Bank of Israel

MONETARY POLICY REPORT

July–December 2015

Preliminary version

44

February 2016

According to the Bank of Israel Law, 5770-2010, the Bank of Israel has three objectives: (1) to maintain price stability as its central goal; it was established that price stability is defined as an annual inflation rate of between 1 percent and 3 percent; (2) to support other objectives of the Government's economic policy, especially growth, employment and reducing social gaps, provided that this support shall not prejudice the attainment of price stability, and (3) to support the stability and orderly activity of the financial system. In order to attain these objectives, the Bank of Israel employs various tools, chief among them the monthly decision on the appropriate level of the short term interest rate. In addition, the Bank intervenes in the foreign exchange market.

Section 55(a) of the Bank of Israel Law, 5770–2010, establishes the publication of this report, which is submitted to the government and the Knesset Finance Committee twice a year. The report surveys the monetary policy implemented in the period covered by the report. It also surveys the policy required, in the view of the members of the Bank of Israel's Monetary Committee—the forum in which monetary policy decisions are reached—for the inflation rate to be within the range set by the government and to achieve the other objectives of the government's economic policy. A survey of financial stability appears in the Financial Stability Report for the period covered.

In accordance with Section 55(b) of the Law, this report explains why the inflation rate deviated from the target range set by the government for more than six consecutive months, beginning with the publication (on July 15th, 2014) of the Consumer Price Index (CPI) for June 2014. The rate of inflation during this period declined to below the lower bound of the target range, and explanations appear in Section A (Policy and Targets) inside.

The Monetary Policy Report for the second half of 2015 was prepared by economists in the Research Department, within guidelines set by the Bank of Israel Monetary Committee. This report is based on data that were published up to January 25, 2016, the date of the decision on the interest rate for February 2016.

Should there be any changes to this publication, they will appear on the Bank of Israel website: www.bankisrael.org.il

Summary

Monetary policy: During the second half of 2015, the Monetary Committee decided to leave the interest rate at a level of 0.1 percent. For both January and February, which belong to the first half of 2016, the Monetary Committee also decided to leave the interest rate at the same low rate. In the announcements of the interest rate decisions for November and December—as well as the announcements for January and February—the Committee made use of forward guidance in announcing that monetary policy is expected to remain accommodative for a considerable time, even in view of the increase in the US federal funds rate. In addition, the Bank of Israel continued to purchase foreign currency.

Inflation and inflation expectations: During the twelve months ending in December 2015, the CPI declined by one percent. The energy component continued making the main contribution to the CPI, as a result of the sharp decline in global oil prices. The policy measures adopted by the government, and primarily the reduction in VAT and the cancelation of the television levy, also contributed to the decline in the CPI. Net of the direct effect of energy prices and the government policy measures, the CPI rose by 0.6 percent. Inflation expectations for the next year, based on the various sources, remained lower than the target range, although the forward expectations for the medium and long terms are at the center of the target range or slightly below it.

Domestic real economic activity: The economy resumed growth at the moderate rate that has characterized it during the last two years. GDP grew by a rate of 2.1 percent during the third quarter of 2015, after stagnating during the second quarter. This was due to, among other things, the drop in exports as a result of factors of a transitory nature and the decline in the rate of growth in world trade. Nondurables private consumption continued to lead economic growth. In the labor market, employment continued to grow, unemployment remained low and wages continued to rise at a moderate rate. The indicators for the end of the period being surveyed pointed to an improvement in domestic activity and exports.

The exchange rate: The nominal effective exchange rate (the average in December relative to the average in July), of the shekel remained stable. Relative to the dollar, it depreciated by about 2 percent and relative to the euro it appreciated by about 1 percent. Various models of the equilibrium exchange rate indicated that the shekel was overvalued.

The global environment: The global economy continued to grow at a moderate pace. Advanced economies grew moderately while emerging markets, and primarily China, experienced a decline in growth rates. This development was accompanied by volatility in the markets and sharp declines in commodity prices. In the US, despite the low rate of inflation, the continuing improvement in the labor market and the assessment that inflation is expected to return to its target led the Fed to raise its federal funds rate by one-quarter of a percentage point in December, the first increase in seven years. In Europe, despite the consistent yet moderate growth during the past year, inflation remains close to zero and inflation expectations for the longer terms were

revised downward. As a result, the ECB has adopted an even more accommodative monetary policy. Thus, toward the end of the period being surveyed, there was a divergence of monetary policies between the main economic blocs.

The housing market: An increase in home prices was renewed after some moderation during the previous half of the year. In addition, the number of transactions and the volume of new mortgages increased sharply during the period being surveyed and reached record levels. Even though the risk characteristics of the new mortgages remained low as a result of past steps taken by the Banking Supervision Department, the growth in the share of mortgages continues to be the main risk component in bank credit. The volume of building starts remained at a high level. The rate of increase in rents remained relatively stable.

Financial markets: Domestic share indexes have declined since August, in line with the global trend, accompanied by an increase in volatility against the background of declines in the stock markets of advanced economies. Yields increased in the short-term segment of the real and nominal yield curves and declined in the long-term segment. The spread between similar corporate and government bonds remained unchanged during the period being surveyed.

Fiscal developments: The government budget for 2015 was approved in November. In October, the government reduced the VAT rate by one percentage point. Tax revenues exceeded the forecast of the Research Department made at the beginning of the year by about NIS 6 billion. Tax revenues grew in real terms by 6.1 percent relative to 2014. Net of legislative changes and one-time revenues, total tax revenues rose by about 7.9 percent in real terms. The actual deficit was 2.15 percent of GDP (in terms of actual GDP), compared with 2.75 percent of GDP in the budget (in terms of actual GDP) and the ratio of public debt to GDP declined to 64.9 percent.

