax revenues. Total tax revenues (adjusted for legislative changes) in January-March were some 12 percent higher than in the first three months of last year. Expenditure in January-March (excluding credit) was about NIS 2.2 billion lower than the level consistent with the full outlay of budgeted expenditure. According to the Bank of Israel forecast of economic growth and in line with the model of tax revenues, the government deficit in 2007 is expected to fall below 2 percent of GDP.

3. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) rose by 0.2 percent in March, in line with forecasters' predictions. The rise after adjusting for seasonal factors was also 0.2 percent.

Over the past twelve months the CPI has fallen by 0.9 percent, significantly below the inflation target. Excluding housing, the CPI has risen by 0.4 percent over the past twelve months.

If the components of the CPI are divided into those directly affected by the exchange rate and the price-of-energy component ("imported" items) on the one hand, and "domestic" components not directly affected by them on the other, a marked difference is evident between the paths followed by the two groups in the past year. The prices of the domestic components of the index continued to rise in the first quarter of 2007. In contrast, following the decline in prices of the imported components of the index over the past year, the fall continued in the first quarter of 2007. According to one of the Bank of Israel's econometric models, the inflation rate of the domestic component of the CPI was 4 percent (2007:Q1 compared with 2006:Q1), while the imported price component fell by 4.6 percent.[1]

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

Inflation expectations for one year ahead derived from the capital market—break-even inflation—declined by 0.8 percentage points to 0.5 percent, significantly below than the lower limit of the target range.

Israeli forecasters' assessments of one-year inflation are below the midpoint of the target range, at an average of 1.4 percent, a drop of about one percentage point from the previous month's average. On average, they forecast inflation of 1.2 percent in 2007. Regarding the indices in the next three months—April to June—the forecasters expect the CPI to rise by a total of about 0.6 percent.

Most of the private forecasters predict that the Bank of Israel interest rate will be cut by 25 basis points in April and again in May. On average they forecast that the Bank's interest rate in a year's time will be 3.6 percent.

Prior to the interest rate decision for May, the *makam* curve reflected expectations in the financial markets that the Bank of Israel interest rate will decline moderately during the next year.

The makam and bond markets

In the month prior to the interest rate decision, the 10-year CPI-indexed interest rate remained steady at 3.3 percent. The nominal yield on unindexed 10-year *Shahar* bonds declined by 0.2 percentage points, to 5.1 percent. The *makam* yield for one year declined last month from 4.4 percent to 4.1 percent.

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

Before the current interest rate decision, the Bank of Israel interest rate was 1.25 percentage points lower than the federal funds rate. US capital market data at the time of the meeting indicated a strong probability of no change in the US rate in the coming months.

The gap between the yields on 10-year unindexed shekel bonds and US bonds of the same term narrowed during the last month from about 70 basis points to 40 basis points.

The expected real interest rate

The expected real interest rate for one year forward rose in April by 0.8 percentage points to 3.6 percent, after falling by a total of 1.4 percentage points during the previous half year.

The money supply

The (M1) money supply has increased by 11.5 percent in the last twelve months: the current-account deposits component rose by 19.7 percent, and the cash element by 1.2 percent.

[1] For a fuller discussion of this subject see the Bank of Israel Annual Report, 2006, pp. 105–09 and Box 3.2 (pp. 128–31).

The econometric models[2]

Various scenarios were examined using the Bank of Israel's econometric models. According to the Research Department's model, in the scenario with the exchange rate moving around the level of NIS 4.1 to the dollar and with the Bank of Israel's interest rate at 4 percent, inflation would return to the lower part of the target range in the last quarter of 2007. According to the Monetary Department's quarterly model, in the scenario of a decline in the Bank of Israel's interest rate to 3.6 percent in 2007:II and with gradual depreciation of the shekel to NIS 4.25 to the dollar in 2008:II, inflation would return to within the target range in the second quarter of 2008. The results of the models are sensitive to changes in the exchange rate.

