Bank of Israel

Report to the public of the Bank of Israel's discussions prior to setting the interest rate for February 2008

The discussions took place on 27 and 28 January 2008

11 February 2008

General

Before the Governor makes the monthly interest rate decision, discussions are held at two levels. The first discussion takes place in a broad forum, in which the relevant background economic conditions are presented, including real and monetary 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 economic departments of the Bank (the Research, Monetary, Foreign Currency, and Foreign Exchange Activity departments) 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 economic departments 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

National Accounts estimates indicate rapid growth in 2007, with a growth rate of 5.3 percent. The Bank of Israel Companies Survey conducted towards the end of 2007 shows that companies in most industries assess that activity will continue rising in the first quarter of 2008. Nevertheless, the Bank of Israel notes that the slowdown in growth in the advanced economies, particularly the US, is expected to affect Israel's economy. In the last month the probability of a scenario in which a slowdown in the expansion of world trade and a fall in demand reduces Israel's growth rate to 3.6 percent increased.

The National Accounts

National Accounts estimates indicate a continued rapid increase in GDP in 2007:Q4. According to those estimates, private consumption increased by 7.2 percent in 2007, investment in the principal industries rose by about 18 percent, exports (excluding

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diamonds) by 8.6 percent, and imports (excluding defense imports, ships, airplanes and diamonds), by about 14 percent. Public consumption increased by 2.6 percent in 2007, similar to its increase in each of the last two years.

The composite state-of-the-economy index

The composite state-of-the-economy index rose by 1.2 percent in December, a steep rise that supports the assessment that economic activity is expanding at a fast pace. The indices for the previous two months were revised upwards—the October index from a rise of 0.8 percent to 1.1 percent, and the November index from 0.6 percent to 1.1 percent. It should be noted that the rise in the index in the fourth quarter of the year was higher than that in the fourth quarters of 2005 and of 2006.

All components of the index rose in December, with the exception of the index of manufacturing production (which dropped in November by 0.5 percent, following its sharp rise in October).

In the whole of 2007, the composite index increased by 8.3 percent, after rising by 7.5 percent in 2006.

The labor market

The number of employee posts rose by 4.1 percent last year (August to October 2007 compared with August to October 2006). The (gross) real wage per employee post increased by one percent over the same period. This is explained by the fact that a large share of new jobs are part time, and are filled by new, lower-paid, workers, and some are in industries that employ less-skilled employees, and is also due to the continued lowering of tax rates on wages.

Preliminary trend data of the Central Bureau of Statistics (CBS) show the rate of unemployment reached 6.6 percent of the civilian labor force in November; in other words, there are signs of a continuing decline in the unemployment rate.

The Companies Survey

The Companies Survey for the fourth quarter of 2007 shows a continued rapid rise in the output of manufacturing companies, and in retail sales. Companies expect the rise in orders from and sales to the domestic and export markets to continue in the first quarter of 2008.

Foreign trade and the balance of payments

Goods exports (excluding diamonds) increased by about 17 percent in 2007 (in dollar terms). Exports increased faster in the fourth quarter of 2007, by 12.4 percent (compared with the third quarter, quarterly rate, seasonally adjusted, in dollar terms). Exports expanded at a fast pace in the first and last quarters of 2007, and at a slower pace in the second and third quarters. Goods exports (excluding diamonds) to the US constitute about 30 percent of Israel’s total exports, and of high-tech exports, about 40 percent.

Goods imports (excluding ships, airplanes and diamonds) grew by 19.3 percent in 2007 (in dollar terms). These imports increased by 6.7 percent in 2007:Q4 (compared with the 2007:Q3, quarterly rate, seasonally adjusted, in dollar terms).

According to CBS estimates, the current account surplus of the balance of payments in 2007 was about 34 percent lower than that in 2006, with a drop from $7.9 billion to $5.2 billion, bringing it to about 3.2 percent of GDP.

2. Budget data

The government budget deficit, excluding credit, was essentially balanced in 2007. The very low deficit was the outcome of the sharp rise in tax revenues in 2007, some NIS 15 billion higher than the original budget forecast. The 2008 budget passed by the Knesset is in line with the original targets set by the government: a deficit ceiling of 1.6 percent of GDP, and a real rise of 1.7 percent in government expenditure (after deducting expenses related to the Second Lebanon War and the disengagement from Gaza).

3. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) rose by 0.6 percent in December, above forecasters' predictions prior to its publication. The part played by the increase in energy and food prices again featured prominently in the rise in the index. This was the second consecutive month with a high rise in the index in relation both to the path consistent with the inflation target and to prior assessments. In the course of 2007 the index rose by 3.4 percent, exceeding the inflation target. The index excluding the energy and food components—which account for 24 percent of the overall index—rose by 1.6 percent in 2007.

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

Inflation expectations for the next year derived from the capital market (break-even inflation) rose in January to an average of about 2.5 percent, compared with an average expectation of about 2 percent in December. Israeli forecasters' one-year-ahead inflation predictions stayed steady in the last month, at an average of about 2.5 percent.

The Israeli forecasters expect, on average, that the cumulative change in the CPI in January to March 2008 will be a negative 0.2 percent. The Bank of Israel and the domestic forecasters expect inflation over the previous twelve months to come within the target range in the second half of 2008. It should be borne in mind that even when the monthly indices in 2008 become consistent with inflation of about 2 percent, inflation measured over the previous twelve months will return to the target range only in the second half of the year. The Bank of Israel's assessments are that at the end of 2008 inflation over the previous twelve months will be close to the midpoint of the target range.

The forecasters expect on average that the Bank of Israel's interest rate for February and March will remain unchanged, and will reach 4.6 percent by the end of 2008.

The makam and bond markets

The interest on 5-year CPI-indexed bonds stayed steady in January at an average of 3.2 percent, similar to its level in December. The nominal yield on 5-year unindexed government bonds slipped by about 0.1 percentage points over the past month, and in January averaged about 5.6 percent. The yield on one-year *makam* rose by 0.2 percentage points in January, to an average of 4.8 percent.

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

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

The gap between the yields on unindexed shekel bonds and US 10-year bonds widened during the last month from 203 basis points on 26 December to 233 basis points on 13 January.

The expected real interest rate

The expected real interest rate (the Bank of Israel interest rate *minus* inflation expectations) for one year forward was about 1.8 percent in December, a drop of about 0.2 percentage points from its rate in December, the result of expected inflation rising faster than the interest rate.

The money supply

The annual rate of increase of the (M1) money supply in January was about 18 percent (the increase over the previous twelve months).

The econometric models[1]

Various scenarios were examined using the Bank of Israel's econometric models. According to the Research Department's quarterly model, in which the closing of the output gap constitutes a dominant inflationary element, in the scenario in which the unemployment rate falls to 7 percent by the end of 2008, the exchange rate remains steady at around NIS 3.70 to the dollar, and the Bank of Israel's interest rate stays at its current level of 4.25 percent, inflation in 2008 would be 2.2 percent. According to this model, if the recent trend of the reduced transmission between changes in the exchange rate and inflation (due largely to the weakening of the link between the exchange rate and housing prices) continues, inflation is expected to converge to the upper limit of the inflation target towards the end of 2008.

According to the Monetary Department's quarterly model, in the scenario in which the Bank of Israel interest rate continues at the current rate of 4.25 percent in the first quarter of 2008 and then declines gradually to reach an average level of 3.7 percent in the last quarter, with an average exchange rate of about NIS 3.77 to the dollar in the last quarter, inflation would reach 1.6 percent in 2008. The results of the models are very sensitive to changes in the exchange rate.

[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.

4. The foreign currency market and the share market

The foreign-currency market

In the month since the previous interest rate discussions, the shekel strengthened against the dollar, from about NIS 3.88 to the dollar (on 24 December) to NIS 3.68 (on 24 January), i.e., an appreciation of 5.4 percent. During the last month the shekel strengthened against the euro, from NIS 5.59 to the euro on 24 December to NIS 5.41 on 24 January, an appreciation of 3.3 percent.

The share market

Between 24 December (the date of the previous interest rate decision) and 24 January the TA-25 index fell by about 13 percent, as share markets throughout the world fell sharply.

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

Israel's risk premium as measured by the five-year CDS spread increased steeply this month from around 32 basis points to 55 basis points, its highest level since the outbreak of the global credit crisis. CDS spreads for most emerging market governments widened at similar rates.

6. Global economic developments (see Appendix for greater detail)

Attention in financial markets around the world was focused on the steep drops in share indices in stock markets everywhere, falls which reflect a growing concern that the slowdown in the US economy may be more severe than expected previously. Economists are of the view that the likelihood that global growth will slow has risen. Credit spreads in the US financial markets widened further this month. The tightening of credit terms itself had the effect of slowing economic activity. The investment houses on average expect a global growth rate of about 4.1 percent in 2008. The IMF expects the rate to be about 4.3 percent.