Forecasts of the Research Department: At the beginning of the second half of the year, the Research Department presented an optimistic forecast, based on the optimistic forecasts worldwide. Thus, the Research Department expected that inflation would return to within the target range within 12 months and that by the end of 2016 it would return to around the midpoint of the range, and also that the rate of growth in GDP would increase. During the second half of the year, the Research Department revised downward its growth forecasts for 2015 and 2016, following weaker than expected growth in the third quarter and a downward revision of forecasts of world trade. According to this forecast, inflation will be somewhat below the lower bound of the target range at the end of 2016 and the Bank of Israel interest rate will start to rise only in the fourth quarter of 2016.

In accordance with the Bank of Israel Law (see the description at the beginning of the report), Section A explains why the rate of inflation has deviated from the target range set by the government for more than six consecutive months. In addition, it describes the policy adopted by the Committee in order to return the rate of inflation to within the target range and presents its assessment of the time required to do so. Section B describes the background conditions and their effect on interest rate policy.[1]

A. Policy and targets

In the second half of 2015, the Monetary Committee kept the interest rate at the low level of 0.1 percent. During this period, the Monetary Committee for the first time used forward guidance and explicitly communicated to the public that monetary policy would remain accommodative for a considerable time. This was despite the increase in the US federal funds rate. The Committee initiated this policy with the interest rate announcement for November 2015 and used it again in December and in January and February of 2016. During the period being surveyed, the Bank of Israel continued to purchase foreign currency. The CPI measured over the 12 months ending in December declined by one percent. In other words, the inflation rate was significantly lower than target range defined as price stability (1–3 percent annually). Several factors were responsible for inflation deviating from the target range during the second half of the year, and primary among them was the decline in commodity prices, especially oil prices. The global price of oil continued to fall during this half year, for the most part surprisingly sharply, and the rate of decline reached about 50 percent. This is a continuation of the dramatic decline that began in mid-2014 and, in cumulative terms, the rate of decline has reached about 70 percent. According to assessments, the decline in energy prices has directly contributed to a decrease of about one percent in the CPI and added to this is its indirect effect through lower prices of goods and services, whose cost of production has fallen with energy prices. Additional factors that have kept inflation below the target range include the administrative decisions by the government since September that were intended to reduce the cost of living, such as the decision to reduce VAT and to cancel the television levy. Added to these is the one-off reduction in water prices at the beginning of the year. The administrative decisions have cumulatively reduced the CPI by 0.6 percent. Net of these one-off effects and of the direct effect of declining energy prices, the CPI increased by 0.6 percent this year, which is still somewhat below the lower bound of the inflation target range.

The Committee was of the opinion that the decline in the inflation rate during this period was a result of the aforementioned factors—that is, the dramatic decline in commodity prices, especially oil, and the administrative decisions of the government—rather than weakness in domestic demand. According to forecasts compiled at the beginning of the period being surveyed, which were based on forecasts by the Research Department and on the expectations in

[1] Since October 2015, there have been vacant seats on the Monetary Committee, which has operated with four members.

the capital market, inflation over the coming 12 months was expected to rise to above the lower bound of the target range during 2016 and to reach its center by the end of the year. These forecasts were based on the expectation that oil prices would stabilize at the level they reached in mid-2015, following a marked increase during the quarter that preceded the preparation of the Research Department's forecasts. However, expectations were not born out. The continued decline in oil prices surprised markets in Israel as it did global markets, and reduced inflation to levels close to zero in advanced economies. This led to a downward revision of inflation expectations in the medium term. The forecasts at the beginning of the period also included the expectation that economic growth in Israel would improve, against the background of similar improvement abroad as projected by international entities. During this period, GDP grew at a lower than expected rate as a result of the slower than expected growth in the global economy, while growth in nondurables consumption continued. This growth was supported by accommodative monetary policy, and was also manifested in a resilient labor market and an increase in wages.

Although inflation expectations remained outside the target range, the Committee assessed that during the period being surveyed the time was not appropriate to use unconventional tools, such as bond purchases or a negative monetary interest rate, which are resorted to in exceptional circumstances. The Committee stressed that monetary policy remains particularly accommodative since the interest rate remains at a historically low level. In addition, the Bank of Israel continued to intervene in the foreign exchange market in order to support the interest rate policy. In the interest rate discussions for November, and also for subsequent months, the Monetary Committee decided to leave the interest rate unchanged and also aimed to guide expectations by communicating to the public that monetary policy would remain accommodative for a considerable time.

The Committee is of the opinion that the monetary policy that it is implementing, i.e., a very low interest rate over time and the purchase of foreign currency, will contribute to returning inflation to within the target range during the first half of 2017, after the one-off effects of price reductions at the government's initiative, including the steps taken in January and February 2016, have dissipated and on the assumption that the prices of oil and other commodities will stabilize. Furthermore, during the past year the rate of increase in nominal wages in the business sector has accelerated and this is expected to help in returning inflation to the target range. Finally, inflation expectations in the medium and long terms indicate that the financial markets also believe that over time monetary policy will lead to the achievement of the inflation target. In this context, it is important to note that, according to law, monetary policy should be forward-looking and does not act to offset price declines that have already occurred.

The members of the Committee assessed that there are risks in adopting a more accommodative monetary policy using unconventional means, such as a negative interest rate. One of the main risks to financial stability from a low interest rate environment is related to increased demand for housing loans. This raises the concern that when the interest rate eventually rises, some borrowers will find it difficult to make the payments on the variable rate component of their mortgage. The members of the Committee were of the opinion that the steps taken by the Banking Supervision Department in recent years are working to limit this risk since the risk characteristics of mortgages declined and then stabilized.