4. Capital flows, the foreign currency market, and the share market

Capital flows

In the month since the last interest rate decision, the shekel strengthened by about 3 percent against the dollar, and by about 1 percent against the euro.

The negative interest rate differential between the shekel and the dollar in the last month was again a contributing factor to the export of short-term capital by the business sector. In contrast, pressure for further appreciation of the shekel deriving from the current account surplus and nonresidents' investments in the economy continued.

The foreign-currency market and the share market

As mentioned above, in the month since the last interest rate decision, until a few days before the current discussion, the shekel strengthened by about 3 percent against the dollar, from about NIS 4.20 to the dollar on 26 March to NIS 4.07 on 18 April. This occurred concurrently with the weakening of the dollar against many currencies around the world. The shekel strengthened against the euro by about 1 percent in the last month, from NIS 5.58 to the euro on 26 March to NIS 5.52 on 18 April.

The leading share indices on the Tel Aviv Stock Exchange rose markedly in the last month, following their rises since the beginning of the year. The Tel Aviv 100 index rose by about 6 percent between 26 March, the date of the last interest rate decision, and 18 April, the date of the current broad forum discussion. Since the beginning of the year this index has climbed by 13 percent.

5. Israel's financial risk, the sovereign risk premium, and foreign investment house surveys

Israel's risk premium as measured by the five-year CDS spread remained stable in April at around 18 basis points. The yield gap between 10-year *Shahar* bonds and US government bonds of the same term narrowed by about 30 basis points from the time of the previous interest rate decision to the current one.

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[2] The Bank of Israel uses econometric models to test various scenarios. Due to their nature, including the fact that their results naturally depend on certain assumptions about relevant variables, the scenarios should be viewed as one input among several in the discussions on the interest rate.

The foreign investment houses continue to describe Israel's economy in a positive light, and commend its strong macroeconomic fundamentals.

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

Strong global economic growth is expected to continue in 2007. The IMF expects a global growth rate of 4.9 percent in 2007, and a similar rate in 2008. The US economy is expected to grow by 2.2 percent in 2007, the European economy by 2.3 percent, and Japan's economy by 2.3 percent. China's economy is expected to grow by about 10 percent in 2007, and India's by 8.4 percent.

The federal funds rate is expected to decline from its current level of 5.25 percent by 25 basis points in the second half of 2007. The ECB is expected to raise its interest rate by 25 basis points to 4 percent, in the second quarter.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR MAY 2007

The inflation rate in the last twelve months, minus 0.9 percent, was significantly below the target range. Inflation expectations for one year forward derived from the capital market fell significantly in the past month and currently stand at 0.5 percent, and the average of the forecasts of Israeli economic forecasters is about 1.4 percent.

Prior to this current interest rate decision, most of the private forecasters expected that the Bank of Israel would cut the interest rate for May by 25 basis points, and for June, again, by the same rate. The average of the assessments of the Israeli forecasters is that in a year's time the Bank's interest rate will be 3.6 percent. The expectation derived from the capital market via the *makam* yield curve is that the interest rate a year hence will be lower than its current level.

On average, the Israeli forecasters assess that the CPI for April, May and June will rise by a total 0.6 percent, and that inflation viewed retrospectively over twelve months is expected to be below the target range for most of 2007.

The scenarios examined using the econometric models show that in those scenarios where the shekel depreciates somewhat, this constitutes the main factor in gradually bringing inflation back to within its target range. According to one of the models, assuming a 25 basis point cut in the interest rate for May, there would need to be a further 25 basis point reduction in the interest rate in the second quarter in order to bring inflation to within the target range during the year. The interest rate required to attain the inflation target depends to a considerable degree on future exchange rate developments. The drop in the unemployment rate which has already occurred constitutes a factor that acts to bring inflation gradually back to within the target range.

In the month preceding the current interest rate decision, Israel's sovereign risk premium, as measured in the 5-year CDS market, remained steady. The yield gap between 10-year *Shahar* bonds and US government bonds of the same term contracted by about 30 basis points in the last month.

