BANK OF ISRAEL

Office of the Spokesperson and Economic Information

September 7, 2020

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

The discussions took place on August 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 August 24, 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 0.1 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 percent.

The discussion focused primarily on the effects of the coronavirus crisis on Israel's economy in the short and long terms, and on the policy required to reduce the scope of the adverse economic impact on businesses and households and to support an economic recovery that is as rapid as possible.

Main points of discussion

The significant negative impact on the economy resulting from the coronavirus crisis that began in March, the process of economic recovery that began with the removal of the limitations, and the risk of deterioration in economic activity in view of the second wave of infections and the political uncertainty were the focus of the Monetary Committee's discussions.

The Committee discussed the status of the real economy. Based on the first estimate of National Accounts data for the second quarter of 2020, GDP contracted by 28.7 percent (in annual terms), and its level is 11 percent lower than what would have been expected if not for the crisis. Most of the negative impact was in domestic activity—private consumption and investment—while the negative impact on exports was slightly more moderate. There was an increase in public consumption, against the background of the response of government policy to the crisis. An analysis of rapid indicators of activity shows that after a relatively rapid recovery in June, there was some slowdown in the pace of recovery in July and August. The level of credit card purchases in July was lower than the level forecast by data from recent years, but from the beginning of August there was an increase in purchases. Indices of mobility to workplaces moderated in July to up to 20–30 percent below their precrisis levels; in the beginning of August there was an increase in mobility to retail and recreation places. The Committee noted that considerable uncertainty remains both with regard to the development of the health situation and with regard to the date of the approval of the budget for 2021, which is liable to weigh on the continuation of the recovery.

Although there is difficulty in precisely assessing the labor market situation in view of the variance in data from various sources, all the data still point to marked weakness. Based on Labor Force Surveys conducted by the Central Bureau of Statistics, the "broad unemployment rate", which includes the unemployed, those temporarily absent from work for reasons related to the Covid-19 crisis, and those dismissed from their positions between March and July who are not looking for work, is about 12 percent in July(for those aged 15 and above).

The Research Department updated its macroeconomic forecast, to reflect two possible scenarios. In the relatively optimistic scenario, in which there is control over the pandemic, GDP is expected to contract by 4.5 percent in 2020, and to grow by 6 percent in 2021. Under this scenario, the deficit is expected to be 13.2 percent in 2020 and 8.2 percent in 2021, and the debt to GDP ratio is expected to be 75 percent in 2020 and 78 percent in 2021. In the more pessimistic scenario, where only partial control of the pandemic is achieved, GDP is expected to contract by 7 percent in 2020 and to grow by 3 percent in 2021. Under this scenario, the deficit is expected to be 14.6 percent in 2020 and 12 percent in 2021, and the debt to GDP ratio is expected to be 78 percent in 2020 and 87 percent in 2021.

The Committee was presented with updates about the development of the coronavirus crisis around the world and its economic ramifications. The global economy contracted sharply in the second quarter. Investment houses forecast positive growth in the second half of the year, but for 2020 overall a marked contraction of GDP is expected in most economies. The removal of the lockdowns and the reduction of social distancing carried out by numerous countries led to some recovery, but the economy is far from returning to its level of just before the pandemic. The inflationary environment around the world remained low and far from central banks' targets. Central banks in advanced economies continue to implement the special steps that were announced in view of the crisis.

The Committee referred to the inflation environment which remains low. The CPI for June declined by 0.1 percent and the CPI for July increased by 0.2 percent, and over the preceding 12 months, the inflation rate was -0.6 percent, compared with a rate of -1.6 percent at the time of the previous interest rate decision. The main contribution to the increase in year over year inflation was from the rise in fuel prices, which reduced the negative contribution of the energy component in the CPI. In the CPI net of energy, fruit and vegetables, there was inflation of -0.4 percent, similar to the level of previous months. There is a methodological difficulty in calculating the Consumer Price Index as long as the limitations on economic activity lead to certain products and services not being consumed and thus their prices not being able to be measured, and there is a change in households' consumption basket. However, an analysis conducted by the Research Department indicates that it appears that the change in the composition of the consumption basket has not yet had a major impact on the inflation rate actually experienced by households, and it is close to the official inflation rate. Inflation expectations for the coming year from all sources remained below the lower bound of the target. In the coming months, the year over year inflation rate is expected to remain negative. Medium-term forward inflation expectations increased, so that inflation expectations at the end of the second year are slightly below the lower bound of the target, and expectations for longer terms are within the target range.

The Committee discussed developments in the foreign exchange market. Since the previous interest rate decision, the shekel weakened by 0.6 percent in terms of the nominal effective exchange rate, while strengthening by approximately 1 percent against the dollar, and weakening by 3.5 percent against the euro. The exchange rate and its impact on exports, employment and economic activity, and the return of the inflation rate to the target remain a focus of the Committee's discussions and policy decisions.

The Committee discussed developments in Israel's capital markets. An improvement can be seen in the functioning of the credit market, with stability in interest rates, supported by the Bank of Israel's steps and the government-guaranteed credit funds. The Business Tendency Survey points to some moderation in companies' credit constraints, but the limitation is still higher than before the crisis. The Committee was of the opinion that there is not a broad credit constraint in the economy and that in general the credit market itself is functioning appropriately. However, there are indications of credit difficulties concentrated in certain industries and in small companies. Government bond yields remained low, and it appears that the Bank of Israel's intervention in the corporate bond market, which began in July, contributed to a marked decline in spreads on the main Tel Bond indices. Equity market prices rose in line with the global trend.

Within the framework of the discussion, the Committee referred to the mechanism of the intervention tools available to it. Since the onset of the crisis, the Committee has implemented a range of steps, to enhance the extent of monetary-policy accommodation, to ensure the continued orderly activity of financial markets and to support the mechanism of monetary pass-through to credit in the economy. The Committee discussed a number of alternatives regarding monetary steps that can be implemented at this time in view of the situation in the economy. It was noted that the tools that the Committee is utilizing at this time are providing a response to the needs of the economy.

Five Committee members were of the opinion that the interest rate should be kept at its current level of 0.1 percent. They were of the opinion that this low interest rate level supports the recovery of economic activity and the gradual return of the inflation rate to within the target range, and particularly in view of the Bank of Israel operating additional tools in the credit market. One Committee member voted in favor of reducing the interest rate to 0 percent. He was of the opinion that an interest rate lower than 0.1 percent is more appropriate due to the magnitude of the crisis and the adverse impact, anomalous in its magnitude, on the employment level.

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:
Dr. Adi Brender, Head of Macroeconomics and Policy Division, Research Department
Mr. Tal Biber, Head of the Markets Division, Markets Department
Dr. Golan Benita, Chief of Staff to the Governor
Mr. Uri Barazani, Acting Spokesperson of the Bank
Mr. Arad May, Secretariat of the Monetary Committee
Mr. Yoav Soffer, Advisor to the Governor
Mr. Eliezer Borenstein, Research Department