During the period being surveyed, several considerations led to the decisions to leave the interest rate at its low level: (1) A low inflationary environment: Actual annual inflation was negative throughout the period being surveyed. This was primarily the result of global supply factors, i.e., the continuing decline in commodity prices, and particularly oil prices, and domestic administrative factors, such as the reduction in the VAT rate. Net of the energy component and the effect of administrative measures, the inflation rate is somewhat below the lower bound of the target range. The short-term expectations are low and are affected by the administrative price reductions that have not yet come into effect and by the continuing decline in commodity prices. Forward inflation expectations for the medium (4–7 years) and long (8–10 years) terms are close to the center of the target range. **(2) GDP grew by a moderate rate:** GDP continued to grow at the moderate rate that has characterized it during the last two years and which is due primarily to the slowdown in demand for exports and the decline in investment (Table 1). Private consumption, supported by accommodative monetary policy, continued to lead the growth in GDP and supported improvement in the labor market, i.e., the employment rate remained high and an increase in the real wage was apparent. **(3) Most of the leading economies continued to maintain an accommodative monetary policy, although toward the end of the period being surveyed expectations developed of a divergence of monetary policies between the main economic blocs:** The ECB continued to maintain an accommodative monetary policy, the interest rate in leading economies remained low and additional countries reduced their interest rates. Toward the end of the period being surveyed, there were growing expectations that the US Federal Reserve would raise the federal funds rate in December and this indeed occurred at the Fed meeting in mid-December. **(4) The level of the exchange rate and moderate global economic activity weighed on exports:** The nominal effective exchange rate stabilized at a low level during the period being surveyed. In addition, global growth remained moderate, primarily due to the slower rates of growth in the emerging and developing markets. As a small and open market, Israel is influenced to a great extent by these developments and they continued to weigh on exports. **(5) The housing market continued to exhibit a high level of activity:** There was an increase in home prices and in mortgage volumes. However, at the same time, the stock of homes for sale and building starts grew.

The Committee members assess that accommodative monetary policy for a considerable time, alongside economic forces—primarily continued domestic economic growth, a low unemployment rate, and an increase in wages—will work to return inflation to within the target range during the first half of 2017. This rests on the assumption that there will be no further deterioration in the global economy and that commodity prices will remain stable.

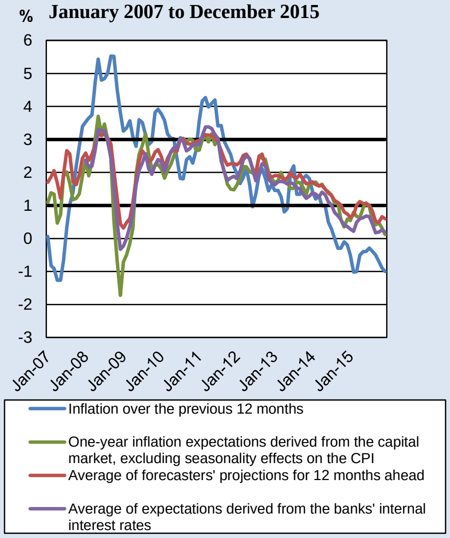
B. Background conditions and their effect on interest rate policy[2]

Actual inflation measured over the preceding 12 months was negative during the entire period being surveyed, primarily due to an unexpectedly sharp decline in commodity prices, especially oil prices. To this were added structural changes in the economy and administrative steps taken by the government. During the first quarter of 2015, the downward trend in inflation continued and in March actual inflation during the previous 12 months stood at negative 1.0 percent. This was primarily due to supply-side factors, including the decline in oil prices that began in 2014, the drop in global prices of food inputs and the sharp declines in the CPI in January and February as a result of one-time factors (the reduction in electricity and water prices as a result of, among other things, the transition to natural gas). However, changes in the CPI between March and July were consistent with the inflation target and inflation during the 12 months ending in July stood at –0.3 percent. Furthermore, at the beginning of the period being surveyed, the Committee was presented with the predicted future path of inflation—according to both the capital market and the forecast of the Research Department made in June—which showed that inflation during the subsequent 12 months would rise to around the lower bound of the target range (Figure 1). The Research Department's forecast was based on several factors and particularly on the view that the price of oil would stabilize after having remained almost unchanged in March–July (from the beginning of 2014 until January 2015, oil prices declined by about 55 percent, which was one of the main factors contributing to the sharp declines in inflation during the first half of 2015). Added to this is the effect of one-off factors (the lowering of electricity and water prices at the beginning of 2015) and the increase in wages in the economy (which are expected to support domestic demand). Nonetheless, the members of the Committee noted at that time that there was also a risk that inflation would continue to decline, as it was possible that the price of oil would resume its downward trend and that the appreciation in terms of the nominal effective exchange rate would continue. During the subsequent four months (August–November), there was a change in the CPI trend when some of these risks were realized. Thus, commodity prices resumed their decline (Figure 2), particularly the price of oil, which from July to September declined by about 25 percent and fell again at the end of the period being surveyed. To this was added additional and unexpected administrative changes initiated by the government, in particular the reduction in the VAT rate, the cancelation of the television levy and a further reduction in the price of electricity. According to estimates, these changes cumulatively reduced the CPI for September–October by about 0.6 percent. For the year as a whole, inflation over the previous 12 months totaled –1.0 percent. As mentioned, the members of the Committee felt that the decline in the CPI does not reflect weak domestic demand but rather "imported inflation" and one-off factors (Figure 3). Although inflation expectations in the short term are below the target range, they reflect the sharp decline in oil prices and the administrative lowering of prices which have not yet gone into effect. Medium-long term expectations (5–10 years) remain anchored in the middle of the target range. Net of the

[2] Table 3 presents the background conditions as they were known to the Committee members.

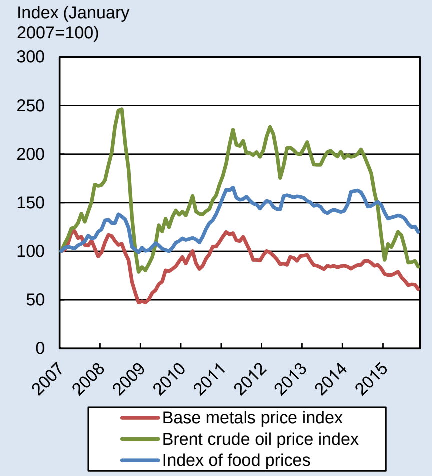
energy component and one-off factors, inflation during the 12 months that ended in December was 0.6 percent, somewhat below the lower bound of the target range.

