BANK OF ISRAEL
Office of the Spokesperson and Economic Information

12 October 2009

Report to the public of the Bank of Israel's discussions prior to setting the interest rate for October 2009

The discussions took place on 23 and 24 September 2009

General

Before the Governor makes the monthly interest rate decision, discussions are held at two levels—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 real, monetary and financial 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 Research and Market Operations Departments of the Bank and economists from various departments who prepare and present the material for discussion. The data, estimates and assessments in these minutes are those that were available at the time of the discussions.

In the narrow forum, the directors of the Research and Market Operations Departments and two other participating members of management 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

The Bank of Israel assessment at the time of the discussions on the interest rate for October was that the recovery in economic activity was continuing, but there was uncertainty regarding its strength. The halt in the decline in economic activity, which had been expected to occur only at the end of 2009, had taken place already in the second quarter of the year. The Bank of Israel expects GDP in 2009 to be the same as in 2008, with a rise in the unemployment rate to 8.1 percent (annual averages). GDP is expected to grow by 2.5 percent in 2010, and the unemployment rate to increase slightly to 8.3 percent.

The National Accounts

The National Accounts figures for the second quarter of 2009 published by the Central Bureau of Statistics (CBS) on 16 September showed an increase of 1 percent

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in GDP in the second quarter (annual rate, compared with the first quarter). This was the same as the CBS estimate dated 16 August. According to the updated CBS figures, the increase in business sector product in the second quarter was revised upwards from 0.7 percent to 1.3 percent, with upward revisions also to the increase in private consumption (from 4.4 percent to 5.6 percent), nonresidential investment (from a negative 14.3 percent to a positive 2.5 percent), exports excluding diamonds (from 0.9 percent to 26.3 percent), and imports excluding diamonds (from a negative 13.8 percent to an increase of 3.2 percent). By contrast, government expenditure was revised downwards from an increase of 20.2 percent to one of 12.1 percent.

The composite state-of-the-economy index

The Bank of Israel's composite state-of-the-economy index for August increased by 1.3 percent, following increases of 1.1 percent in the July index and 0.7 percent in the June index (changes from previous month, with the initial June and July indices revised upwards). The rise in the index continues the upward trend that started in May 2009, and strengthens the assessment that there has been a positive turnaround in economic activity. The increase in August reflects mainly an increase in goods and services exports. There is uncertainty, however, about the strength of the recovery. The index of manufacturing production declined in July by 2.8 percent (compared with the previous month, seasonally adjusted), following a 1.6 percent increase in June. The trade and services revenue index fell by 3.3 percent in July, following its 3.7 percent increase in June (compared with the previous month, seasonally adjusted).

The labor market

The nominal wage per employee post in the business sector increased by 3.3 percent in June from its May level. In the three months April–June the wage declined by 3.7 percent compared with the level in the previous three months (seasonally adjusted, annual rate).

The number of employee posts (seasonally adjusted) was the same in June as in May. National Insurance data show a 2.3 percent decline in employment in April–June compared with the previous three months.

The unemployment rate increased to 8.0 percent in the second quarter, from 7.6 percent in the first quarter.

The Companies Survey

Partial preliminary results from the Bank of Israel's Companies Survey for the third quarter relate to companies' reports at the beginning of the quarter of recovery in their activity and an improvement in their situation compared with the second quarter. In most industries, orders for the last quarter of 2009 remain moderate.

Foreign trade and the balance of payments

Goods exports (excluding diamonds) increased by 5.2 percent in August from their July level (in dollar terms, seasonally adjusted). In the three months June–August these exports surged by 32 percent (in dollar terms, seasonally adjusted, annual rate) from their level in the previous three months.

Goods imports (excluding ships, aircraft and diamonds) fell by 0.4 percent in August from their July level (in dollar terms, seasonally adjusted). In the three months June–August these imports swelled by 43.8 percent (in dollar terms, seasonally adjusted, annual rate) from their level in the previous three months.

