BANK OF ISRAEL

Office of the Spokesperson and Economic Information

March 9, 2020

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

### The discussions took place on February 23 and 24, 2020.

## 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 24th, 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 0.25 percent. Five Committee members supported the proposal to keep the interest rate unchanged, and one Committee member supported the proposal to reduce it to 0.1 percent.

The discussion focused primarily on the inflation environment in Israel, the exchange rate, economic activity, and the risks to global and domestic growth in view of the spread of the coronavirus.

## Main points of discussion

Other than current data from the financial markets and some of the forecasts, the data available to the Committee were up-to-date as of the fourth quarter of 2019, and some to January 2020, and were therefore not affected by the implications of the spread of the coronavirus. The Committee discussed the situation as shown by the data, and also discussed developments and assessments in connection with the effects of the spread of the virus, as known during the discussion on February 24.

The Committee discussed the uncertainty and risks to global economic activity. The data indicated low growth in Europe and negative growth in Japan, while the American economy continues to show strength. It was noted that the global political risks have declined in view of the progress in trade talks between the US and China and the progress in the Brexit process, but the slowdown in world trade that began before the outbreak of the coronavirus has continued. The Committee members noted that the global growth forecasts were revised slightly downward, and there was a more significant revision regarding China. According to the assessments of most global financial institutions, if the spread of the virus is contained in the coming months, the damage to the global economy will be limited in scope and will take place mainly in the first quarter of 2020. Assessments are that in such a case, the virus will mainly affect demand and the production and supply chain. The Committee noted that until recently, the reactions of the global capital markets to the spread of the virus was moderate. However, in the days preceding the discussion, in view of the continued spread of the virus to additional regions, there were sharp price declines, and government bond yields declined due to assessments that the central banks may adopt more accommodative monetary policies. The Committee also discussed the drop in oil prices and in goods indices that took place in parallel with the drop in demand in China. The Committee members agreed that there was tremendous uncertainty regarding the extent to which the virus would affect global activity and trade, but it is clear that the risks tend to be heavy.

The Committee discussed developments that occurred in the inflation environment in recent months. The Committee members noted that the year over year inflation rate remained low after the CPI reading for January surprised slightly to the downside. They emphasized that the index excluding volatile items—energy and fruits and vegetables—indicates a similar inflation environment. However, it was agreed that the moderating inflation does not reflect weakness in demand, and is affected to a large extent by the appreciation of the shekel. The Committee members said that 1-year inflation expectations from most sources declined, mainly in view of the further strengthening of the shekel and the decline in oil prices. The Committee's assessment was that in the coming months, year over year inflation is expected to decline further, before moving back toward the lower bound of the target. In this context, the Committee members' assessment was that one-year inflation expectations also include expectations of price increases due to the possibility that there may be an increase in VAT. The Committee members noted that medium- and long-term expectations remained stable since the previous interest rate decision, and that inflation expectations for 5–10 years, net of the inflation risk premium, are at the midpoint of the target range.

The Committee members discussed the appreciation of the shekel and the fact that the shekel was notable in its strengthening relative to most currencies since the previous interest rate decision. The Committee's assessment was that this development is weighing on the return of inflation toward the target. The Committee members noted that since the previous interest rate decision, the Bank of Israel intervened significantly in the foreign exchange market. The Committee members discussed the impact of Israel being added to the WGBI index. They emphasized that the Bank of Israel is prepared to prevent an excessive appreciation of the shekel by purchasing foreign exchange as necessary, particularly if the appreciation is due to factors of a financial nature.

With regard to economic activity, the Committee's assessment was that the economy will continue growing at around its potential pace. While the relatively high growth rate in the fourth quarter was impacted by volatility in vehicle imports, growth was still 3.7 percent in the second half of the year as a whole. The Committee's position was that growth was balanced in 2019. Growth in the fourth quarter encompassed all uses except for investment in residential construction. The Committee members' assessment was that the labor market remains tight. Most recent data showed a decline in the unemployment rate and that the participation rate and the employment rate remained high. The Committee members noted that the increase in the nominal wage continues despite some decline in its rate of increase. Most Committee members agreed that the initial indicators of activity in the first quarter—including the Business Tendency Survey and the Composite State of the Economy Index—support the assessment that the economy continues to grow strongly. In contrast, some of the members noted that health tax data indicated moderation. The Committee members emphasized the uncertainty regarding the effect of the spread of the coronavirus on activity in Israel. Their assessment was that if the crisis does not persist or spill over into additional countries, and particularly if significant preventative measures are not required in Israel, no significant impact is expected on macroeconomic activity in Israel. However, even under such a scenario, some harm is possible to some industries such as the construction and tourism industries. They added that if the crisis persists and becomes worse, there may be a greater impact in Israel. The Committee members emphasized that the basic market conditions put the Israeli economy in a good position relative to the world. They also emphasized that the Committee has a variety of tools to expand monetary accommodation if necessary. The Committee also discussed the effects of fiscal uncertainty, in view of the continued political uncertainty and the effects of deficit reduction measures.

After a discussion, five Committee members were of the opinion that the interest rate should be kept at its current level. The data available to the Committee showed that the economy continues to grow at close to its potential rate, the labor market remains tight, inflation is low but is expected to begin converging toward the target range in about a year, and as such, the interest rate can be left at its current position. However, they added that in view of the inflation environment and the risks to activity due to the continued spread of the coronavirus, the Bank will continue intervening in the foreign exchange market or will use additional monetary tools as necessary in order to increase the scope of accommodation of monetary policy.

In contrast, one Committee member voted in favor of reducing the interest rate to 0.1 percent. He claimed that the cumulative appreciation is liable to adversely impact economic activity and to act toward a continued decline in inflation, which in any case is at a low level. In addition, according to that same Committee member, the moderation of economic activity worldwide is a significant risk that, together with the expected impact of the fiscal contraction, requires an enhancement of the level of monetary accommodation. This Committee member did not reject the possibility that it may be necessary to lower the interest rate even below 0.1 percent.

The Committee members were of the opinion that in view of the inflation environment in Israel, the monetary policies of major central banks worldwide, the moderation in the global economy, and the continued appreciation of the shekel, it will be necessary to leave the interest rate at its current level for a prolonged period or to reduce it, in order to support a process at the end of which inflation will stabilize around the midpoint of the target range, and so that the economy will continue to grow strongly. Moreover, the Committee members noted that the Committee is taking additional steps as necessary to make monetary policy more accommodative.

**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, Director of the Research Department

**Other participants in the narrow-forum discussion:**
Mr. Eddy Azoulay, Chief of Staff to the Governor
Mr. Uri Barazani, Acting Spokesperson of the Bank
Mr. Tal Biber, Head of the Markets Division, Markets Department
Mr. Arad May, Secretariat of the Monetary Committee
Mr. Ari Kutai, Economist in the Research Department
Mr. Yoav Soffer, Advisor to the Governor