Figure 1
Inflation and Inflation Forecasts, January 2007 to December 2015



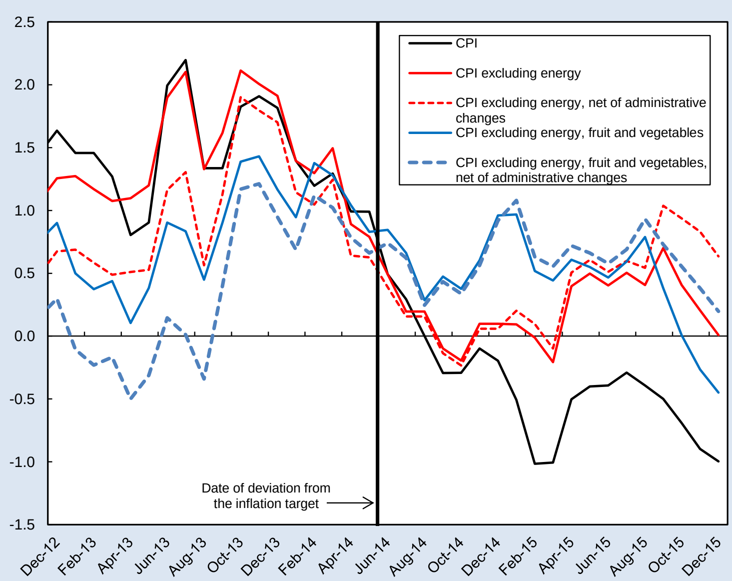
SOURCE: Based on Central Bureau of Statistics.

Figure 2
Price Indices of Base Metals, Crude Oil and Food, January 2007 to December 2015



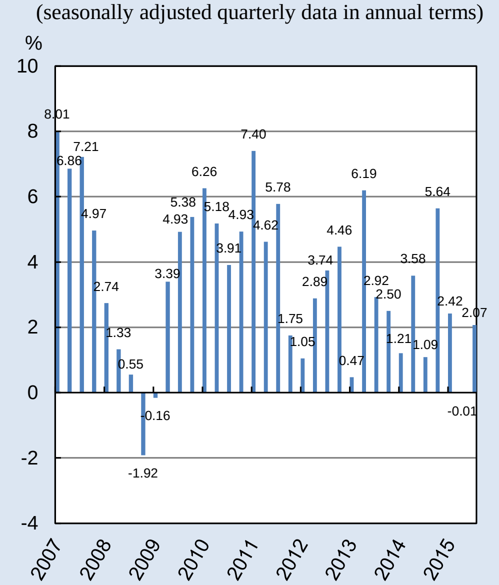
SOURCE: Based on Bloomberg.

Figure 3
Actual Inflation Over the Past 12 Months Based on the CPI and Partial Indices



SOURCE: Based on Central Bureau of Statistics.

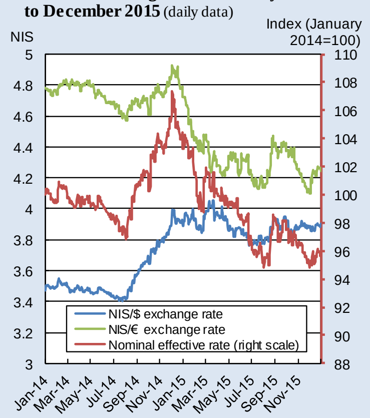
Figure 4
GDP Growth Rates, 2007:Q1–2015:Q3
(seasonally adjusted quarterly data in annual terms)



SOURCE: Based on Central Bureau of Statistics.

During the course of the period being surveyed, the economy continued to grow at a rate that characterized it during the last two years. Weakness in exports continued to weigh on the GDP growth rate, but nondurables private consumption offset this by supporting the expansion of GDP. During the second quarter, the economy did not grow, but the members of the Committee felt that this did not constitute a change in the trend of economic growth. At the beginning of the period being surveyed, economic indicators pointed to continued growth during the first half of 2015, at a similar rate to that during the last two years (Figure 4). The second estimate for the first quarter of 2015 stood at 2.1 percent. Private consumption continued to lead economic growth and the second estimate was revised upward from 5.5 percent to 7.5 percent. However, there was a major downward revision in the growth of exports, from 9.4 percent to 1.9 percent. The data for the second quarter of 2015, which included, among other things, the Survey of Companies, the Composite State of the Economy Index, and the figures for tax revenues and the labor market, indicated that the economy continued to grow at a moderate rate in the second quarter as well. In contrast, foreign trade data pointed to weakness in exports and it appeared that this was primarily a result of temporary disruptions in the chemical industry. Members of the Committee felt that the rest of the decline in exports during the first half of the year derived primarily from the contraction in world trade. In this context, some members of the Committee expressed concern that current economic growth is based less on exports, which serve as a driver of growth and increasing productivity in a small and open economy. In August, the first estimate for the second quarter was published and it indicated a standstill in growth—exports of goods and services (excluding diamonds and startup companies) contracted by 11.6 percent, and private consumption, which led economic growth in previous quarters, grew by only 0.9 percent. Nonetheless, members of the Committee assessed that this did not represent a major change in the rate of growth in GDP but rather temporary weakness, that the decline in exports should be viewed against the background of disruptions in the chemical industry and the drop in foreign demand, and that the decline in private consumption came against the background of exceptionally high growth in durable goods imports in previous quarters. They noted that nondurables consumption continued growing at a high rate, employment continued to expand and real wages had increased. Furthermore, the current indicators for the third quarter showed that the economy is continuing to grow at a moderate rate. Thus, foreign trade data and the Composite State of the Economy Index for July–August pointed to expansion. These indicators were later confirmed by the first estimate of GDP growth in the third quarter, which showed that the economy had returned to the moderate growth that characterized the previous two years and nondurables private consumption continued to grow at a fairly high rate of 6.4 percent. There was also a recovery in exports, although this occurred after two quarters of contraction. Starting in October, there was deterioration in the security situation, although its effect on GDP was relatively moderate and was felt primarily in incoming tourism. The indicators for the fourth quarter—which included, among others, the Consumer Confidence Index and the Companies Survey—pointed to a continuation of the moderate improvement in the rate of growth of GDP and indicated that it was based primarily on domestic demand. The members of the Committee felt that as long as global demand is weak, it would continue to weigh on growth of exports.