The most recent data on inflation in the major economies are higher than expected. Energy prices, however, recently eased back from their peak level. The risks to US economic growth, instability in the financial markets, and the increase in the credit spreads were the main factors leading to the Federal Open Market Committee decision, in an unscheduled meeting, to announce a cut of 0.75 percentage points in its federal funds rate, to 3.5 percent. At the time of the current discussions on the Bank of Israel's interest rate for February, the financial markets expect a further cut in the Fed rate at the next meeting at the end of January, with further reductions to follow in the course of 2008. Expectations regarding the ECB interest rate until the end of the first quarter of 2008 range from a reduction to no change.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR FEBRUARY 2008

Against the background of developments since the previous interest rate decision on 24 December 2007, the discussion focused on participants' assessments of how inflation would develop, particularly in light of the latest two CPIs which were unexpectedly high and above the seasonal path consistent with the inflation target. This occurred alongside increased concern that the slowdown in the US and in global growth would be more severe than originally expected—concern that was expressed, inter alia, in sharp drops in stock markets around the world, and that led to the unscheduled cut in the federal funds rate by 0.75 percentage points on 21 January. At the time of the discussion the Fed was expected to make another reduction in the interest rate in its scheduled meeting on 30 January, with further cuts to follow in the course of 2008. Participants in the discussion reviewed the implications of these developments and the growing uncertainty about global growth and growth in the US and in Europe in particular on inflation and economic growth in Israel.

One of the participating department directors recommended cutting the interest rate for February by 0.25 percentage points, arguing that even with such a reduction, the inflation target for 2008 could be achieved, based on the fact that inflation in 2007 excluding the food and energy components was close to the midpoint of the target range. He added that he placed great weight on the increased probability of a significant cut in the Fed interest rate, which he thought would considerably lower the value of the dollar vis-à-vis the shekel, and reduce inflation.

The other participants recommended leaving the interest rate unchanged at 4.25 percent. They explained that in their view the factors operating in different directions were in balance at this interest level. The intention was to return inflation (over the previous twelve months) to the target range about the middle of the year, and close to its midpoint by the end of the year, and to continue to underpin financial stability. They put forward the following considerations:

- Inflation over the previous twelve months was expected to be above the upper limit of the target range in the next half year. Inflation expectations derived from the capital market are above the midpoint of the range (the average in January was about 2.5 percent), after rising in the previous month.
- Economic activity continues to expand rapidly. The rising trend of commodity prices world wide (mainly food and energy prices) played a significant role in boosting inflation in the second half of 2007, against the background of buoyant demand in the economy and the closure of the output gap.
- On the other hand, certain factors were acting to moderate the rise in prices. The expected slowdown in US and global growth is expected to ease inflationary pressures in Israel, due to the possible drop in demand for Israel's exports as well as the possible negative impact on domestic demand. Likewise, the weakening of the global economy is expected to reduce global demand for energy products, whose steep price rises added to inflationary pressures in 2007 world wide and in Israel.
- In addition, the cut in the Fed interest rate already made and the expectation of a further reduction, in reaction to the slowdown in US economic growth and intended to achieve financial stability, help to weaken the dollar. Although the connection between the shekel/dollar exchange rate and inflation has loosened

somewhat in the last few months, the weakness of the dollar against the shekel serves to reduce inflationary pressures in Israel.

In the discussion it was noted that unlike other economies, particularly the US, in which demand is expected to fall and where there is concern over a significant slowdown in growth, and in which problems have developed in the operation of the financial markets, Israel's economy continues to expand at a fast pace, and the financial markets are functioning well.

Taking into consideration all of the above, the Governor decided not to change the interest rate for February 2008 and to leave it at 4.25 percent.

The Bank of Israel will continue to monitor economic developments closely with the intention of achieving the price-stability target. Subject to this, the Bank will continue to support the attainment of a range of objectives of macroeconomic policy, in particular the encouragement of employment and growth. In addition, the Bank will continue to support the stability of the financial system.

The decision was made and published on 28 January 2008.

