Bank of Israel

MONETARY POLICY REPORT

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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 economic developments that took place during 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 first half of 2016 was prepared by economists in the Research Department, within guidelines set by the Bank of Israel Monetary Committee.[1] This report is based on data that were published up to July 25, 2016, the date of the decision on the interest rate for August 2016.

[1] Since October 2014, the Monetary Committee has been operating with a smaller composition than usual. It currently includes four members.

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Summary of recent economic developments

Monetary policy: During the first half of 2016, the Monetary Committee decided to leave the interest rate at a level of 0.1 percent. For both July and August, which belong to the second half of 2016, the Monetary Committee also decided to leave the interest rate unchanged. Similar to the announcements of the interest rate decisions for November and December of 2015, all announcements in the first half of 2016 included forward guidance in announcing that monetary policy is expected to remain accommodative for a considerable time. In addition, the Bank of Israel continued to purchase foreign currency, purchasing $4 billion, about $0.9 billion of which were purchased as part of the program intended to offset the effects of natural gas production on the exchange rate. The rest were purchased as part of the program intended to moderate excessive fluctuations in the exchange rate.[2]

Inflation and inflation expectations: During the twelve months ending in June 2016, the CPI declined by 0.8 percent. The energy component continued making the main contribution to the decline of the CPI, as a result of the sharp decline in global oil prices, even though this trend reversed itself during the first half of the year. The policy measures adopted by the government, primarily the reduction in VAT and the cancelation of the television levy, also contributed to the decline in the CPI in the past year, but it seems that this contribution is close to dissipating. Net of the direct effect of energy prices and the government policy measures, the CPI rose by 0.6 percent in the past year.[3] If the volatile prices of fruit and vegetables are also excluded, the increase in the CPI reached 0.8 percent. While short-term inflation expectations (1–3 years), based on the various sources, increased slightly over the period (June average compared with the December 2015 average), those expectations were quite volatile during the period, declining sharply at the beginning of the period and correcting later on. Forward expectations for the medium and long terms remained at the center of the target range or slightly below it throughout the period.

Domestic real economic activity: The economy continued to grow at the moderate rate that has characterized it during the last two years, except for a slight—and apparently temporary—decline in the first quarter of 2016. The decline in the first quarter was mostly a result of contraction in exports, mainly in the four main export industries.[4] The

[2] In this program, the Bank of Israel acts in the foreign exchange market when there are excessive fluctuations in the exchange rate that are not in line with basic economic conditions, or when the foreign exchange market is not functioning properly. In contrast to the program intended to offset the effects of natural gas production, in this program the Bank does not declare the volume of purchases in advance.

[3] A discussion of the core inflation indices, and the considerations in favor of excluding various items from the general CPI, appears in Ribon, S. (2009), "Core Inflation Indices for Israel", Discussion Paper 2009.08, Bank of Israel Research Department. See also the discussion on prices in the Bank of Israel Annual Report for 2015.

[4] Electronic components, chemicals, pharmaceuticals and transport vehicles.

contraction of exports was partly a result of the decline in the growth rate of world trade and of the accumulated appreciation of the shekel, as well as one-off developments among a number of large exporters in the economy. In contrast, current private consumption continued its impressive growth and to lead economic growth. The labor market remained robust, with employment continuing to grow, unemployment remaining low, wages continuing to increase, and the economy close to full employment.

The exchange rate: During the first half of the year, the shekel remained stable in terms of the nominal effective exchange rate (the average in June relative to the average in December), and relative to the dollar. Relative to the euro, the shekel appreciated by about 3 percent. Various models of the equilibrium exchange rate indicate that the shekel is overvalued.

The global economy: The growth rate of global economic activity moderated during the reviewed period, and in parallel, the forecasts by leading international organizations were revised downward. These organizations also estimated that the risks to the growth forecasts tended downward. The weakness was focused on the emerging markets, but the advanced economies—particularly the US and the eurozone—also lost momentum. These developments were accompanied by sharp fluctuations in the markets and in commodity prices, particularly the price of oil, which declined sharply at the beginning of the period, and later rose. The accommodative monetary policy around the world increased during the period. In March, the ECB announced the implementation of quantitative easing totaling 80 million euros, and the central banks of China and Japan also took accommodative measures. At the beginning of the reviewed period, assessments increased in the markets and among members of the Federal Reserve that there would be a delay in the next interest rate increase in the US. These assessments increased particularly toward the end of the period, after the results of the referendum in the UK led to the decision to leave the European Union (Brexit). However, once the markets calmed, and against the background of a positive employment report in the US, the markets again ascribed significant likelihood to an interest rate increase in the US this year.