Figure 5
Selected Exchange Rates, January 2014 to December 2015 (daily data)

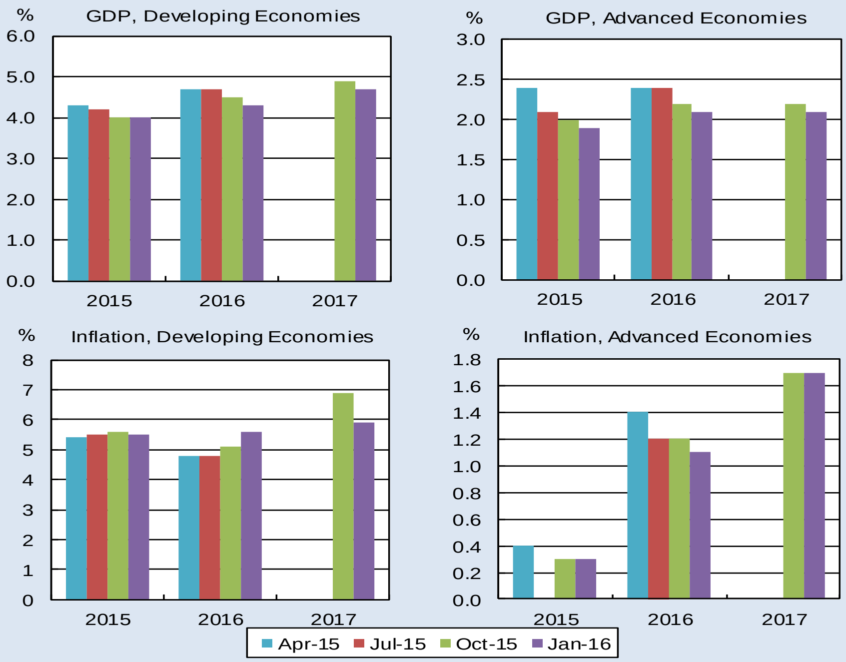


SOURCE: Bank of Israel.

For the period being surveyed as a whole, the shekel maintained stability in terms of the nominal effective exchange rate. Its potential effects on exports and on inflation were among the factors that led the Bank of Israel to continue buying foreign currency. At the beginning of the period being surveyed, the exchange rates of the shekel against the dollar and the euro stabilized at a low level (Figure 5). The members of the Committee estimated that, based on various models of the equilibrium exchange rate, the shekel was overvalued. They were concerned at that time that the cumulative appreciation, primarily against the euro, was likely to erode the improvement in exports at the beginning of the year and they stated that this concern is growing in view of the forecasts that world trade would continue to grow at only a moderate rate and the fact that about one-quarter of Israeli exports are designated for the eurozone. In addition, the appreciation had a moderating effect on inflation and it was expected that this would reduce inflation in subsequent months. Between August and October, there was a change in the trend of the exchange rate, as the shekel depreciated in terms of the nominal effective exchange rate, following the global strengthening of the euro. Nonetheless, the members of the Committee were of the opinion that the cumulative appreciation during the previous half of the year was still affecting exports. During the subsequent months, the shekel appreciated in terms of the nominal effective exchange rate and returned to the low rate that prevailed at the beginning of the period being surveyed. In order to complement monetary policy, the Bank of Israel continued to purchase foreign currency and during the period being surveyed (until December) the purchases reached $4.1 billion. About $1.5 billion of that was part of the program to offset the effect of the production of natural gas on the exchange rate.

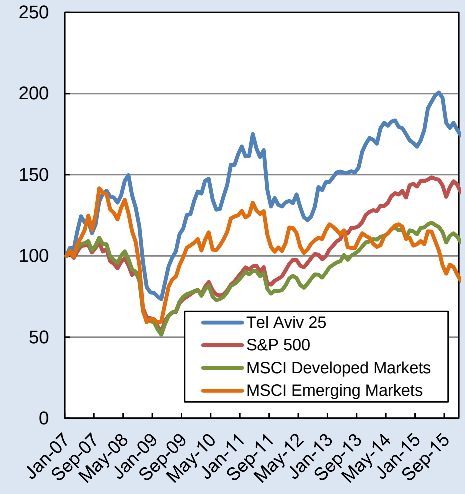
Global economic activity remained moderate and the forecasts of global growth have been revised downward, primarily due to the situation in emerging markets. The beginning of the period being surveyed continued to be characterized by concerns regarding the effect of the debt crisis in Greece, which began during the first half of the year. In addition, international organizations, such as the IMF and the OECD, revised downward their growth forecasts for both 2015 and 2016 (Figure 6). The reasons for this include weak growth in the US during the first quarter, as well as weak growth in emerging economies against the background of falling commodity prices. In August, financial markets were very volatile, as the sharp declines in China's stock prices, which began in previous months, began to spread to other stock markets (Figure 7). The members of the Committee noted that the developments in the financial markets should be evaluated over time and that it is still unclear if they will affect the real economy, and in particular Israel's. Therefore, they felt that these developments do not require a response by means of the interest rate. At the beginning of the fourth quarter, the data indicated that the global economy was continuing its recovery. In the US, there were signs that growth in the third quarter would slow and there was a reduced probability that the Fed would raise the interest rate this year (Figure 8). Other central banks reduced their interest rates (Figure 9) and there were increased expectations that the ECB would take additional accommodative measures in view of the low inflationary environment (actual and expected inflation; Figure 10). This expectation, along with reduced concerns of a crisis in China, led to an increase in the major share indexes, a decline in yields and spreads and primarily a sharp drop in risk indices. Toward the end of the period being surveyed, it became clearer that the US was continuing to recover. Estimates indicated that the US is continuing to grow at a moderate rate and that the labor market is continuing to improve. As a result, there was an increased probability of an increase in the interest rate already in 2015. These forecasts were indeed borne out in mid-December, when the Fed raised the interest rate by 0.25 percentage points. In contrast, the ECB enhanced its monetary accommodation.