The surplus in the current account of the balance of payments totaled $2.1 billion in the second quarter of 2009, following a similar surplus ($2.3 billion) in the first quarter. In contrast with the first half of 2008, when goods imports exceeded goods exports by $3.1 billion, in the first half of 2009 goods exports exceeded goods imports by $500 million.

2. Budget data

The overall budget deficit in January–August 2009, excluding credit, totaled NIS 19.4 billion, compared with a surplus of NIS 1.5 billion in January–August 2008. The large deficit reflects the steep drop in tax revenues resulting from the economic slowdown, moderated by some underspending of the budget. Excluding the effects of changes in tax rates and one-off receipts, tax revenues declined by about 11 percent in real terms in January–August compared with the equivalent period in 2008.

Government domestic expenditure in January–August was NIS 4.1 billion lower than the seasonal path consistent with full budget expenditure (i.e., underspending of 2.7 percent).

In the budget for the years 2009 and 2010 the deficit ceiling set by law was increased from 1 percent of GDP to 6 percent of GDP in 2009 and 5.5 percent in 2010. The decision was taken as a result of the recession and the sharp drop in tax revenues. Based on an analysis by the Research Department, the Bank of Israel expects the deficit in 2009 to be below the revised ceiling.

3. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) rose by 0.5 percent in August, in line with forecasters' expectations. The increase in the index was affected by the increase in the price of water (from 15 July), and it may be assumed that it was also affected by the one percentage point increase in VAT in July. There was a steep increase of 1.2 percent in the housing component in August.

Since the beginning of 2009 the CPI has increased by 3.7 percent, and seasonally adjusted by 2.5 percent. Since the beginning of the year the annual rate of inflation, based on the seasonally adjusted CPI and excluding the effect of government actions (i.e., excluding the effect of the increase in VAT and other prices controlled by the government) was 2 percent.

In the last twelve months the CPI increased by 3.1 percent, slightly above the upper limit of the inflation target range.

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

One-year-forward inflation expectations derived from the capital market ("break-even inflation") in September (to 22 September) averaged 2.3 percent, close to the 2.4 percent average in August.

The Israeli forecasters assess, on average, that inflation measured over the previous twelve months will be above the upper limit of the inflation target range until the middle of 2010, and that then it is expected to decline towards the midpoint of the range.

The Israeli forecasters predict on average that inflation one year forward will be 2.3 percent, and that in the three months September, October and November 2009 the change in the CPI will be a cumulative decline of 0.1 percent.

With regard to the interest rate, Israeli forecasters on average expect that the Bank of Israel rate for October will increase by 0.1 percentage points, and that twelve months hence the interest rate will be 2.8 percent.

An analysis of the slope of the *makam* yield curve shows that the capital markets expect an increase in the Bank of Israel interest rate towards the end of 2009, and expect the rate to be about 2.4 percent in twelve month's time.

The makam and bond markets

Real yields to maturity on CPI-indexed five-year government bonds remained unchanged this month (to 22 September) from their August level, at 1.5 percent. The yield on 5-year unindexed government bonds fell in September to an average of 3.8 percent, from an average of 4.1 percent in August. The yield on one-year *makam* increased to about 1.8 percent in September, from 1.6 percent in August.

New corporate bond issues in September totaled about NIS 4 billion, and since the beginning of the year, about NIS 30 billion, compared with about NIS 22 billion in the whole of 2008. In the period from 23 August to 23 September the Tel-Bond 20 index increased by 1.4 percent, and the Tel-Bond 40 index declined by 1.6 percent.

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

Prior to the current interest rate decision, the Bank of Israel interest rate was 0.5 to 0.75 percentage points higher than the US federal funds rate, and 0.25 percentage points lower than the ECB rate.