The housing market: Activity in the housing market remained lively during the reviewed period: Home prices continued to increase, and the volumes of transactions and of new mortgages taken out remain high. During the second quarter, the real weighted interest rate on new mortgages increased, and the increase in new mortgages moderated against the background of the increasing risk in the banking system's housing credit portfolio and the measures taken in the past by the Banking Supervision Department. The volume of building starts remained at its high level—although toward the end of the period there was some moderation—and the stock of homes for sale reached record levels. The number of building permits continued to increase. The annual growth rate of rents remained stable at the level that characterized it in recent years.

The financial markets: The domestic share indices declined sharply during the reviewed period (both in shekel terms and in dollar terms, June average compared with December average), against the background of the declines in the leading indices in Europe and in contrast to the indices in the emerging markets and in the US, which increased slightly. As such, the domestic indices continued the downward trend since the beginning of the second half of 2015. The yield curves showed declined in all ranges, mainly in the medium-to-long part of the nominal curve and in the long part of the real curve. This is in line with the decline in short-to-medium term inflation expectations and with stable long-term expectations. The spreads between corporate bonds and similar government bonds remained stable during most of the first half, and declined slightly toward the end of the half.

Fiscal developments: The cumulative domestic deficit (excluding net credit provision) totaled NIS 1.8 billion in January–June, compared with NIS 1 billion (in fixed prices) in the same period last year. It is about NIS 4.9 billion below the seasonal path that is consistent with the deficit target for 2016. The deviation reflects revenues that are about NIS 3.2 billion higher than the path, and expenses that are about NIS 1.7 billion lower than the path. Tax revenues increased by 9.5 percent in real terms relative to June of 2015. Net of legislative changes and one-off revenues, total tax revenue increased by about 11.3 percent in real terms.

Forecasts of the Research Department: At the beginning of the first half of the year, the Research Department presented a forecast in which it projected that inflation would return to within the target range at the beginning of 2017, and that the Bank of Israel interest rate would increase gradually starting in the last quarter of 2016. During the first half of the year, the Research Department revised downward its inflation forecasts for 2016 and 2017, and the expected path of the interest rate, after energy prices showed further declines that were surprising in their strength at the beginning of the first quarter, and following one-time administrative measures taken by the government. In the more updated forecast from June 2016, the assessment that inflation is expected to return to within the target range toward the end of the first half of 2017 remained in place. In view of this, and due to developments abroad, particularly the expected interest rates in the US and in other economies, the interest rate path was lowered, and is expected to increase only toward the end of 2017.

Monetary Policy

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 at the time interest rate decisions were made and the Committee's point of view.

A. Policy and targets

There were a number of main developments in the background of the decisions to leave the interest rate at its low level during the reviewed period: The inflation environment remained low; the GDP growth rate remained moderate; most of the central banks in the leading economies continued their very accommodative monetary policies; the level of the exchange rate and the moderation of global activity weighed down on exports; and the housing market continued to show a high level of activity.

In the first half of 2016, the Monetary Committee kept the interest rate at the low level of 0.1 percent. During this period, the Monetary Committee continued to use the measure adopted with the announcement of the interest rate for October 2015—forward guidance—and explicitly communicated to the public its assessment that monetary policy would remain accommodative for a considerable time, and that if necessary, it would use foreign currency purchases. In the 12 months ending in June, the Consumer Price Index declined by 0.8 percent (Figure 1), meaning that inflation developed significantly below the price stability target range of 1–3 percent per year.[5] There are a number of factors that have led to the fact that inflation was outside the target range during the reviewed period, chiefly the decline in commodity prices, primarily the price of oil. While the price of oil did increase toward the end of the reviewed period, its effect is felt with some lag. In addition, oil prices remained very low from a historical perspective. The CPI therefore still partly reflects the effect of the dramatic decline that took place in mid-2014 and continued until the beginning of the reviewed period (a cumulative decline of about 75 percent, see Figure 2). According to estimations, the decline in energy prices directly contributed a decline of about 0.6 percentage points to the CPI, and there was also apparently an indirect contribution through lower prices of goods and services whose manufacturing cost declined due to the lower energy prices. The additional factors in the CPI not returning to the target range include administrative decisions made by the government since September 2015 with the aim of reducing the cost of living.[6] These contributed a cumulative decline of 0.8 percentage points to the CPI. Absent these one-time effects, and absent the direct effect of the decline in energy prices, the CPI increased by 0.6 percent in the 12 months ending in June. If the volatile

[5] The annual inflation rate has been outside the target range since June 2014, and from September 2014 it has been negative (See Figure 3).

