BANK OF ISRAEL
Office of the Spokesperson and Economic Information

January 10, 2011

Report to the public on the Bank of Israel's discussions prior to setting the interest rate for January 2011

The discussions took place on December 26 and 27, 2010

General

Before the Governor makes the monthly interest rate decision,[1] discussions are held at two levels—the first in a broad forum, and the second in a narrower one.

In the broad-forum discussion, the relevant background economic conditions are presented, including real, monetary and financial 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 Research and Market Operations Departments of the Bank 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 Research and Market Operations Departments and two other participating members of management 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

Indicators published in the last month (in the period from the decision on the December interest rate on November 22 till the current decision on December 27), showed that economic activity continued to increase. The increase resulted mainly from an increase in consumption of durables and in fixed investment.

[1] When the Monetary Committee is appointed, in accordance with the new Bank of Israel Law, interest rate decisions will be made by the Committee.

POB 780 Jerusalem 91007 Israel
Tel: 972-2-6552712/3 Fax: 972-2-6528812 www.bankisrael.org.il

Labor market data for the third quarter of 2010 show a continuation of the positive trend: although the rate of unemployment rose slightly in the third quarter compared with the second, this was due to a higher rate of participation on the labor market with a concurrent increase in the employment rate. Both nominal and real wages increased, in spite of the rise in labor supply.

The latest figures of goods exports (November–December 2010) show a moderate upward trend, but in general foreign trade data still reflect weakness, against the background of a very moderate growth in world trade.

The National Accounts

GDP is expected to grow in the fourth quarter of 2010 at an annual rate of 3.9 percent (seasonally adjusted), and maybe even at a higher rate. The continued GDP growth derives from a faster increase in private consumption and fixed investment, with a more moderate increase in exports. Imports are expected to remain unchanged.

The expected increase in private consumption in the forth quarter is based on the rapid increase in imports of consumer durables. The expected growth of fixed investment is based on the sharp rise in the Purchasing Managers Index and increased capital goods imports. In addition, the rise in the index of capital utilization in the third quarter is also expected to boost investment from the fourth quarter.

Initial partial data from the Bank of Israel Companies Survey for the fourth quarter support the assessment that economic activity continued to expand buoyantly in all industries, and this is reflected in companies' reports of activity in the fourth quarter of 2010 and in their expectations regarding activity in the first quarter of 2011. The Purchasing Managers Index also increased in November, and was above 50 percent for the fourth consecutive month, indicating expansion. Consumer confidence indices declined this month, but their level still remained relatively high.

The composite state-of-the-economy index

The composite state-of-the-economy index for November, which increased by 0.1 percent following similarly moderate increases since July, indicates that economic activity continued to grow slowly. The moderate rise of the index in November was the outcome of rises in the indices of manufacturing production, trade and services revenue and goods exports, which were offset by declines in the indices of consumer goods imports, raw material imports and services exports.

The labor market

The positive developments in the labor market in the first half of the year continued in the third quarter. The unemployment rate increased to 6.6 percent in the third quarter from 6.4 percent in the second, but according to the Central Bureau of Statistics Manpower Survey Labor, this increase was accompanied by a 0.7 percentage point increase in the participation rate to 57.8 percent, and a 0.6 percentage point increase in the employment rate to 54 percent. The average real wage per employee post increased by 0.4 percent in the third quarter compared with the second, and the nominal wage by 0.7 percent (both seasonally adjusted). Data on Health Tax receipts in November point to an increase in total wage payments compared with the total in November 2009.

Foreign trade

In November, goods exports remained unchanged, while goods imports fell by 4.5 percent from their October level. The Triple Trade Index[2] and Israel's exports have been steady for several months, indicating the standstill in both world trade and in Israel's foreign trade.

2. Budget data

The domestic deficit (excluding credit) from the beginning of 2010 until November was NIS 12.8 billion, compared with NIS 24.1 billion in January–November 2009. On the basis of the current data, the deficit in 2010, excluding credit, is expected to be about 3.5 percent of GDP, compared with the deficit ceiling of 5.5 percent of GDP. Assessments of the costs of the Carmel fire are that from a macroeconomic standpoint they will not be significant.

