

Report to the public of the Bank of Israel's discussions prior to setting the interest rate for January 2007

The broad-forum discussions took place on December 24, 2006, and the narrow-forum discussions on December 25, 2006

January 2007

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 various 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.

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

The data on real activity indicated that economic growth was continuing at the fast pace evident in the first half of 2006. According to the assessments presented at the meeting (which took place a few days before the publication of the Central Bureau of Statistics' initial estimates for 2006) GDP growth was expected to reach 4.8 percent in 2006, and 4.6 percent in 2007. Fixed investment was expected to rise by 6.2 percent in 2006 and by 7.1 percent in 2007. The rise in fixed investment reflects the increase in investment in the principal industries, particularly in machinery and equipment, whereas investment in housing is not yet showing an increase. The outstanding feature of the balance of payments is the current account surplus, which is expected to reach close to 5 percent of GDP in 2006.

Indices of real activity

Seasonally adjusted data indicate that manufacturing production from the beginning of the year was 8 percent higher than in the equivalent period in 2005. The path followed by the index of manufacturing production during 2006 also shows the upward trend, with a rise of 2 percent from June to October, i.e., an annual rate of 6

percent. This, despite a 0.9 percent fall in manufacturing production from September to October.

Unlike most indicators that pointed to a rapid rate of growth, the composite state-of-the-economy index rose in November by only 0.1 percent, similar to the rise in October, after rising by about 0.5 percent a month from July to September.

Goods imports and exports

Goods exports continued to increase; in January–November 2006 they were 15 percent higher than in January–November 2005, with high-tech exports leading the way. The rise in goods imports has slowed in the last few months; since the beginning of the year they have risen by 9 percent compared with their level in the equivalent period in 2005.

The current account of the balance of payments

Seasonally adjusted figures show that the current account surplus reached \$ 6.2 billion in the first three quarters of 2006 (about 6 percent of GDP in this period), up from \$ 4 billion in the first three quarters of 2005. The surplus is expected to continue rising in 2007.

The labor market

The rate of participation in the labor market (seasonally adjusted) in the third quarter of 2006 was 55.6 percent, similar to the rate in the fourth quarter of 2005; the rate of unemployment fell to 8.3 percent, down from 8.8 percent in the last quarter of 2005. Most of the increase in the number of employees occurred in the business sector, with an average increase of 70,000 in the first three quarters of 2006 compared with the equivalent period in 2005.

Unit labor costs, after falling in the last two years, rose somewhat in the third quarter of 2006. This was due to the rise in the hourly cost of labor while productivity remained steady, apparently because of workers' absence from work during the war in the north.

2. Budget data

Budget data for November indicate a continued recovery in tax revenues. Tax revenues since the beginning of the year are some NIS 11 billion ahead of the seasonal budget path. The government's domestic expenditure since the beginning of 2006 exceeds the original seasonal budget path by about NIS 1.2 billion, and this at a time when payments from the compensation fund for damages in the war in the north plus the other war-related expenses (to date) totaled some NIS 2.6 billion. At the time of the discussion, the total government deficit in 2006 was expected to be one percent of GDP.

The Knesset is expected to pass the 2007 budget presented by the government, with the deficit not exceeding the ceiling fixed by the government, 2.9 percent of GDP.

3. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) declined by 0.2 percent in November, following its falls of 0.7 percent in October and 0.9 percent in September. The decline in November was in line with that expected by private economic forecasters, and was due mainly to the appreciation of the shekel against the dollar and the fall in the prices of housing, transport and communications.

In the last twelve months the CPI has fallen by 0.3 percent, and since the beginning of 2006 by 0.1 percent. The sharp drop in inflation is to be seen against the background of the strengthening of the shekel against the dollar by 8.5 percent in the last twelve months, and the rapid impact of changes in the exchange rate on inflation in Israel. The rate of inflation is below the lower limit of the path consistent with the inflation target.

The division of the components of the CPI into those directly affected by the exchange rate and the energy component on the one hand, and “domestic” components not affected by them, on the other, points to a substantial difference between them—the “domestic” price component rose in 2006, while the “imported” price component fell.

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

Inflation expectations for one year ahead derived from the capital market—break-even inflation—were 1.3 percent in December, down from 1.5 percent in November. From January to September 2006 these expectations were close to the midpoint of the inflation target range, and since October they have been below the midpoint.

