September 20, 2016

Summary of the Monetary Committee discussions on July 5, July 12, August 24, and September 6, 2016 regarding a change in the frequency of interest rate decisions

Background data

A main policy tool for the Bank of Israel, as for most central banks worldwide, is the monetary interest rate. The decision regarding the interest rate is made at a preset frequency, though the frequency of decisions among OECD countries is not uniform. In several central banks, including the Bank of Israel, the frequency of the decision is monthly. However, in most central banks, including those of major economies, decisions are made 8 times per year (twice quarterly), or even less—in some banks, the decisions are reached at a frequency of 4-6 times per year.

The variance worldwide as well as a reduction in the frequency at several central banks in recent years indicate that there is not one particular frequency for reaching decisions that is correct, and the question of what the optimal frequency is remains an open question. This question was now examined again at the Bank of Israel, and in particular the advantages and disadvantages, and the possibility of reducing the frequency of reaching interest rate decisions to eight decisions per year. The examination indicates that compared with the existing situation, there are advantages and disadvantages to a situation of 8 decisions per year. Three Committee members were of the opinion that the advantages of switching to a twice-quarterly frequency are greater than the disadvantages, while one Committee member was of the opinion that the disadvantages markedly outweigh the advantages, and therefore opposed the decision.

The considerations for and against a switch to a frequency of 8 decisions per year:

1. **The frequency of 8 times per year is in line with the entrenchment of the inflation targeting regime.** The stability of long-term inflation expectations indicates the entrenchment of the inflation targeting regime in Israel, and the credibility ascribed to the Bank of Israel. This entrenchment, accompanied as well by moderation in the volatility of the inflation rate, allows the Bank of Israel to slightly spread out the frequency of decisions, since rapid responses to stabilize expectations are not required. A frequency of monthly decisions is today mostly a feature of developing economies, and economies characterized by a high basic rate of inflation. Among the banks making 12 decisions per year, Israel has the lowest average rate of inflation over the past two decades, and inflation that is stable relative to others.
   The Committee member who opposed the decision was of the opinion that it is wrong to link the frequency of decisions to the level of long-term inflation

expectations and the volatility of inflation expectations. In his view, the Bank's role is to ensure that the inflation rate is within the target range set by the government. Stability of the inflation rate is a secondary goal in this regard. Long term inflation expectations have been anchored within the target range for more than a decade, and thus should not serve as a consideration for changing the frequency precisely at this time. In contrast, the inflation rate in the past two years and most short-term inflation expectations are below the target range, and thus all the more so do not justify a change in frequency.

2. **Frequency of eight times per year is in line with the low volatility of economic variables in Israel.** Relatively low volatility indicates that there is no need for frequent changes of policy. The volatility of Israel's main economic variables—GDP, inflation, and effective exchange rate—is not high in international comparison. The volatility of the external terms of trade, which is a variable representing exogenous shocks to the economy, is not high either. Long-term inflation expectations are very stable and are nearly not influenced by cyclical or transitory economic shocks. While low volatility of economic variables can actually be a result of greater volatility in the interest rate, an examination by the Bank of Israel does not support this assessment.
   The Committee member who opposed the decision was of the opinion that the ability to change the interest rate is a central bank's most effective policy tool, and in the past the Bank has efficiently utilized the flexibility accorded by this tool. Thus, in the five years after the global financial crisis the Bank changed the monetary interest rate (in both directions) more than any other advanced-economy central bank. The effective use of interest rate decisions was one of the main contributing factors to the high growth rate and stability of growth in Israel during that time.
   The aforementioned Committee member also asserted that the monthly frequency contributes to stability even when the Monetary Committee decides not to change the interest rate. Inherent in a decision to leave the interest rate unchanged is a "calming message" to decision makers in the business sector and it clarifies that in the Committee's opinion, the new information that has become available since the previous interest rate decision does not require a change in policy. In contrast, an increase in the span between decisions, as a result of a reduction in the frequency, is liable to lead to a double-dose interest rate change (by 0.5 percentage points), a decision that will increase the disquiet in the markets as it indicates a "crisis situation" or otherwise lead to increased use of alternative measures, such as foreign exchange purchases.

3. **Lower frequency will allow more extensive analysis of fundamental trends,** and will help bring the focus of the discussion from one based on monthly data, which include much "noise", to lower frequency data, which more reliably represent the state of the economy at any given time. The Monetary Committee examines the economic environment and makes its decisions based on a professional discussion of all the factors and considerations involved in setting the interest rate. A move to a slightly lower frequency will enable the Bank's professional staff as well as the Monetary Committee to more extensively examine trends in the economic environment, with better balance between short term developments and more fundamental developments, as a greater volume of fundamental information accrues between meetings at a lower frequency.

The Committee member that opposed the decision claimed that the interest rate decisions were always reached after utilization of the full information available to the Bank, based on the most up to date economic analysis, and that the monthly frequency did not impact the "depth" of the discussion. The horizon of data used by the Bank's economists when formulating the assessment of the situation ahead of the decision was determined by the content of the issue, and was not impacted by the length of the span between decisions.