The gap between the unindexed ten-year shekel government bond yield and the ten-year US government bond yield narrowed this month, from 187 basis points on 24 August to 165 basis points on 22 September

The expected real interest rate

The Bank of Israel interest rate *minus* twelve-months-forward inflation expectations derived from the capital markets increased in September by about 0.3 percent from its August level, to an average of *minus* 1.5 percent.

The monetary aggregates

In the twelve months to September 2009 the M1 monetary aggregate (cash held by the public and demand deposits) grew by 65.3 percent, and the M2 aggregate (M1 plus unindexed term deposits of up to one year) by 20.5 percent. The rapid increase in M1 was partly due to the public's switching from term deposits to current accounts in light of the low level of interest on the term deposits.

The econometric models[1]

Various scenarios of the development of inflation and other variables in the next year were examined using the Bank of Israel's econometric models. The underlying assumptions were that GDP would be the same in 2009 as in 2008, that there would be growth of 2.5 percent in 2010, that the low interest rates around the world would start to rise in 2010, that prices of imported inputs would increase, and that world trade would drop by 18 percent in 2009 and would increase by 4.4 percent in 2010.

The baseline scenario of the quarterly DSGE (dynamic stochastic general equilibrium) model, which places great weight on expectations and which uses the Bank of Israel reaction function based on the smoothing of the interest rate path, under the assumption that housing prices would increase at an annual rate of 2 percent in the next few months, and that the (quarterly average) exchange rate from the third quarter of 2009 to the end of 2010 would move between NIS 3.84 and NIS 3.95 to the dollar, gave a modest increase in the Bank of Israel interest rate to an average of 1 percent in the last quarter of 2009 and 1.5 percent in the last quarter of 2010. Inflation was expected to be 4.1 percent in 2009, and 1.1 percent in 2010.

The Error-Correction (EC) model yielded inflation of 4.2 percent in 2009 and 2 percent in 2010, with the Bank of Israel interest rate increasing from an average of 1.2 percent in the last quarter of 2009 to 3 percent in the last quarter of 2010. In this scenario the average exchange rate in the last quarter of 2009 would be NIS 3.90 to the dollar, and NIS 3.93 in the last quarter of 2010.

4. The foreign currency market and the share market

The foreign-currency market

During the month between the previous and the current interest rate discussions (i.e., from 24 August to 22 September), the shekel strengthened by about 2 percent against the dollar, from NIS 3.80 to the dollar on 24 August to NIS 3.73 on 22 September. In the same period the shekel weakened by about 1.5 percent against the euro, from NIS 5.44 to the euro to NIS 5.52.

The nominal effective exchange rate of the shekel, calculated as the average shekel exchange rate against 24 currencies (representing 33 countries) weighted according to the volume of Israel's trade with those countries, showed a shekel appreciation of 0.3 percent in the period.[2]

The share market

[1] 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. In the abnormal conditions prevailing in the global financial markets since the outbreak of the worldwide financial crisis, and bearing in mind that the models do not directly reflect such events, the weight that can be attached to the forecasts derived from the models is reduced.

[2] The weight of the dollar in the effective exchange rate is about 24 percent, and that of the euro, about 35 percent.

The Tel Aviv 25 share price index on 22 September was similar to that on 24 August. In the same period the Dow Jones index rose by 3.4 percent.

5. Israel's financial risk, the sovereign risk premium

Israel's risk premium, as measured by the five-year CDS spread, declined from 1.15 percentage points to 1 percentage point in the period between the previous and the current discussions on the interest rate. The risk premium of most emerging market countries also declined in this period.

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

The global economic environment continues to improve, both with regard to the financial side, and with regard to economic activity. A year after the collapse of Lehman Brothers, towards the end of the third quarter of 2009 it seems that the global economy is recovering from the crisis and is returning to a path of moderate growth, with the help of massive governmental support.

Expansionary monetary policy, together with significant budgetary expansion in most countries, continues to support the recovery of the global economy.