Israeli forecasters’ assessment of one-year inflation dropped in the month since the last interest rate decision to 1.5 percent, on average, below the midpoint of the target range. The forecasts assessed that the Bank of Israel’s interest rate for January will be cut by 25 basis points, and some expect another, similar, reduction for February.

The *makam* curve reflects expectations of a reduction in interest rate of about 30 basis points in the next twelve months—an expected cut of 25 basis points in January followed by a more moderate reduction in February.

The makam and bond markets

In the month prior to the interest rate decision, five-year CPI-indexed interest rates rose by 0.2 of a percentage point to 3.7 percent, while the 10-year indexed rate remained stable at 3.6 percent. The nominal yield on unindexed 5-year *Shahar* bonds dropped to 5.4 percent, and on 10-year bonds it declined by 0.2 of a percentage point, to 5.7 percent. The decline in the *Shahar* interest rates in December occurred against the background of lively purchasing activity by nonresidents. The *makam* yield for one year has remained unchanged since the last interest rate decision, at 5.1 percent.

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

Before this interest rate decision, the Bank of Israel interest rate was 25 basis points lower than the Federal Reserve rate. US capital market data indicate a strong probability of no change in the US federal funds rate in the coming months.

The gap between the yields for 10-year unindexed shekel bonds and US bonds of the same term contracted significantly during the last month from 130 basis points to 104 basis points.

The expected real interest rate

As the cut in the Bank of Israel interest rate for December was similar to the drop in inflation expectations, the expected real interest rate for one year forward remained unchanged in December at about 3.8 percent.

The money supply

The growth rate of the money supply (M1) over the previous twelve months was 6.3 percent in November, lower than the rates of increase in previous years. In 2005 the money supply increased by 24 percent.

The econometric models¹

The various scenarios that were examined using the Bank of Israel's econometric models showed that in the scenario that included a cut in the interest rate and the consequent nominal depreciation of the shekel, inflation would return to within the target range in the last quarter of 2007. The various models showed that a reduction of the interest rate to 4.5 percent in the first quarter of 2007 would lead to the convergence of the inflation rate to within the target range in the last quarter of 2007.

4. Capital flows, the foreign-currency market, and the share market

Capital flows

The strengthening of the shekel in the last few months occurred against the background of a surplus in the current account of the balance of payments that is expected to exceed \$ 6 billion in 2006, and heavy foreign investment in Israel. It is assessed that the current-account surplus could reach 6 percent of GDP in 2007.

The foreign-currency market and the share market

During the last month the shekel strengthened against the dollar. In the days immediately preceding the interest rate decision for December the exchange rate was around NIS 4.30 to the dollar, and it is currently around NIS 4.19. The shekel also strengthened against the euro in the last month, from NIS 5.64 to the euro at the time of the previous interest rate decision, to NIS 5.53 in the days prior to the current decision.

The Tel Aviv 100 share price index has risen by about 13 percent in the period from the beginning of 2006 to 25 December.

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.

5. Israel's financial risk, the risk premium, and foreign investment house surveys

Israel's risk premium as measured by the five-year CDS spread edged down slightly in December to 23 basis points (from 26 basis points at the time of the previous interest rate decision), similar to the reduction in CDS spreads in other emerging-market economies. The yield gap between 10-year *Shahar* bonds and US government bonds of the same term contracted from the time of the previous interest rate decision to date by about 25 basis points.

The Fitch ratings agency raised Israel's foreign-currency and local-currency credit rating outlook from "stable" to "positive." In its announcement, Fitch noted the improved dynamism and resilience of Israel's economy following the reforms implemented in the last few years. It also commended the reduction in Israel's debt/GDP ratio and the expected continuation of this trend.

6. Global economic developments (full details in appendix)

Despite the slowdown in the US growth rate, economic data from other regions of the world remain strong. In Europe, growth rates for 2006 surprised on the upside, while China and India continued with their rapid expansion.

Global growth is expected to continue in 2007, albeit at a more moderate pace. On average, investment houses expect global growth of about 4.7 percent in 2006, slowing to about 4 percent in 2007.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR JANUARY 2007

The inflation rate in the last twelve months was significantly below the target range, and stands at -0.3 percent. The inflation estimates and expectations to twelve months ahead are lower than the midpoint of the target range. Inflation expectations derived from the capital market stand at about 1.3 percent, and the average of the forecasts of private economic forecasters are about 1.5 percent.