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, Director of the Monetary Department
Mr. Barry Topf, Director of the Foreign Currency Department
Mr. Balfour Ozer, Member of Management
Dr. Ohad Bar-Efrat, Advisor to the Governor and Head of International Affairs
Mr. Gaby Fiszman, Chief of Staff to the Governor
Dr. Yossi Saadon, Bank of Israel Spokesperson

Appendix: Major Global Economic Developments

U.S.

The weakness of US economic data published this month surprised the market, and strengthened assessments that the US economy would experience a recession as early as in the first quarter of 2008. The labor market, that had been strong till now, weakened considerably in December. This is an indication that the recession in the housing market evident for a long time has started to spread to other economic spheres. Labor market data for December show a rise in the number of job seekers, and a decline in the number of wage earners in the private sector, with only a small increase in the number of public sector employees. The rate of unemployment rose by a significant 0.3 percent, to 5 percent, an increase of 0.6 percent over the last two months.

Housing market data continue to indicate deterioration, and the very high stock of unsold houses is not expected to fall in the near future. Data of the manufacturing sector generally indicate weakness, with the sector's purchasing managers' index showing a significant fall, and manufacturing production also performing weakly. Wholesale sales in December were disappointingly low, and consumer confidence surveys continue to point to a decline in confidence among American consumers.

Against this backdrop, the investment houses assess that growth in the US will slow significantly in the first half of 2008. Many economists are now of the opinion that the US economy will actually go into a recession, but that it will be a short one, and not very severe.

President Bush announced that he will present a $140 billion fiscal aid package to Congress for approval.

Data on inflation published in the last few months show that it continues to rise, against the background of high energy and commodity prices and the weak dollar. The US Consumer Price Index rose by 4.1 percent in 2007. Nevertheless, economists, including those in the Federal Reserve, expect that although inflation will remain high in the first months of 2008, it will ease back thereafter, in light of the expected economic slowdown.

The Federal Open Market Committee took the exceptional step of reducing the interest rate on 21 January (a week before its scheduled meeting) by 0.75 percentage points to 3.5 percent. It did this against the background of the risks to US growth, instability in the financial markets, and the rise in credit spreads. At the time of the discussions on the interest rate for February in the Bank of Israel, the financial markets expect another cut in the Fed rate in the scheduled meeting at the end of January, and further reductions during 2008.

Europe

Against the background of tighter financial conditions due to the crisis, growth in the eurozone slipped in the last quarter of 2007 and was expected to continue to slow in the first half of 2008. According to a survey conducted by the ECB in January, there was a further marked contraction of credit given to households and businesses. The strengthening of the euro during the last year also constitutes a factor acting to restrain growth. Data published this month indicate a slowdown in the manufacturing and services sectors, with consumer and business confidence indices also showing weakness. In contrast, the labor market remains strong, with unemployment in the eurozone falling to 7.2 percent, its lowest level for twenty-five years. Nonetheless, economists and the ECB see downside risks to growth.

Inflation in 2007 was 3.1 percent, against the background of the rise in energy and food prices. The ECB expects inflation to stay above its target (less than 2 percent) in 2008, and that it will moderate gradually thereafter. The ECB is concerned over the risks of inflation deriving from the rise in commodity prices rolling over into wage rises.

The central bank left the interest rate unchanged this month at 4.0 percent. ECB interest rate futures currently price in a 40-basis-point reduction in the rate in the first half of the year.

Japan

Recently published data show that growth in Japan dropped significantly in the fourth quarter of 2007. Private consumption has been falling since May, against the background of the absence of wage increases. In addition, the slowdown in the global economy, the rise in energy and commodity prices, and the recent sharp drop in building starts are expected to lower growth in the future. Some investment houses even expressed concern recently that Japan may be facing a recession.

Inflation indices published this month show a rise, mainly due to the rise in energy and food prices.

The Bank of Japan (BoJ) left the interest rate unchanged this month at 0.5 percent, as expected.

Based on investment houses assessments and central bank interest rate futures, the BoJ interest rate is expected to remain unchanged in the near future. Recently, economists have started predicting that that the BoJ may actually reduce the interest rate in order to boost growth.

The emerging markets

Growth in Asia and Latin America is expected to remain strong, particularly in China, India and Brazil.

The risk to growth in the emerging markets recently rose markedly in light of the expected slowdown in the US, the probability of tighter global credit conditions, and sharp exchange rate adjustments. Concern grew that decoupling of the emerging markets from the advanced economies may not proceed.

Inflation risks increased, and inflationary pressures are expected to remain strong during the year.