Israel's economy continues to enjoy the benefits of several positive developments, the most notable of which is the current account surplus, which in 2006 reached about 5 percent of GDP. Fiscal discipline too was notable. In the first quarter of the year tax revenues continued to exceed, and expenditure fell short of, their expected seasonal paths. These developments help bolster foreign investors' faith in Israel's economy, which is reflected by the extent of foreign investments in Israel.

The main factors supporting real appreciation of the shekel are the current account surplus in the balance of payments and the flow of foreign investment into the economy. The real appreciation is defined as a combination of the strengthening of the nominal exchange rate and the high rise in domestic prices compared to price rises abroad.[3] It was pointed out in the discussion that in the medium and long terms, monetary policy is unable to influence the real exchange rate, because although a reduction in the interest rate acts to weaken the nominal exchange rate of the shekel, over time it also leads to higher domestic inflation.

Changes in the exchange rate affect inflation in Israel relatively strongly and quickly. In the last month the shekel strengthened by about 3 percent against the dollar, and by about 1 percent against the euro. That is to say that the strengthening of the shekel occurred against a background of both domestic and foreign factors. In the discussion it was noted that hitherto, over the last year, the strengthening of the shekel—including its effect on housing prices—has been a key cause of negative inflation.

It was stressed in the discussion that developments of prices in the economy were not uniform. In the past 12 months the housing index had fallen 6.6 percent, and this was an important factor in the lowered inflation; CPI excluding housing had risen in the past 12 months by 0.4 percent. Furthermore, using models developed by the Bank of Israel, the consumer price index (excluding housing and fuel) is split into a component of locally produced goods and services and an import component.[4] This analysis points to the continuing action of opposing forces: on the one hand, the fall in prices of the import component, stemming primarily from the strengthening of the shekel against the dollar, and on the other hand, the rise in the local component in line with the growth in output demand.

The data on real activity continue to indicate a high rate of growth. No inflationary pressures from the labor market are evident as yet, due to the rapid rise in productivity that caused a reduction in unit labor costs. However, the rate at which unit labor costs are falling has slowed.

One of the department directors participating in the discussion recommended reducing the interest rate for May by 50 basis points, arguing that the probability of bringing inflation back to the target range by the end of 2007 should be raised as much as possible. In this context it was claimed that a relatively large reduction in the

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[3] The change in the effective real exchange rate of the shekel is measured by the ratio of the nominal exchange rate of the shekel (against the currencies of Israel's trading partners) to the movement of prices in Israel compared to price developments in Israel's trading partners, weighted by each country's relative share of Israel's trade.

[4] For a discussion on the local and import components of the consumer price index, see the Bank of Israel Annual Report 2006, pp. 107-108 and Box 3.2 (pp. 128-131).

interest rate this month could reduce the inflow of short-term capital, which may stem from expectations of a continued reduction in the interest rate.

Most of the departmental directors participating in the discussion recommended lowering the interest rate for May by 25 basis points. They based their recommendation regarding the size of the reduction on the following considerations:

- The reduction in the interest rate this month alongside the rapid economic growth (and the continuing process of a narrowing of the output gap) would cause inflation to gradually return to within the target range. They noted that the inflation registered in the local component (of the consumer price index) indicated the force of demand in the economy acting on inflation, and though these forces were currently being offset by the strengthening of the shekel, they are still in the pipeline.
- Although some of the change in the exchange rate of the shekel against the dollar was indeed affected by local factors, another part stemmed from the weakening of the dollar worldwide, and these trends could change.
- The Bank of Israel has a responsibility to help maintain financial stability. In this context, attention was drawn to the steep price rises in the local financial markets.
- In the current situation of rapid economic growth, a relatively moderate reduction in the interest rate was called for.

Following a 25 basis point reduction in the Bank of Israel interest rate for May, the Bank's interest rate would be 1.50 percentage points lower than the Fed funds rate.