Figure 6
IMF Projection of Growth and Inflation Rates in Developing and Advanced Economies, 2015, 2016 and 2017



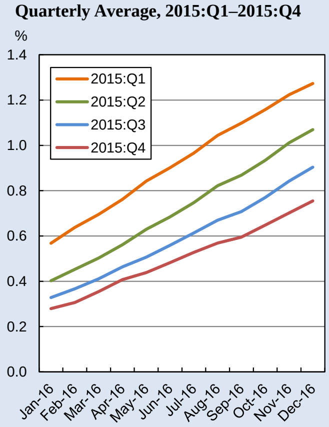
SOURCE: International Monetary Fund.

Figure 7
Global Share Indices (in dollar terms), January 2007 to December 2015
(monthly averages, January 2007=100)



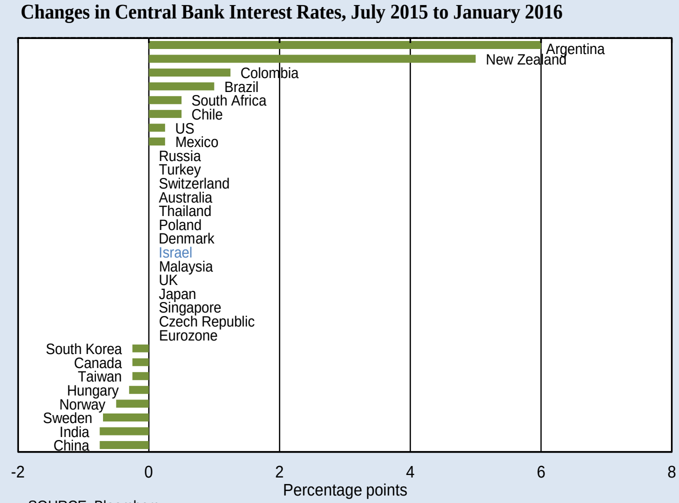
SOURCE: Bloomberg.

Figure 8
Projected US Federal Funds Rate, January 2015 to December 2016, Based on Interest Rate Futures Contracts, Quarterly Average, 2015:Q1–2015:Q4



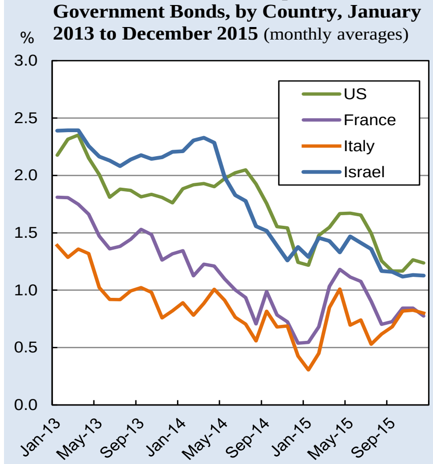
SOURCE: Based on Bloomberg.

Figure 9
Changes in Central Bank Interest Rates, July 2015 to January 2016



SOURCE: Bloomberg.

Figure 10
Nominal and Real Yield Spread on 5-Year Government Bonds, by Country, January 2013 to December 2015 (monthly averages)



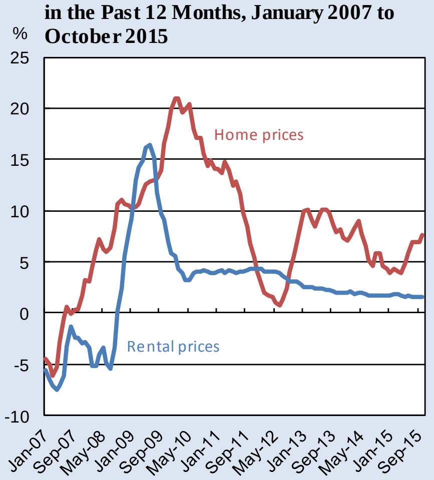
SOURCE: Foreign data–Bloomberg; Israeli data–Bank of Israel.

Most countries enhanced their monetary accommodation. Toward the end of the period, the financial markets expected the monetary policies of the two main blocs to diverge. During the period being surveyed, most of the leading economies intensified their monetary accommodation in view of the low inflationary environment, which was primarily, though not exclusively, the result of the drop in commodity prices. Although growth in Europe has resumed in a consistent manner, albeit at a slow pace, actual inflation remained low during the period being surveyed and inflation expectations were revised downward (Figure 10). Therefore, at the beginning of December, the ECB reduced the interest rate on commercial banks' deposits by 10 basis points to –0.3 percent and in addition it extended the bond-purchasing program at least until March 2017. In Japan, quantitative easing continues and some countries which have not yet lowered their interest rate to near-zero levels—such as China and Canada—have now reduced their interest rates. As the US economy had recovered towards the end of the period being surveyed, the Monetary Committee assessed that the financial markets are expecting a divergence in the monetary policies of the main blocs, i.e., enhanced quantitative easing in Europe and other leading economies and an upward path for the interest rate in the US. The members of the Committee also noted that at this stage it is still difficult to determine how these opposing processes will impact on markets in Israel.