3. Developments on the nominal side

Inflation

The November CPI rose by 0.1 percent, within the range of forecasters' inflation predictions of an increase of between 0 percent and 0.3 percent. Inflation in the last twelve months and since the beginning of 2010 stands at 2.3 percent, within the range of the price stability target. Excluding the housing component, the CPI has increased by 1.6 percent since the beginning of 2010.

[2] This index measures the total foreign trade of the US, Germany and Japan, and it provides an early indicator of world trade.

The increase in the index in November was due mainly to the clothing and footwear component, which rose by 2.2 percent, and transport and communications, which rose 1.1 percent .

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

Market-based one-year-forward inflation expectations ("break-even inflation") declined to about 3 percent this month, in line with the average of the forecaster's assessments.

The forecasters expect, on average, that in the three months December 2010 to February 2011 the CPI will rise by a total of between –0.1 percent and +0.2 percent.

Most of the forecasters, on average, do not expect the Bank of Israel to change the rate of interest for January 2011. On average they expect that in twelve months' time the interest rate will be 3.1 percent.

The makam and bond markets

Yields on Israeli indexed and unindexed government bonds increased in this period by between 10 and 30 basis points (b.p.) along the entire curve, with indexed bonds showing the greater increase. These developments regarding Israeli government bonds showed the same general trends as did government bonds abroad, which started with steep increases in yields in the US, although the increase in Israel was a more moderate one. Yields on *makam* increased along the entire curve as it flattened.

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

Prior to the current interest rate decision, the Bank of Israel interest rate was 1.75–2.0 percentage points higher than the US federal funds rate and 1 percentage point higher than the ECB rate.

The yield gap, between ten-year unindexed Israeli and US government bonds, contracted significantly to 128 b.p. as a result of a sharper increase in yields in the US.

The expected real interest rate

The Bank of Israel interest rate—*deflated* by the twelve-months-forward inflation expectations derived from the capital markets—averaged *minus* 1 percent in November (to the date of the current discussions), an increase of 0.2 percentage points from its November level, due to the decline in inflation expectations.

The monetary aggregates

The slowdown in the rate of increase in the monetary aggregates continued, and some aggregates actually decreased. The M1 monetary aggregate (cash held by the public and demand deposits) decreased in November by 1 percent, further to its 0.7 percent decline in October. In the twelve months up to (and including) November, M1 increased by 1.7 percent. The M2 aggregate (M1 plus unindexed term deposits of up to one year) increased by 1 percent in November after remaining unchanged in October; in the twelve months to November it increased by 2 percent.

The credit markets

The total outstanding balance of credit to the business sector decreased by 0.3 percent in October, after falling at a similar rate in September; since the beginning of the year it has increased by about 2 percent. The outstanding balance of credit to households increased by 1 percent in October, due to increases in the outstanding balances of both mortgages and non-housing loans. Since the beginning of the year the outstanding balance of credit to households has increased by 10.6 percent.

The housing market

House prices, which are not included in the CPI and which are taken from the Central Bureau of Statistics (CBS) survey of house prices, increased on average by 0.4 percent in September–October, after rising by 1.9 percent a month on average in August–September. Since the beginning of the year house prices have increased by 12.2 percent, and in the past twelve months by 18.2 percent.

The housing component in the CPI, which is based mainly on the costs of renewed rental contracts, remained unchanged in November, after declining by 1.1 percent in October. It should be noted that at this time of year there is a low seasonal factor in house rentals.

The value of new mortgages granted in November increased by 10 percent compared with the level in October, but was still at a lower level than in the summer months. The main increase occurred in CPI-indexed, fixed interest mortgages, although unindexed floating interest mortgages still constitute the major part of the mortgage market. The increase in mortgages occurred despite the increases in the rate of interest on both indexed and unindexed floating interest mortgages.

In December the government increased the rate of purchase tax for 2011 and 2012 on purchases of houses by multiple-house owners. This measure is expected to reduce the price of houses for single-house owners, by reducing purchases of houses for investment purposes. In addition, from January 2011 an exemption from the 20 percent betterment tax will be granted to those owning a house in addition to their residence if they sell the second property in 2011 or 2012. The exemption will apply to the sale of up to two houses. At the end of the exemption period, the legal state will revert to the prior situation. This measure is expected to increase the supply of houses for sale in the short run.