[6] Reduction of VAT, lowering electricity and water prices, cancellation of the television levy, lowering prices on price-controlled food products, and lowering public transit fares.

prices of fruit and vegetables are also removed, the increase in the CPI climbs to 0.8 percent. These index readings are still lower than the lower bound of the inflation target, but they are close (see Figure 3).

The Monetary Committee was of the opinion that the decline in inflation during the period was a result of the factors reviewed above—the dramatic decline in commodity prices, chiefly oil, prior to the period, and the government's administrative decisions—and not of weakness in domestic demand. According to the assessments formulated at the beginning of the reviewed period—which were based on the forecast prepared by the Bank of Israel Research Department and on expectations derived from the capital market—inflation in the coming 12 months was expected to return to around the lower bound of the target range at the end of 2016, and to reach the midpoint of the range during 2017. These assessments were based, inter alia, on the expectation that the price of oil would stabilize at the level it reached at the end of 2015, but this expectation was not realized. Oil prices declined sharply in January, and only thereafter did they begin rising gradually. The sharp decline in January surprised the global markets as it surprised the markets in Israel, and had an impact on the advanced economies, and led to a decline in the pace of inflation and in medium-term inflation expectations.

The assessments at the beginning of the period included a decline in the economic activity growth forecast in Israel in 2016, because international organizations made downward revisions to their assessments regarding 2015 and expected weakness in global activity and trade, particularly among the OECD countries. During the period, GDP grew less than forecast, particularly due to underperformance of exports relative to the forecast. While the worsening in exports is linked to slower-than-expected growth in the global economy and to the appreciated level of the shekel, but it apparently is also the result of temporary factors, which are concentrated in a number of individual industries. In contrast, the growth in current consumption continued, supported by the accommodative monetary policy, and also reflected in the robust labor market and the continued increase in wages.

Even though inflation expectations for two–three years deviated at times from the target range, the Monetary Committee was of the opinion that during the reviewed period there were no conditions created that would require the use of unconventional tools, such as bond purchases or a negative monetary interest rate. First, such tools are used under extra-ordinary circumstances. The Monetary Committee's assessment was that there are risks to further monetary accommodation through unconventional measures such as a negative monetary interest rate. One of the main risks to financial stability from the low interest rate environment has to do with the increased demand for housing credit. This raises concern that if the interest rate increases later on, some borrowers will have difficulty repaying mortgage components taken out at variablerate interest. The members of the Monetary Committee also believed that the measures taken by the Banking Supervision Department in recent years are acting to reduce this risk, since there was a marked decline in the risk characteristics of the mortgages, followed by stability. Second, the economy was characterized by positive developments—the labor market remained robust, wages and the employment rate increased, private consumption increased to a significant extent, and inflation expectations for the medium and long terms constantly showed that the prevailing assessment in the financial markets was also that monetary policy would over time lead to a return of inflation to within the target range.

The Monetary Committee emphasized that monetary policy would remain very accommodative because the interest rate is at an historically low level. In addition, the Bank of Israel continued to intervene in the foreign exchange market in order to support monetary policy. In all interest rate discussions that took place during the reviewed period—and in discussions dealing with the interest rate for the first months of the second half of 2016 (July–August)—the Monetary Committee decided not to change the interest rate, and it continued to use forward guidance by communicating to the public its assessment that monetary policy would remain accommodative for a considerable time.

The Monetary Committee was of the opinion that the monetary policy it adopted—a very low interest rate over time and foreign exchange purchases—will contribute to returning inflation to within the target range toward the middle of 2017, based on the dissipation of the one-time effects of the price reductions initiated by the government, the assumption that oil and other commodity prices would stabilize, and the fact that according to initial assessments the UK's exit from the European Union would not slow activity beyond the forecast. Moreover, in the past year-and-a-half, the pace of increase in nominal wages in the business sector accelerated against the background of the robustness in the labor market, and this is expected to influence the return of inflation to within the target range. In this context, it is important to note that according to the law, monetary policy is forward-looking and does not act to offset price declines that have already taken place.