Activity in the housing market—home prices and the volume of transactions and new mortgages—remains at a high level and continued to be one of the main considerations dictating against additional monetary accommodation. The risk characteristics of mortgages remained relatively low, as a result of the measures taken by the Banking Supervision Department. At the beginning of the period being surveyed, there was an increase in the annual rate of change in home prices, after price increases had moderated in the previous half of the year (home prices increased by 3.4 percent during the 12 months ending in April). Although home prices in July–August rose at a relatively moderate rate (0.3 percent), this did not affect the annual rate of increase since the previous year had included the stagnation in the market due to the anticipation of the Zero VAT plan and the effect of Operation Protective Edge (Figure 11). In September and October, there was some acceleration in the rate of increase in home prices, and over the 12 months ending in October, home prices increased by 7.6 percent. The high level of activity in the housing market was also reflected in the number of transactions and the volume of new mortgages. Thus, the number of transactions reached a record level in June, as did total new mortgages granted during the 12 months ending in December (NIS 64 billion). Nonetheless, the members of the Committee estimated that the high level of activity was partly due to the correction following a period in which many potential first-time buyers delayed their purchase while waiting for the Zero VAT law. They pointed out that the rise in prices is occurring simultaneously with developments that are expected to moderate the rate of increase in prices, i.e., an increase in the stock of housing for sale and in building starts and the increase in long-term yields that occurred during the previous half of the year.

The forecasts presented to the Committee by the Research Department changed significantly during the period being surveyed against the background of changes in the global environment. The forecast presented by the Research Department at the end of June predicted that inflation would return to above the lower bound of the target range already at the end of the second quarter of 2016 and that the Bank of Israel interest rate would gradually be raised in 2016. In the Research Department's forecast presented at the end of September, the growth rates for 2015 and 2016 were revised downward due to the drop in global demand, which is expected to weigh on exports, and due to the publishing of weaker than expected growth estimates for the second quarter of 2015. In this forecast, the Research Department estimated that inflation would return to above the lower bound of the target range only at the end of 2016, against the background of one-off administrative measures taken by the government and the continuing decline in oil prices. The forecast revised downward the expected path of the Bank of Israel interest rate, such that the interest rate would begin to rise only in the second quarter of 2016 and at the end of 2016 would stand at 0.5 percent at the end of the year (as opposed to 1.25 percent in the forecast given in June). The forecast at the end of December again revised downward expected economic growth in 2015 and 2016. The update for 2015 was a result of weaker than expected growth figures for the third quarter while the update for 2016 was primarily the result of the continuing downward revisions of projected growth in world trade. This forecast expected inflation to be somewhat under the lower bound of the target range only at the end of 2016, as a result of the continuing drop in oil prices, and that inflation would return to the target range at the beginning of 2017. According to the forecast, the Bank of Israel interest rate would begin to rise only at the end of the fourth quarter of 2016 (Table 2).

Figure 11
Rate of Increase in Home Prices and Rents in the Past 12 Months, January 2007 to October 2015



SOURCE: Based on Central Bureau of Statistics.

Tables

Table 1
Development of GDP, imports and uses
(Seasonally adjusted data, quantitative rates of change compared to previous period, in annual terms)

	2013	2014	2015	2014:Q2	2014:Q3	2014:Q4	2015:Q1	2015:Q2	2015:Q3
GDP	3.3	2.6	2.3	3.6	1.1	5.6	2.4	0.0	2.1
Business sector product	3.4	2.3	2.1	3.4	-1.4	7.7	2.2	-1.1	2.5
Imports excluding defense, ships, aircraft and diamonds	-2.0	3.3	1.9	0.4	12.5	0.5	6.2	-7.6	-3.1
Private consumption	3.9	3.7	4.5	6.6	5.8	7.7	5.9	0.9	2.5
of which: private consumption excluding durable goods	3.7	3.2	4.9	5.3	3.8	7.2	7.3	2.9	5.0
Public consumption	4.0	3.3	2.8	6.3	7.5	1.9	0.1	-1.3	1.2
of which: public consumption excluding defense imports	3.8	2.9	3.4	6.2	6.7	1.0	0.2	1.2	3.5
Gross domestic investment	1.7	1.0	0.6	-4.4	0.9	-1.3	18.4	1.2	-17.2
of which: in fixed assets	3.6	-2.0	-1.5	0.2	-7.5	10.0	-7.7	-3.7	0.6
Exports excluding diamonds	-0.6	2.6	-1.2	1.6	-2.9	5.5	-5.1	-10.9	7.6
of which: exports excluding startups	-1.8	4.9	-1.3	-1.0	-1.9	3.4	-4.2	-11.3	9.1

SOURCE: Based on Central Bureau of Statistics.

Table 2
Forecasts of inflation and the interest rate for the coming year[a]
(percent)

	Bank of Israel Research Department [b]	Capital market[c]	Private forecasters[d]
Inflation rate	0.6	0.1	0.5
(range of forecasts)			(-0.2 to 1.2)
Interest rate[d]	0.3	0.2	0.2
(range of forecasts)			(0.1 to 0.75)

[a] The Research Department Staff Forecast relates to the figure in another four quarters. The other forecasts relate to the figure in another 12 months.
[b] Research Department Staff Forecast from December 28, 2015.
[c] Seasonally adjusted inflation expectations. Interest rate projections are based on the *makam* market. The figures reflect the averages for December.
[4] Projections made in December, following the publication of the CPI for November.
SOURCE: Bank of Israel.