The Research Department assessment

According to the staff forecast, inflation in 2011 is expected to be 2.6 percent, with a gradual increase in the Bank's interest rate, to about 3.3 percent in the last quarter of 2011.

The main reason for the forecast being above the midpoint of the inflation target range is the housing component (rentals), which is expected to continue increasing relatively rapidly, an increase in aggregate demand, and increased energy and commodity prices. Factors acting in the opposite direction, i.e., to slow the rate of price increases, include the low rate of inflation in the developed economies and the appreciation of the shekel in the last few quarters.

The main risks to real economic activity and inflation in Israel derive from developments abroad and in the housing market. Nevertheless, a renewal of substantial capital inflows into Israel, should that occur, with the pressures towards appreciation that they cause, would have a moderating effect on growth and inflation, and thereby a slowing effect on the pace of interest rate increases.

4. The foreign currency market and the share market

The foreign-currency market

During the period from November 21 to December 24, the shekel appreciated by about 1.3 percent against the dollar, and by about 5.5 percent against the euro, similar to the trend in currencies of countries with high growth rates. In terms of the nominal effective exchange rate[3] the shekel appreciated by 2.8 percent.

The share market

Since the previous interest rate discussions, the Tel Aviv share price indices increased, in line with the general trends in most stock markets around the world, but

[3] Calculated as the trade-weighted average shekel exchange rate against 28 currencies (representing 38 of Israel's trading partners). The weight of the dollar in the effective exchange rate is about 25 percent, and that of the euro, about 33 percent.

at a somewhat more moderate rate. The Tel Aviv 25 index increased by 3.2 percent, and during the period it reached an all-time record level.

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

Israel's risk premium, as measured by the five-year credit default swap (CDS) spread, increased slightly to 116 b.p., similar to the trend in CDS spreads of countries not related to the debt crisis in Europe.

6. Global economic developments (see Appendix for further details)

As in the previous month, most of this month's economic data presented a positive picture with regard to the economies of the US, China, and some European countries, prompting investment houses to make significant upward adjustments to their forecasts of growth in the next two years. In the US the monetary expansion continues, in the form of QE2, and a new fiscal program was launched, consisting mainly of tax relief. It seems that the markets brought forward by a few months their forecast of the timing of an increase in the interest rate in the US. In Europe the debt crisis spread, with reductions in the ratings and rating outlooks in some European countries (the PIGS) and doubts about other countries. Europe as a whole, spearheaded by Germany, generally presented surprisingly buoyant macroeconomic data, which in the third quarter were based also on domestic demand, and not only exports. In the emerging market economies, headed by China, rapid growth persisted. The favorable economic data published on the one hand, and the concern resulting from the high levels of debt and the European debt crisis on the other, prompted investors to switch this month from government bonds to risk assets and led to capital inflows to countries with high growth rates. This resulted in higher yields on government bonds in the major economies, strengthening of the currencies of countries with rapid growth, and increases in share prices. Inflation remained low in the advanced economies. Increased demand for commodities pushed their prices up, boosting inflation in the emerging markets.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR JANUARY 2011

In the narrow-forum discussion, four members of management make recommendations to the Governor regarding the appropriate rate of interest for the economy. In the current discussions on the interest rate for January, all the participating members of management recommended that the Governor leave the interest rate unchanged, at 2.0 percent.

Leaving the interest rate at 2 percent is consistent with the process of gradually restoring a more normal interest rate environment—a process aimed at stabilizing inflation within the target range, and supporting further growth of economic activity while maintaining financial stability. The pace of interest rate increases depends on the inflation environment, growth in Israel and globally, the monetary policies of the major central banks, developments in asset prices, and the exchange rates of the shekel. At the current rate of interest, monetary policy continuous to be expansionary.

Several issues were discussed, in particular the effect on the exchange rate of the possible widening of the interest rate differential between Israel and abroad, the effect of the exchange rate on inflation, and an assessment of the inflation environment.