In the three months from September to November 2006 the CPI fell by a total of almost 2 percent. The effect of those monthly indices on the rate of inflation viewed retrospectively over twelve months will continue to be felt until the last quarter of 2007. Hence, throughout most of 2007, inflation viewed over the previous twelve months is likely to remain below the lower limit of the target range.

Due to the recent decline in inflation, the private forecasters expect a cut of 25 of basis points in the Bank of Israel interest rate for January 2007. Prior to the decision for January, the expectation derived from the capital market was of a reduction of 30 basis points during the next year.

The participants in the discussion related to the scenarios derived from the econometric models, according to which, subject to a reduction in the interest rate, there is a relatively high probability that inflation would revert to the target range in

the last quarter of 2007. The return to within the target inflation range and the rate of interest required for this depend to no small degree on the future changes in the exchange rate.

In the month prior to the current interest rate decision the financial indicators in Israel continued to strengthen. In the international financial markets Israel's country risk premium, as measured in the 5-year CDS market, declined. The yield gap between 10-year *Shahar* bonds and US government bonds of the same term narrowed considerably. The Fitch ratings agency raised Israel's foreign-currency and local-currency credit rating outlook from "stable" to "positive."

Much of the discussion focused on the analysis of the factors causing the strengthening of the shekel, which was one of the major reasons for the reduction of inflation to below the lower limit of the target in the last few months, and that even led to negative inflation rates. Changes in the exchange rate are known to have an immediate impact on inflation in Israel. As noted above, the division of the CPI into two major groups of components shows a significant difference between them in 2006: prices rose in the "domestic" component, while prices fell in the component directly affected by the exchange rate and energy prices.

The strengthening of the shekel reflects several positive developments, with the rise in the current-account surplus and the growing confidence of foreign investors in Israel's economy—reflected by the amount of foreign investment—at the top of the list. In addition, the greater openness of the economy to external factors, most recently via the implementation of the reform regarding market makers in the government-bond market, boosted the demand of financial entities for long-term government bonds of the *Shahar* type. As mentioned above, this led to the narrowing of the yield gap between these bonds and US government bonds of the same 10-year term.

The data on real activity continue to indicate that the economy is still enjoying a high rate of growth. Assessments presented in the discussion pointed to growth of 4.8 percent in 2006 and 4.6 percent in 2007 (the initial estimates of the Central Bureau of Statistics were published a few days after this discussion). The impact on GDP of the war in the north in the third quarter of 2006 was smaller than the Bank of Israel's earlier assessment. The rise in investment in the principal industries supports the assessment that activity will continue to expand. The rate of unemployment fell from 8.8 percent in the second quarter of 2006 to 8.3 percent in the third quarter. Despite that reduction, no inflationary pressures from the labor market are evident at this stage, and the real wage has edged up only slightly. Unit labor costs rose slightly in the third quarter, but have been on a downward trend for two years as a result of the rapid rise in productivity.

Budget data pointed to continued recovery in tax revenues, and the deficit in 2006 is expected to be less than one percent of GDP. The Knesset is expected to pass the 2007 budget in accordance with the framework approved by the government, so that the deficit in 2007 will not exceed the government ceiling of 2.9 percent of GDP.

The discussion focused on the size of the cut in the interest rate for January with the aim of achieving the inflation target in 2007. Some participants argued in favor of a reduction of 25 basis points, while others supported a cut of 50 basis points. The former favored a reduction that was in line with the market expectations, i.e., 25 basis points, that would be accompanied by a statement that it was highly probable that a further cut of another 25 basis points would be made next month. They argued that

this was preferable to the alternative of a cut of 50 basis points now, taking into consideration that it was not advisable to widen the differential between the shekel interest rate and the Fed rate by such a large amount so rapidly, and to avoid the surprise that would be caused by a larger-than-expected cut. Avoiding a surprise reduction in the interest rate would lower the probability of market shocks. Moreover, the positive data on activity and investments support the view that it is not necessary to introduce a substantial change into the monetary conditions to encourage activity, as this is continuing to expand at a fast pace in any case. Those participants favoring the smaller cut in the interest rate considered that this was consistent with the achievement of the inflation target in 2007.