In the US the investment houses expect, on average, that the Fed interest rate will remain at its current low level (0 percent to 0.25 percent) into 2010. The ECB interest rate is also expected to remain at its current level of 1 percent for some time.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR OCTOBER 2009

The Bank of Israel increased the interest rate for September by a quarter of a percentage point to 0.75 percent, after four months of no change in the rate. At the same time the Bank continued with the policy it announced at the beginning of August, of purchasing foreign currency from time to time when there were abnormal movements in the exchange rate that were not consistent with the basic economic conditions or when the forex market was not functioning properly.

In the narrow-forum discussion, four members of management make recommendations to the Governor regarding the appropriate rate of interest for the economy. In the discussions of the interest rate for October, three of them recommended that the Governor increase the interest rate by a quarter of a percentage point, and the fourth recommended that the Governor leave the rate unchanged.

The three participants who recommended an increase in the interest rate noted that inflation over the previous twelve months was slightly above the upper limit of the target range, and that the interest rate was low given that the economy was on a recovery path, even if there was uncertainty regarding the strength of the recovery. The short-term real interest rate (the central bank rate *minus* one-year inflation expectations) was one of the lowest in the advanced economies, as inflation in most of them was expected to be low next year. They also said that the output gap in Israel was lower than that in most of the advanced economies. They added that one-year forward inflation expectations of the domestic forecasters and those based on the capital market were close to the midpoint of the target range, but alongside these were expectations of increases in the Bank of Israel interest rate. They stated further that the latest update to the National Accounts for the second quarter indicated that the recovery in economic activity in the business sector appeared more firmly based than it had in the previous assessment. They argued that the very expansionary monetary policy currently in place was taken against the background of the environment of a serious crisis and concern that the recession would be a severe and long one, and that in light of the current environment of economic activity there was room to increase the interest rate again, following the previous month's increase.

The member of management who recommended that the Governor leave the interest rate unchanged stated that it was important to continue to support the recovery in economic activity. A no-change decision would prevent a widening of the differential between the interest rate in Israel and rates abroad, and would thus serve to reduce the supply of foreign currency on the forex market (compared to a decision to increase the interest rate)—and this at a time when the Bank of Israel was buying foreign currency as necessary. The Bank's foreign currency purchases act to moderate the strengthening of the shekel, and support the recovery trend of economic activity. In this context this member added that interest rates of the leading central banks are expected to remain very low into 2010. This member argued further that despite the continued recovery in activity in Israel and the expectation of faster growth in Israel and world wide, there was uncertainty about the strength of the process. It was expected that the recovery would be a slow one, and that it would be accompanied by a slow process of interest rate increases.

The member who recommended no change emphasized that although the inflation environment, expressed in actual price increases, was slightly above the upper limit of the target range, if the price increases resulting from government decisions were excluded (i.e., the increased tax on cigarettes and fuel, the increase in VAT, and the water surcharge), inflation was close to the midpoint of the target range. Moreover, the output gap, reflected by the high rate of unemployment, among other things, was expected to restrain inflation in the coming year.

The point was added that the monetary environment that affects inflation incorporates both the interest rate and the exchange rate, and the strengthening of the shekel (the appreciation of the nominal effective exchange rate over the last five months) serves to moderate inflation.

At the end of the discussion, taking all the above points into consideration, the Governor decided to leave the interest rate for October unchanged at 0.75 percent, in order to balance the need to continue to support the recovery of economic activity with the need to return inflation to within the price stability target range, while preserving financial stability.

In its announcement of the decision, the Bank of Israel stressed the following:

- Inflation measured over the previous twelve months is slightly above the target range. However, inflation from the beginning of the year, however, excluding the effects of increased tax rates and seasonally adjusted, is around the midpoint of the target range. Inflation expectations for the next twelve months, both those of the forecasters and those derived from the capital market, are also around the midpoint of the target range. The rate of inflation is expected to return to within the target range when the short-term effects of the increases in taxation have run their course. The output gap, reflected by the high rate of unemployment among other things, was expected to restrain inflation in the coming year, as was the appreciation of the shekel in terms of the nominal effective exchange rate in the last few months.