Table 3

National Accounts - data available at the time of decisions on the interest rate

Decision on rate for:		July	August	September	October	November	December
GDP	2015:Q1	2.1	2.0	2.0	1.8	2.0	2.0
	2015:Q2			0.3	0.1	0.1	0.2
	2015:Q3						2.5
Business sector product	2015:Q1	2.6	2.6	1.5	1.4	1.6	1.6
	2015:Q2			-1.0	-1.2	-1.3	-0.9
	2015:Q3						2.7
Nondurables private consumption	2015:Q1	7.5	7.9	5.5	5.8	6.1	5.7
	2015:Q2			0.9	0.6	1.0	1.5
	2015:Q3						2.4
Fixed capital formation	2015:Q1	-6.5	-6.5	-8.0	-8.5	-7.5	-7.9
	2015:Q2			-3.8	-3.4	-4.1	-3.1
	2015:Q3						0.7
Exports excluding diamonds and startups	2015:Q1	-1.9	-2.1	-8.1	-8.1	-7.0	-4.7
	2015:Q2			-11.6	-11.9	-12.2	-11.4
	2015:Q3						9.7
Civilian imports excluding ships, aircraft, and diamonds	2015:Q1	14.0	14.0	4.5	5.1	5.8	6.4
	2015:Q2			-7.8	-7.5	-6.9	-7.0
	2015:Q3						1.3

SOURCE: Based on Central Bureau of Statistics.

Appendix Tables

Appendix Table 1
Developments in the Domestic Asset Markets

(rate of change)

	07/15	08/15	09/15	10/15	11/15	12/15
Yield to maturity (monthly averages, percent)						
3-month *makam*	0.10	0.10	0.08	0.09	0.13	0.12
1-year *makam*	0.12	0.10	0.08	0.09	0.13	0.15
Unindexed 5-year notes	1.23	1.15	1.16	1.01	1.12	1.17
Unindexed 20-year bonds	3.56	3.38	3.44	3.26	3.33	3.33
CPI-indexed 1-year notes	-0.83	-0.43	-0.33	-0.38	-0.18	0.06
CPI-indexed 5-year notes	-0.21	-0.12	-0.05	-0.20	-0.03	0.05
CPI-indexed 10-year bonds	0.79	0.68	0.72	0.56	0.65	0.68
Yield spread between government bonds and private bonds rated AA-AAA[a] (percentage points)	1.25	1.20	1.35	1.33	1.30	1.32
Yield spread between government bonds and unrated private bonds excluding real estate[a] (percentage points)	5.6	5.6	5.8	5.6	5.7	6.5
Stock market (rate of change during the month)						
General shares index	6.8	-4.9	-7.4	4.6	-0.5	0.3
Tel Aviv 25 Index	3.9	-7.8	-5.5	5.5	-0.8	-2.0
Foreign exchange market (rate of change during the month)						
NIS/$	0.4	3.9	-0.2	-1.4	0.3	0.6
NIS/€	-2.0	6.4	0.0	-3.4	-3.6	3.6
Nominal effective exchange rate	-1.3	3.3	-0.6	-1.5	-1.5	1.0
Risk indices derived from trading in shekel-dollar options (monthly						
Implied volatility	9.6	10.1	11.2	10.5	9.7	9.6
Probability of depreciation greater than 5%	3.7	4.4	5.3	4.7	3.7	4.4
Probability of appreciation greater than 5%	3.5	4.2	5.3	4.6	3.7	4.2

[a] CPI-indexed bonds, excluding convertible bonds, with a yield of up to 60 percent and a duration of more than 6 months. The yield spread relates to spreads between all series of corporate bonds and the

SOURCE: Bank of Israel calculations.

Appendix Table 2

The inflation and interest rate environment

(monthly averages)

	07/15	08/15	09/15	10/15	11/15	12/15
Inflation environment (percent)						
Monthly change in CPI	0.2	-0.2	-0.4	0.1	-0.4	-0.1
Forecasters' predictions of monthly CPI (average of forecasts prior to publication of CPI)	0.2	0.0	-0.5	-0.1	-0.2	-0.1
12-month change in CPI	-0.3	-0.4	-0.5	-0.7	-0.9	-1.0
One-year inflation expectations derived from the capital market	1.0	0.5	0.4	0.5	0.3	0.1
Forecasters' one-year inflation predictions	1.0	0.8	0.5	0.5	0.7	0.6
Inflation expectations for various terms [a]						
Short-term (second and third years forward)	1.5	1.3	1.3	1.2	1.3	1.3
Medium-term (fourth to sixth years forward)	1.7	1.8	1.7	1.9	1.7	1.8
Long-term (seventh to tenth years forward)	2.0	2.0	2.1	2.0	2.0	2.0
Interest rates and interest rate differentials						
Bank of Israel interest rate	0.10	0.10	0.10	0.10	0.10	0.10
Derived real interest rate	-0.83	-0.4	-0.3	-0.4	-0.2	0.1
Short-term interest rate differential between Israel and the US	-0.15	-0.15	-0.15	-0.15	-0.15	-0.28
Short-term interest rate differential between Israel and the eurozone	0.05	0.05	0.05	0.05	0.05	0.05
Forecasters' predictions of change in the Bank of Israel interest rate for next month (average forecast, prior to the decision)	0.0	0.0	0.0	0.0	0.0	0.0
Telbor interest - 3-month forward rate in 9 months	0.2	0.2	0.1	0.1	0.1	0.2
Forecasters' predictions of the interest rate a year hence	0.3	0.3	0.3	0.3	0.3	0.3
Long-term (10-year) nominal interest rate differential between Israel and the US	0.2	0.2	0.2	0.1	0.0	0.0
Long-term (10-year) real interest rate differential between Israel	0.3	0.1	0.1	0.0	0.0	0.0

[a] Inflation expectations are measured by the difference between yields on local currency unindexed and indexed bonds. These expectations include an element of risk premium, which rises with the length of the term to which the expectations relate.

SOURCE: Based on Central Bureau of Statistics data and private forecasters' reports.