Bank of Israel

MONETARY POLICY REPORT

July–December 2012

PRELIMINARY TRANSLATION

(Text only, for graphs and tables please see Hebrew version)

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February 2013

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 includes a survey of developments in the areas of price stability and the economy during the period covered by the report, and of the policy required, in the view of the Monetary Committee, to maintain the inflation rate within the range set by the government and to achieve the other objectives of the government's economic policy.

The Monetary Policy Report for the second half of 2012 was prepared by economists in the Research Department, within the guidelines of the Bank of Israel Monetary Committee, the forum in which monetary policy decisions are reached. The report is based on data that were published up to January 25, 2013, the date of the decision on the interest rate for February 2013.

Summary

- **Monetary and macroprudential policy:** In the second half of 2012, the Bank of Israel reduced the interest rate by 0.75 percentage points, to 1.75 percent for January 2013. This was in order to strengthen the economy's ability to deal with the possible negative consequences of a worsening slowdown in the global economy. This step was taken in light of the absence of inflationary pressures, and the increasing signs of a moderation in domestic activity during the second half of the year, particularly toward its end. During this period, monetary policy was accompanied by uncertainty regarding global developments, the GDP growth rate, fiscal policy, changes in markets' reaction to the security and political conditions in the region, and developments in the housing market. In November, against the background of the increase in transactions, and the increase in prices in the housing market, and the marked increase in the balance of housing credit, the Supervisor of Banks issued a directive limiting the loan-to-value ratio of housing loans. The interest rate for February 2013 was kept unchanged at 1.75 percent.
- **Inflation and inflation expectations:** In the second half of the year, the inflation environment ranged slightly below the midpoint of the target range. In the half year reviewed, the CPI increased by 0.7 percent, and increased by 1.0 percent on a seasonally adjusted basis. For the full year of 2012, the CPI increased by 1.6 percent. In the second half of the year, prices of, *inter alia*, energy, communications, and education declined, and the rate of increase of rents moderated. In contrast, there was a 3.6 percent increase in the food component. Against the background of shekel depreciation, the VAT increase, and other tax increases expected in the beginning of 2013, 1-year inflation expectations increased in the middle of the half reviewed to about 2.5 percent. However, toward the end of the year they declined and were slightly below the midpoint of the inflation target range (1–3 percent per year). Inflation expectations for the medium and long terms were stable during the half, at around 2.2–2.5 percent, indicating credibility of monetary policy.
- **Domestic real economic activity:** The economy's rate of growth during the year was around 3 percent (in annualized terms). However, after uses expanded at a relatively rapid pace in the first quarter, there was a moderation—and even a decline—in some of them during the second and third quarters, as an effect of the global slowdown. The unemployment rate and real wages were stable during the year, and the participation rate increased. Various surveys indicated an expected moderation in activity and a slowdown in recruiting workers.
- **The global economic environment:** The slowdown in activity in Europe continued in the third quarter of 2012, and it began to affect the core countries of the eurozone as well. In the fourth quarter, there was some improvement in the markets, following accommodative policy measures and declarations of the intent to keep the eurozone intact. These were reflected in the assessment that the probability of a deterioration in the crisis, and the breakup of the eurozone, declined. In the US, the improvement in real activity continued, though there was increased uncertainty regarding the budget deficit, in particular the handling of the "fiscal cliff", for which a partial solution was found only on the last day of the year. In Japan, the slowdown deepened in the third quarter, after a near standstill in activity in the second quarter. In major emerging and developing markets, there was a slowdown in the growth rate during most of the reviewed period, and at the end there was a slight recovery. Worldwide, the expansionary policy continued: in addition to interest rate reductions, quantitative easing programs were extended and added.
- **The exchange rate:** The shekel weakened in terms of the nominal effective exchange rate in the third quarter, and it appreciated during the fourth quarter. At year end the exchange rate was at a level similar to that in the beginning of the year. In the beginning of the third quarter the shekel depreciated, against the background of concerns of a debt crisis breaking out in Europe. This concern dissipated after Europeans displayed commitment to maintaining the euro bloc and to dealing with the debt problem. Nonetheless, the shekel remained depreciated, due to, among other

things, an increase in local geopolitical risks. In the fourth quarter, security concerns diminished, and the shekel appreciated.