In the discussion it was noted that the inflation environment is relatively high, at least in the short term. Inflation expectations derived from the capital market —break-even inflation—is at the upper limit of the inflation target range; the average of forecasters' predictions are at a similar level, and the CPI, seasonally adjusted, shows a constant increase in inflation since the beginning of the year. Also, the Research Department forecast of inflation in the next twelve months is 2.6 percent, slightly lower than that of the forecasters, but the Department's forecast takes into account an increase in the Bank of Israel interest rate, to an average of 3.3 percent in the fourth quarter of 2011. It was also noted, however, that despite expanded economic activity there were no signs evident as yet of pressure for wage increases, as the supply of labor had also increased. In addition, although inflation expectations derived from the capital market for the medium and long terms are above the midpoint of the target inflation range, the risk premium element they contain is higher than that for short-term inflation expectations, so that actual expectations are lower. The fact that medium- and long-term inflation expectations are close to the midpoint of the target inflation range reflects the credibility of monetary policy.

Participants in the discussion said that an increase in the interest rate would further increase the pressures that already existed at this time for appreciation of the shekel, as widening the interest rate differential would encourage capital inflows that would tend to strengthen the shekel. Moreover, the assessment was also put forward that the appreciation of the shekel in the last few months had helped to moderate inflation, and if the pressures for appreciation continued, they would continue to hold inflation down also in the future. Those pressures, if they do come about, will also moderate the rate of increase of the interest rate. Rapid recovery of activity in the US, however, would bring forward increases in the interest rate there, would narrow the interest rate differential, and enable the interest rate in Israel to increase more rapidly. It was noted that the most recent data regarding the US capital market show market expectations that the interest rate would rise somewhat earlier than previously expected.

Data since the previous discussions indicate that economic activity continues to expand, and the moderate increase of exports in the past two months following a period of decline is consistent with the development of world trade. The recovery in exports is fragile, however, and the debt crisis hanging over several European countries is likely to reduce the strength of demand for Israel’s exports and hence also Israel's rate of growth.

In its announcement of the decision, the Bank of Israel emphasized the following points for keeping the interest rate for January 2011 unchanged:

- Interest rates of the leading advanced economies' central banks are low, and are expected to remain low for a long time. Against this background, the differentials between interest rates in countries with relatively rapid rates of growth, including Israel, and those in the advanced economies encourage short-term capital flows, create pressure for the appreciation of the domestic currency, and therefore present a serious challenge for policy makers.

- Inflation expectations for one year ahead calculated from the capital market and those of forecasters declined a little and entered the target inflation range, and are currently slightly below its upper limit. The Bank of Israel Research Department forecast is that inflation in the coming year will be 2.6 percent, partly due to the appreciation of the shekel last month. Inflation over the previous twelve months is expected to be slightly above the upper limit of the inflation target range during most of 2011, and then to return to within the target range towards the end of the year.

- House prices increased at a slower rate last month, while the housing component of the CPI declined in the last two months, partly due to the measures introduced by the Bank of Israel and the government to cool the real estate market. However, it is still early to know whether there has been a change in the trend of house prices. The Bank of Israel will continue to monitor the developments in this market, and will take whatever steps are needed to underpin financial stability.

- Most of this month's economic indicators support the assessment that economic activity in Israel continues to expand at a rate of about 4 percent per annum. The investment houses revised their growth forecasts for the US upwards. Nevertheless, the debt crisis in several European countries is likely to reduce the pace of recovery in those countries and accordingly presents a risk to the rate of growth in Israel.

The Bank of Israel will use the instruments available to it to achieve its objectives of price stability, the encouragement of employment and growth, and support for the stability of the financial system, including keeping a close watch on developments in the assets market, and especially in the housing market.

The decision was made and published on November 22, 2010.

Participants 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, Member of Management and Head of the Monetary and Finance Division, Research Department
Mr. Barry Topf, Director of the Market Operations Department
Mr. Eddy Azoulay, Chief of Staff to the Governor
Dr. Yossi Saadon, Advisor to the Governor and Bank of Israel Spokesperson
Dr. Yossi Yakhin, Economist, Research Department

Appendix: Major Global Economic Developments

The US

The flow of positive data about the US economy continues. Growth in the third quarter was 2.6 percent (annual rate, seasonally adjusted), and it is supported mainly by business investments and government expenditure. The investment houses and economists increased their growth forecasts for 2011 by up to one percentage point. The Michigan University Consumer Confidence Index rose in December to its highest level for six months; the improvement derived in the main from more optimistic expectations regarding employment, despite the high level of unemployment, 9.8 percent in November, seasonally adjusted. Nonetheless, inflation is still low, the housing industry is still suffering from low demand, and residential investment is still weak, with a 27.3 percent drop in the third quarter (annual rate, seasonally adjusted). It appears that US policy makers consider that it is still necessary to support economic activity, both by means of monetary expansion (in the form of quantitative easing, QE2, with hints of increasing it beyond $600 billion), and via a new program of fiscal incentives totaling $860 billion (compared with $787 billion in the original program), mainly in the form of tax relief, despite Moody’s reported warning of a possible downgrade of the US credit rating.