In summation, the Committee members' assessment is that leaving the interest rate at its current level over time, alongside the economic forces—mainly continued economic growth, the low unemployment rate and the increase in wages—will act to return inflation to within the target range toward the middle of 2017, assuming that there is no further worsening in the global economy and that commodity prices remain stable.

B. Background conditions and their effect on interest rate policy[7]

Actual inflation measured over the preceding 12 months was negative during the entire period being surveyed, primarily due to the continued—and unexpectedly strong—decline in commodity prices, especially oil prices, that occurred prior to the period, in addition to the structural changes in the economy and administrative steps taken by the government. At the beginning of the reviewed period, short-to-medium-term (1–3 years) inflation expectations derived from the capital market declined sharply. In January–February, expectations reached -0.3 percent, and 2–3 year expectations declined to below the lower bound of the target range (Figure 4). The assessment of the Committee members at the time was that the low (and negative) inflation rate was mostly a result of the decline in oil and commodity prices and of administrative measures adopted by the government. They emphasized that monetary policy is not supposed to react to changes of this type as long as they do not cause second-order effects—feedback between them and medium-long term (5–10 years) expectations. While the Monetary Committee was bothered by the decline in 1–3 year inflation expectations that took place at the beginning of the year, the Committee noted that a considerable part of the declines was a result of the fact that expectations in this range are partly adaptive—meaning they are affected by events in the recent past. In contrast, medium-to-long-term expectations remained anchored around the midpoint of the target range throughout the period. The Committee noted that over the period, there were increases in nominal wages and stabilization in commodity prices, and an increase in oil prices (which increased by about 55 percent between January and June), which were expected to support a return of inflation to within the target range toward the middle of 2017.

The economy continued to grow at the pace that characterized it in the past two years, other than a surprising—and apparently temporary—decline in the first quarter of 2016, mainly due to the weakness of exports. Current private consumption continued to support GDP growth throughout the reviewed period, and the labor market remained strong—close to full employment. At the beginning of the period, the main indicators of economic activity pointed to continued growth in 2015 at the pace that characterized it in the past two years (Figure 5). The worsening of the security situation in October 2015 had a relatively moderate effect on GDP, which was mainly noticeable in incoming tourism. The second estimate of GDP growth for the fourth quarter of 2015 was published in March, and showed growth of 3.9 percent (in annual terms). Private consumption continued to lead growth in the economy, and the second estimate of private consumption was revised upward, from 5.8 percent to 7.8 percent. The second estimate of exports indicated a sharp expansion, at a rate of 7.2

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

percent (even though the rate was revised slightly downward, from 7.6 percent in the first estimate). Current data for the first quarter of 2016—which included, among other things, the Companies Survey, the Composite State-of-the-Economy Index, and data on tax revenue and the labor market—showed that the economy continued to grow at a moderate rate in that quarter as well, although there were signs of some moderation in the growth rate. Foreign trade data indicated a sharp decline in exports in the three main industries in the economy.

In May, the first estimate of growth for the first quarter of 2016 was published. It indicated a surprising slowdown in the growth rate, which declined to 0.8 percent (in annual terms). Goods and services exports (excluding diamonds and startups) contracted sharply, by 12.9 percent, while private consumption continued to lead economic growth—as it had done in previous quarters—increasing by 4 percent. The Monetary Committee members continued to note that growth was backed primarily by private consumption, and exports were the cause behind the moderation. The main concern of some of the Committee members continued to derive from the assessment that the economy will not be able to continue being based over time on growth led by private consumption. Regarding the robustness and strength of the labor market, there was full consensus among members of the Monetary Committee, but the concern arose that weakness in exports would trickle into the labor market.