- The continued recovery in economic activity and the expectation of faster growth in Israel and world wide suggest that the current environment is one of recovery from the recession. That said, there is uncertainty regarding the strength of the recovery in Israel, in part because of the uncertainty about the recovery in the global economy.
- Interest rates of the leading central banks around the world are low, and are expected to remain unchanged during the coming months.

The Bank of Israel announced that it will continue to act to achieve its price-stability objective, and will monitor Israeli and worldwide economic developments, and will use the instruments available to it to encourage employment and growth, and to support the stability of the financial system.

The decision was made and published on 24 September 2009.

Those participating in 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, Member of Management and Head of the Monetary and Finance Division, Research Department

Mr. Barry Topf, Director of the Market Operations Department

Dr Ohad Bar-Efrat, Advisor to the Governor and Head of Information and International Affairs Division

Mr. Eddy Azoulay, Chief of Staff to the Governor

Dr. Yossi Saadon, Advisor to the Governor and Bank of Israel Spokesperson

Appendix: Major Global Economic Developments

US

Data received in the month since the previous interest rate discussions in Israel indicate that in the third quarter of 2009 the US economy was on a recovery path from the severe recession it had experienced for two years, and that the recovery was expected to be faster than assessments in the last few months. The US Treasury Secretary declared that from now the government would focus on strengthening growth and not on the rescue strategy it has pursued till now.

According to the latest Federal Reserve's Summary of Commentary on Current Economic Conditions (the "Beige Book"), a particular risk factor is the commercial real estate sector, which is suffering from low occupancy rates and decline in rents, that could result in further losses for banks with loans to that sector.

Retail sales in August were the highest for three-and-a-half years, and greatly exceeded expectations, and might indicate a recovery in consumption.

Although unemployment climbed to 9.7 percent, its highest level for thirty years, it appears that the upward trend in unemployment is slowing, and that employment may stabilize towards the end of the year.

The Fed stated that economic activity is likely to stay at a low level for a considerable period. The large output gap is expected to moderate inflationary pressures, and the main assessment is that this will be the dominant effect.

The absence of inflationary pressure will enable the Fed to return gradually to a neutral policy. The analysts expect the interest rate to start increasing only in 2010, and they consider that the Fed will wait for the start of recovery in the labor market before it embarks on increases in the interest rate.

Europe

The economic recovery in the eurozone economy continued, but not uniformly. Unemployment figures for the second quarter were not as bad as had been expected, but unemployment is expected to continue rising in 2010. Growth is expected to be led by the industrialized countries, headed by Germany. Against the background of data on the manufacturing sector throughout the eurozone that indicate expansion and increases in exports and in factory order books, consumer confidence indices are rising, led by the German consumer confidence index.

The ECB forecast is of 0.2 percent growth in 2010, whereas the market consensus is for 2 percent growth. The ECB decided to leave its interest rate unchanged at 1 percent, and not to hurry to change its expansionary policy. The markets do not expect an increase in the ECB interest rate before the end of the first half of 2010.

Japan

Japan's economic data continue to paint a mixed picture, and result in different assessments of its rate of recovery from its long crisis. Data on output and manufacturing indicate an improvement, but growth for the second quarter was revised downwards. Unemployment increased to 5.7 percent, the wage declined for the fourteenth consecutive month, and there is growing concern over deflation.

The emerging markets

In the emerging market countries (mainly in East Asia but also in South America) the trend of rapid recovery evident in the last few months is continuing, essentially with regard to exports (China) and the increase in commodity prices. In Europe the situation is more problematic, in particular in the emerging market Baltic states that are in a difficult position.

China's economic data, including manufacturing product, retail sales (headed by vehicle sales) strengthen the assessment that the improvement in China's economy will persist. The interest rate was left unchanged, and some of the analysts assess that it might be increased as early as in the first quarter of 2010.