There was renewed optimism in the financial markets that started with the announcement of the QE2 program, although early in the period reviewed it seemed that the increasing severity of the European debt crisis was managing to depress it. The volatility index (VIX) continued to decline, and yields on US government bonds increased. The negative sentiment about US government bonds led to a net exit by investors from government bond funds for the first time in two years, and to an increase in interest on 30-year mortgages to 4.83 percent, its highest level for seven months, which is likely to constitute a burden to the real estate market, in contradiction to the Fed’s intention.

At the same time, optimism in the markets enabled the government to sell its Citi holdings at a profit, and to start issuing parts of GM and AIG and to reduce the cost of its TARP (Troubled Asset Relief Program) to only $25 billion.

Europe

The debt crisis in Europe is still spreading with the reduced ratings and rating outlooks of the PIGS countries and with the spread of the crisis to Belgium, where the lack of political stability makes it difficult to take decisions to reduce the debt. Europe as a whole, however, spearheaded by Germany, generally presented surprisingly buoyant macroeconomic data, with economic activity based on domestic demand, and not only exports. The eurozone grew by 1.6 percent (annual rate) in the third quarter, and the forecasts are for continued growth in the fourth quarter. The OECD expects the recovery in Europe to be a slow one in the next few years.

BIS data show that in the second quarter foreign financial institutions' exposure to the PIGS countries contracted by about $100 billion, but it is still $2.28 trillion, with the banks in Germany and France having the highest exposure.

In Europe it is planned to carry out new stress tests in February, as the previous tests which all big Irish banks and most Spanish banks passed successfully did not gain the confidence of the public.

Japan

Japan continues to exhibit impressive recovery in economic activity: GDP grew by 4.5 percent (annual rate) in the third quarter, although this was supported mainly by private consumption which was itself supported by the government, although in the previous quarters exports to the West and to China were the main engine of growth. Japan's economy, however, is still in the throes of deflation.

The Japanese government recently passed its highest ever budget, $1.1 trillion for the next budget year. The budget still awaits parliamentary approval before it goes into effect. The budget is intended to provide a boost to the domestic economy, although more than half of it is earmarked for repayment of debts. Japan's public debt/GDP ratio is the highest of all the advanced economies.

The emerging markets

The emerging markets continue to show rapid growth, led by China, and the increasing demand for commodities boosts their prices and inflation. The annual inflation rate in China increased this month to 5.1 percent, its highest level in more than two years, in Brazil it increased to 5.6 percent, in Russia 8.1 percent, and in India it declined slightly to 9.7 percent, but the central banks hesitate to increase their interest rates in order to avoid widening the yield gaps vis-à-vis the advanced economies, which would serve to encourage capital flows to them and strengthen their currencies. This attitude may be changing, however, in the case of the People's Bank of China (PBOC), which this month increased its interest rate for the second time in three months, after avoiding doing so since the onset of the crisis. Till now the steps taken by the PBOC focused on increasing the capital requirement, which was raised this month for the sixth time this year.

In light of the continued moderate level of activity in the advanced economies and the rapid growth in the emerging market economies, China and India this month decided to double the trade between them to $100 billion by 2015. This step will help to base growth in the East on its own resources, and reduce its dependence on recovery in the advanced economies. The investment houses expect that demand in the BRIC countries will exceed that of the US within fifteen years.

Despite its positive macroeconomic data, share prices did not increase in Asia in the period reviewed, due to concern that continued tightening in China would have an adverse impact on the economies of the region. Nevertheless, according to Ernst and Young data this is likely to be a record year for new issues to the public around the world, with the majority of recent flotations taking place in Asia.