Current indicators for the second quarter—which include, among other things, the Companies Survey—pointed to the economy returning to growth at the moderate pace that has characterized it in past years, and that the slowdown in the first quarter was temporary. In addition, in the second estimate of National Accounts data for the first quarter—an estimate that was published in June—the growth rate was revised upward, to 1.3 percent. The Committee members were of the opinion that the decline in exports in the first half of the year was mainly a result of contraction in world trade. In this context, some of the Committee members expressed concern that economic growth is relying less on exports, a channel that constitutes a long-term engine for growth and increased productivity in a small open economy. The Committee agreed that the current conditions—low interest rate, high employment level and wage increases—support the continued growth of consumption in the foreseeable future. Looking forward they agreed, throughout the reviewed period, that the main risk to domestic activity is that exports are affected by developments in global activity, particularly the continued trend of weakness in world trade.

Current data for the second quarter of 2016 showed that growth returned to its environment of the past two years, after declining slightly in the first quarter. (According to the third estimate, first-quarter growth totaled 1.7 percent.) Private consumption led growth, and was in line with the increase in imports and in tax receipts. In contrast, goods exports continued to contract. The labor market remained robust.

At the end of the reviewed period, the trend of appreciation of the shekel in terms of the nominal effective exchange rate was halted. However, the accumulated appreciation has an effect on exports and inflation, which is among the factors in the Bank of Israel's continued foreign exchange purchases. The Monetary Committee members' assessment, throughout the period, based on various models of the equilibrium exchange rate, was that the shekel is overvalued. The Committee members noted that the exchange rate showed stability at the beginning of the year (Figure 6), and expressed concern over continued upward pressure created toward the end of the first half of the year. Throughout the period, they emphasized that the level of the exchange rate continues to make it difficult for the export sector and the tradable sector, particularly in view of the weakness in world trade, a situation that is expected to persist and even increase. In order to prevent overappreciation, the Bank of Israel continued to purchase foreign currency—intervention that is an integral part of monetary policy. During the reviewed period, the volume of purchases reached $4 billion, $0.9 billion of which was purchased as part of the program intended to offset the effects on the exchange rate of natural gas production.

Global activity remained moderate, and global growth forecasts were revised downward, mainly due to the situation in the emerging markets. The beginning of the reviewed period was characterized by some improvement in the advanced economies, continued slowdown in the emerging markets, particularly in China, and high volatility in asset and oil prices. International organizations—including the World Bank and the International Monetary Fund—lowered their growth forecasts for both 2016 and 2016 (Figure 7). The IMF also assessed that the downward risks to that forecast increased, and that the factors for this include the weak data in the US against the background of the stronger dollar, and weakness in the energy sector, as well as weak growth data in the developing economies against the background of the decline in commodity prices and worsening terms of trade. In February as well there was high volatility in the financial markets, against the background of increasing concerns over the state of European banks and the high volatility of energy prices (Figures 2 and 8). The Committee members noted that the developments in the financial markets need to be examined over time, and that it is still unclear whether they are a result of changes in the fundamental factors or of the overreaction of the markets to new information, particularly concerning events in China.

At the beginning of the second quarter of 2016, current data showed continued moderation in the global economy. The slowdown was again focused on the emerging markets and on Japan, while there were signs of continued moderate though stable growth in the US and Europe. Oil prices began to increase sharply during this period, although they remained very low by historical scale, and share prices resumed increasing. Toward the end of the period, estimates of first quarter growth in the US were published, and showed a loss of momentum. Many of the emerging markets continued to show weakness, and current data for the second quarter in Europe indicated a very moderate growth rate, although first quarter data surprised to the upside. The IMF again lowered its growth and trade forecasts for 2016 and 2017, and again emphasized that the balance of risks is tending downward.

Throughout the period, the members of the Monetary Committee agreed that the main scenario remained as it was—continued slow but stable recovery in the global economy—but in view of the overall developments presented above, their assessment was that the downward risks increased. In conclusion, the Committee members believed that these developments did not make it necessary to respond through the interest rate, but contributed to their assessment that the interest rate would remain low for a considerable time.

Throughout the period, there was tremendous uncertainty concerning the possibility that the UK would leave the European Union. This apparently had a negative effect on the performance of the global economy, particularly that of the eurozone. There was a referendum in June, and the camp that supported leaving the EU was victorious. The financial markets reacted to the results of the referendum with high volatility, but it is still too early to determine how the move will affect the global economy in general, or Israel in particular, in the medium-to-long term. The IMF's assessment is that the cumulative damage to global GDP will range between 0.1 and 0.3 percent, but there is tremendous uncertainty regarding this forecast.