After the discussion, the Governor decided to reduce the interest rate for May by 25 basis points, to 3.75 percent. This reduction is part of a gradual process which will continue as long as necessary to raise the probability that inflation will return to the target range close to the end of 2007.

The decision was made and published on April 22, 2007.

Those present at 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, Director of the Monetary Department
Mr. Barry Topf, Director of the Foreign Currency Department
Mr. Balfour Ozer, Director of the Foreign Exchange Activity Department
Dr. Ohad Bar-Efrat, Advisor to the Governor and Head of International Affairs
Mr. Gaby Fiszman, Chief of Staff to the Governor

Appendix: Major Global Economic Developments

U.S.

The rate of growth in the US slowed down in the first quarter of 2007, in particular against a background of a slowdown in the housing market. However it does not appear that the weakness of the housing market and certain parts of the manufacturing sector have permeated significantly to the rest of the economy, and unemployment remains low. The Employment Report for March reports on a drop in the unemployment rate to 4.4 percent.

The growth in employment and the rise in real wages supported consumer spending, which continued to rise in 2007, and are expected to continue supporting the economy in the coming quarters.

The Fed expects continued modest growth in 2007 at a pace slightly below its long-term potential, and a similar rate in 2008, though it noted that the risk of not reaching this forecast had risen. Global growth and the weak exchange rate of the dollar are expected to support US growth. The investment houses expect growth of about 2 percent in the first half of 2007 and a faster rate of 2.7 percent in the second half.

The investment houses on average expect that the Fed will lower the interest rate by 25 basis points by the end of the year, with a probability of 84 percent, and futures contracts on the Fed interest rate reflect a 100 percent probability of a cut of 25 basis points in the rate for the same period.

Europe

The investment houses on average expect growth in Europe to reach 2.1 percent in 2007. Growth accelerated in the fourth quarter of 2006 to 3.6 percent. Economic data show that growth continued in the first quarter, albeit at a more modest rate, though it remains firm and comprehensive.

Global growth which remained strong continues to provide support for European exports, and local demand is also expected to maintain its positive momentum. Company investments are expected to remain high against a background of advantageous financing conditions, structural changes in companies' balance sheets, and businesses' increased profits and efficiency. Private consumption is expected to increase against a background of rising disposable income and an improvement in the labor market, where unemployment registered a fall to a low of 7.3 percent. Strong growth was also registered in the services sector. Indices of consumer and business confidence rose to their highest levels since 2001.

The European Central Bank left its key interest rate unchanged at 3.75 percent, though it noted that given the favorable economic environment, it would continue to act to ensure that risks to price stability over the medium term do not materialise.

The investment houses raised their forecasts of the ECB interest rates, and they now expect on average that the central bank will raise its interest rate to 4 percent by the end of the second quarter.

Japan

The Japanese economy grew moderately in the first quarter against a background of continued growth in exports and business sector investments. Household incomes also continued to rise moderately and this supported private consumption, which increased in the first two months of 2007, after falling consistently in 2006. Against this background of growth both in local demand and in demand from overseas, manufacturing also increased.

The Bank of Japan expects the economy to continue growing through 2007. The investment houses on average expect growth of 2 percent in the first half of the year, and slightly faster growth in the second half.

Inflation in Japan is expected to remain around 0 percent in the near future. However in the long term, inflation is expected to move to a positive trend against a background of an output gap that remains positive.

As expected, the Bank of Japan kept its interest rate unchanged this month, for the second consecutive month, at 0.5 percent. In the absence of inflationary pressures, the probabilities derived from the financial markets for an additional raise in the interest rate by the central bank fell.

The emerging markets

The emerging markets continued to present a positive picture. Growth in the Asian emerging markets reached 8.3 percent in 2006, of which about 70 percent referred to China and India. China and India are expected to continue providing the engine of growth for the region. This growth is expected to be supported by an increase in local demand which will offset the expected slowdown in exports. The Asian Development Bank raised its forecast for growth in Asia to 7.6 percent for 2007 and to 7.7 percent in 2008.