Other participants were of the opinion that it was better to reduce interest for January by 50 basis points. These participants thought that it was important to reduce the interest rate by a larger amount this month so that the rate of price increases would be more likely to become consistent with the target inflation rate sooner rather than later. They stressed the very positive fundamentals, such as the decline in Israel's sovereign credit risk, the size of the current account surplus and the expectation that it would increase further, and the flow of foreign investment into the economy. These provided exceptionally favorable conditions for a deeper cut in the interest rate this month, even if it came a surprise to the market players. They added that a cut of 50 basis points would emphasize the importance that the Bank of Israel attaches to the inflation target.

After considering the different recommendations made by the departmental directors, the Governor decided to reduce the interest rate by 50 basis points. The Bank of Israel interest rate for January will therefore be 4.5 percent. It was noted that future changes in the interest rate will be made as required to achieve the inflation target.

The decision was made and published on December 25, 2006.

Those present at the 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, Director of the Foreign Exchange Activity Department
Dr. Ohad Bar-Efrat, Advisor to the Governor and Head of International Affairs
Mr. Gaby Fiszman, Chief of Staff to the Governor

Appendix: Major Global Economic Developments

U.S.

The growth rate in the US slowed in the last year, against the background of the substantial cooling of the housing market, mainly in investment in residential construction. In the third quarter the growth rate was 2.2 percent, in annual terms.

The investment houses expect an annual growth rate of 2 percent in the fourth quarter. The most widespread view among economists is that the slowdown in growth will continue in 2007, with a growth rate lower than the trend (i.e., lower than 3 percent).

The most recent inflation data generally indicate a downward trend, with core inflation over the previous twelve months down to 2.6 percent. The level of inflation in general, however, remains slightly above what the Fed would consider comfortable, and some risks of inflationary pressure, particularly from the labor market, remain. This is expressed in the Fed's interest rate announcement and statements by Federal Reserve economists. Nevertheless, the Open Market Committee expects inflation pressures to moderate over time, reflecting reduced energy prices, contained inflation expectations, and the expected decline in the growth rate to below its potential. The investment houses also expect a fall in inflation to 2 percent at the end of the last quarter of 2006, and to below 2 percent in the second quarter of 2007.

In its December meeting the Fed left its target for the federal funds rate unchanged at 5.25 percent, but its announcement included a reference to additional firming. In contrast the investment houses and the interest rate futures market expect a further reduction of about 25 basis points in the second quarter of 2007.

Europe

Europe experienced firmer growth in 2006, and it extended to the various sectors in the economy. Growth continued in the third quarter, at an annual rate of 2 percent, slower than in the first half of the year. Domestic demand continued to provide the main impetus to growth in the third quarter. The latest economic data and several confidence surveys indicate continued economic growth in the fourth quarter. The investment houses expect growth of 2.9 percent in that quarter.

The investment houses expect the growth rate to ease to 1.2 percent in the first quarter of 2007, and then to accelerate again to a rate of 1.9 percent as early as in the second quarter.

The rate of inflation fell in the third quarter to 1.7 percent, below the 2 percent upper limit of the target set by the central bank. The drop in the inflation rate is ascribed mainly to the decline in oil prices since August. The European Central Bank (ECB) lowered its inflation forecast, and it expects inflation to surge at the beginning of 2007, against the background of the expected rise in VAT in Germany, and to remain around the 2 percent level during the year. The investment houses share this view.

The ECB raised the monetary interest rate by 25 basis points in December to 3.5 percent, maintaining its tendency towards firmer monetary policy. That decision reflects its concern that the high liquidity and the rapid expansion of the money supply and credit constitute an upside risk to the inflation forecast. The investment houses expect a further rise of 25 basis points in the interest rate by the second quarter

of 2007, and then a halt to the increases. The market for central bank interest rate futures reflects a similar interest rate trend.

Japan

Japan's economy continued to show moderate growth, an annual rate of 0.8 percent, in the third quarter. This was driven mainly by the companies sector and the continued rise in exports. Capital investment continued to expand against the background of high company profits and businesses' high confidence.

Inflation in Japan remains positive, with a level of 0.6 percent (annual) posted in the third quarter. In the light of this the central bank left the rate of interest unchanged at 0.25 percent. The Governor noted that the Bank of Japan is not hurrying to raise the interest rate, because of the relatively slow growth rate in the third quarter. Nevertheless, the Bank still tends towards tighter money. The investment houses expect a rise of 25 basis points in the interest rate in the first quarter of 2007.