Most of the leading economies increased monetary accommodation (Figure 9). At the beginning of the period, monetary accommodation was increased in most of the leading economies in the world, against the background of the low inflation environment, a situation that is mainly, though not only, the result of the decline in commodity prices. Actual inflation in the advanced economies remained low during the reviewed period, and inflation expectations were revised downward (Figure 7).

The Federal Reserve raised its interest rate in December 2015, as expected, and immediately thereafter the markets projected that the interest rate would increase at least once by September 2016 (Figure 10). The likelihood of an interest rate increase in 2016 declined significantly as a result of the weak employment report that was published in May, and due to the referendum result in the UK. However, since then, the volatility in the financial markets has declined significantly, and a strong employment report was published in June. As of the time of this writing, there is an expectation that the interest rate will increase again this year. In Japan and in Europe, quantitative easing continues. In February, the Bank of Japan for the first time declared a negative interest rate on deposits, and in March the ECB declared the implementation of quantitative easing totaling €80 billion. Throughout the reviewed period, the Committee members agreed that monetary policy around the world remained accommodative, and their assessment was that in view of the current situation, it is expected to remain so and even to grow more accommodative in the near future.

The Committee members agreed that the risks inherent in the housing market remained high. Activity in the housing market—home prices and the volumes of transactions and of new mortgages—continues to indicate robust activity despite the increase in interest rates on new mortgages, and it continues to serve as a main balance against further monetary accommodation. The risk characteristics of mortgages remained stable, following the measures adopted by the Banking Supervision Department. At the beginning of the reviewed period, there was an increase in the annual rate of change of home prices, further to the increases in the previous half-year (home prices increased by 7.8 percent in the 12 months ending in April, see Figure 11). The robust activity in the housing market was also reflected in the number of transactions and in the volume of new mortgages taken out. The number of transactions remained high, as did the stock of new homes available for sale. Total mortgages issued in the 12 months ending in May also remained high—around NIS 5 billion per month.

During the period, members of the Monetary Committee expressed concern over the fact that home prices continued to increase, and over the fact that the volume of new mortgages remained high. A continuation of this trend is worrying, since it is taking place despite the continued increases in interest rates on new mortgages in most tracks, and despite the continued increases in the gap between these interest rates and the interest rates on government bonds. However, the increase itself reflects the effect of the measures adopted by the Banking Supervision Department with the objective of reducing the risk to the banking system from the increase in the mortgage portfolio. With that, the assessment of the Committee members was that the increase in mortgage rates reduces the attractiveness of investing in dwellings, and they noted that the price increases are taking place in parallel with developments that are expected to moderate the pace of price increases—the increases in the stock of homes available for sale and in building starts.

The staff forecasts presented to the Monetary Committee by the Research Department changed significantly over the reviewed period against the background of changes in the global environment. The forecast presented by the Research Department at the end of December contained the assessment that inflation would return to within the target range at the beginning of 2017, and that the Bank of Israel interest rate would increase gradually beginning in the fourth quarter of 2016 (Figures 12 and 13). In the forecast presented at the end of March, the Research Department revised the forecast growth rates for 2017 slightly downward because global demand declined, which is expected to weigh down on exports. In that forecast, the Research Department's assessment was that inflation would return to within the target range only toward the middle of 2017, due to one-time administrative measures taken by the government, the continued decline in oil prices, and the moderating effect of inflation in the first half of

2016. The forecast contained a downward revision of the path of the Bank of Israel interest rate, forecasting that the interest rate would begin to increase gradually from the second quarter of 2017, and that at the end of 2017 it would be 0.5 percent (compared with 1 percent in the forecast provided in December).

The forecast published at the end of June again lowered the projected path of inflation and of the interest rate, against the background of similar revisions in forecasts provided since then by the leading international institutions, particularly after the Brexit decision. The forecast slightly lowered the inflation path, but left in place the assessment that inflation would return to within the target range within about a year. The interest rate path is currently expected to remain stable until the end of 2017, against the background of the expected interest rate paths in the US and in other economies, which were revised downward since the previous forecast and in particular since the Brexit decision. In addition, the growth forecast for the current year was reduced because exports showed an exceptional—although apparently partly temporary—slowdown in the first quarter of 2016. The forecast notes that the balance of risks in terms of inflation and growth is tending downward at the end of the period.