4. **A frequency of two decisions per quarter is in line with the frequency of leading central banks.** The global trend is to reduce the frequency of the decision. The frequency of interest rate decisions was recently reduced at the ECB (European Central Bank), the BOJ (Bank of Japan), and the BOE (Bank of England) to that of the US Federal Reserve—8 decisions per year. With that, the world's four leading central banks will make interest rate decisions at an identical frequency of 8 times per year. Out of 19 OECD countries conducting independent monetary policy (with the ECB as a single bloc), 9 central banks make such decisions 8 times per year[1], 3 central banks make decisions of lower frequency (in Sweden and Norway—6 times, and in Switzerland—4 times), and only 7 banks (Australia[2], South Korea[3], Hungary, Turkey, Poland, Chile and Israel) decide 12 times.
   The Committee member who opposed the decision was of the opinion that the reductions of the frequency at the ECB, BOJ, and BOE are not related to a decline in the challenges facing those banks, but rather is related to those banks having exhausted the traditional interest rate tools when the interest rate reached zero (or near-zero) and they moved to quantitative easing policy, which is not dependent on the frequency of monetary committee meetings.[4] As evidence, countries that were more "conservative" in interest rate policy, and as a result the central bank interest rate is far from zero, such as Poland and Australia, did not reduce the frequency to 8 interest rate decisions yearly.

5. **Committee members agreed that the lower frequency incorporates reduced flexibility to respond to an unexpected event with an interest rate change at a predetermined date.** Monthly frequency allows greater flexibility in reaching decisions, with moderate changes in the interest rate and monitoring of the markets' response. It is also better coordinated with the frequency of main monthly data, particularly with the publication of the CPI and labor market data. While most Committee members viewed the loss of flexibility as a secondary consideration, the Committee member that opposed the decision claimed that there could be situations in which the negative impact of the loss of flexibility is likely to be significant. To illustrate this point, he pointed to the Committee's experience in 2013 when the Monetary Committee attempted to reduce the frequency of the decision to 10 times per year, and was forced to rescind the decision several months after reaching it in view of the sharp appreciation of the exchange rate.
   After several discussions on the issue, most Monetary Committee members reached the conclusion, as noted, that the advantages of switching to 8 decisions

[1] New Zealand—7 times per year.
[2] Australia—11 times per year.
[3] The South Korea central bank also decided to switch to a frequency of 8 decisions per year, beginning in January 2017.
[4] The Monetary Committee is only required to occasionally set the amount of total purchases.

per year outweigh the disadvantages and the risks. They claimed that as the flexibility to make monetary policy decisions at any time, as well as the ability to convey messages to markets regarding the state of the economy, is retained even after the change, the effectiveness of policy will not be adversely impacted. Likewise, they noted that in those cases in which central banks recently reduced the frequency of decisions, a negative market reaction was not seen. They emphasized that the decision does not derive from the current interest rate environment, and maintained that the decision to reduce the frequency of decisions is correct both for the current times and the period when the interest rate will increase.

The Committee member that opposed the decision asserted that the reasoning presented to the Committee does not justify reducing the frequency of the decisions at this time. He claimed that the loss of the flexibility provided by monthly frequency is material, and the decision would not be reached if not for the low rate of interest in the economy that limits, he claims, the extent of the use of the interest rate tool. The low interest rate drove, in his contention, central banks of Europe and Japan in their decision to reduce the frequency of interest rate decisions. The frequency of Committee meetings does not impact on monetary policy so long as the interest rate is set at its current level, but is likely to adversely impact flexibility and efficiency of monetary policy when the interest rate again is raised.

Participants in the discussion:

Members of the Monetary Committee

Dr. Karnit Flug, Governor of the Bank of Israel, and Chairperson

Dr. Nadine Baudot-Trajtenberg, Deputy Governor of the Bank of Israel

Prof. Reuben Gronau

Prof. Nathan Sussman, Director of the Research Department

Other participants in the discussion:

Andrew Abir, Director of Market Operations Department

Tal Biber, Head of Markets Division in Market Operations Department (at discussions on July 5, 12, and August 24)

Francoise Ben-Zur, Head of Financial Division in Market Operations Department (at July 5 discussion)

Dr. Amit Friedman, Advisor to Director of Market Operations Department

Daniel Hahiashvili, Chief of Staff to the Governor (at discussions on July 5, 12, and August 24)

Dr. Edward Offenbacher, Senior Advisor for International Research Relations (at July 5 discussion)

Mimi Regev, Head of the Market Surveillance and Analysis Unit (at July 5 discussion)

Dr. Sigal Ribon, Head of Monetary Division in Research Department

Esti Schwartz, Secretary of the Monetary Committee and the Supervisory Council (at discussions on July 5, 12, and August 24)

Ilan Socianu, Assistant to Secretary of Monetary Committee and Supervisory Council (at Sept 6 discussion)
Yoav Soffer, Spokesperson of the Bank of Israel (at discussions on July 5, 12, and September 6)