- **The financial markets:** The trend of decline in the risk premium measured in domestic financial markets, which began in the first half of the year, continued in the half year reviewed. Domestic stock prices increased, moving in tandem with returns on leading financial markets, and even surpassing some of them. Yields to maturity of government bonds, which currently are fairly low, increased in August–September, similar to the worldwide trend. However, they later declined, in contrast to the worldwide trend. Risks reflected in CDS contracts and in the VIX increased in the third quarter and declined in the fourth quarter. The balance of credit to the business sector, primarily bank credit, remained stable, with growth in non-bank credit along with a decline in credit from abroad. In contrast, the balance of credit to households increased. The increase occurred almost completely in housing credit.
- **Fiscal policy:** In the beginning of the second half of 2012, there was uncertainty regarding the steps that would be taken in order to reduce the deficit in 2012, regarding the approval of the 2013 budget, and regarding the deficit and government expenditure in 2013. Later in the half, the increases in tax rates—some of which went into effect in 2012—reduced the concern of eroding credibility of fiscal policy. The deficit in 2012 was 4.2 percent of GDP, compared with an estimate of 3.4 percent of GDP at the beginning of the year, and an original target of 2 percent of GDP which was set at the end of 2010. The deviation in the deficit stemmed mainly from tax receipts which were lower than forecast when the budget was being constructed.
- **Home prices:** After home prices remained stable in the first quarter of the year, they increased by a cumulative 5.4 percent from March-April[1] to October-November. In the third quarter, along with the increase in home prices, there were marked increases in the volume of new mortgages and in the number of home purchases. Together, these increased the concern of a renewed trend of increase in home prices, especially in light of a decline in the Israel Land Administration's rate of marketing properties.
- **The forecast:**[2] Based on the staff forecast which was published at the end of December 2012 (an updated forecast is expected to be published at the end of March 2013), the Research Department projects that the rate of inflation during the next four quarters will reach 1.8 percent. The growth rate in 2013, net of the effect of expected gas production from the Tamar reservoir, was revised slightly downward to 2.8 percent. The downward revision in projected growth reflects the worsening in global activity, a deterioration which is expected to continue. Likewise, it reflects a continuing negative effect of Operation "Pillar of Defense" on incoming tourism. The growth forecast including natural gas production, which is not expected to impact on the level of employment or unemployment in the short term, is 3.8 percent. The Bank of Israel interest rate is projected, according to the forecast, to be 1.75 percent through all of 2013. The main risks to the forecast are a deterioration in the debt crisis in Europe, geopolitical and regional political risks, uncertainty regarding fiscal policy after the elections, and the risk—which recently declined—from fiscal restraint in the US.

1. THE BACKGROUND AND INFLATION

The factors considered in the monetary policy decisions

The Bank of Israel Law, 5770-2010, defines the Bank's objectives as: maintaining price stability—

[1] The Central Bureau of Statistics survey of owned homes presents home prices on a two-month basis.
[2] The last forecast during the period being reviewed was presented on December 24th, 2012, the date of the publishing of the interest rate decision for January 2013. The forecasts that were presented to the Committee during the period being surveyed will be discussed below.

defined as an inflation rate within a range of 1–3 percent within a period of up to two years—as its central goal, supporting the stability of the financial system, and supporting the other objectives of the government's economic policy, especially growth, employment, and the reduction of social gaps, provided that they do not negatively impact price stability over the course of time.

In formulating monetary policy, the Monetary Committee consistently monitors economic developments in the domestic and global environments, as well as their effects on the policy objectives, and sets the interest rate that is appropriate to achieving the targets.
Monetary policy is formulated under conditions of uncertainty, regarding both the state of the economy in the present as well as future risks. Policy has to be determined through assessing future risks, since policy steps affect the economy with a lag. During the second half of 2012 (the period reviewed in this report), the uncertainty regarding domestic and global real economic developments and the risk assessment were reflected in the fact that Monetary Committee members formulated different positions on the preferred timing and pace of interest rate reductions.

There were five main issues in the background of the Committee's decisions during the period reviewed:
1. **The inflation environment** did not pose a risk in terms of policy objectives. Actual inflation ranged slightly below the midpoint of the target range, and reflected, among other things, a moderation in the housing prices component in the CPI (which essentially reflects rents). One-year inflation expectations, based on different sources, were within the target range. During most of the reviewed period they were slightly above the midpoint of the target range, and toward the end they declined a bit to under the midpoint.
2. **The deterioration in the real economy worldwide**, particularly in Europe, was the main risk factor for domestic activity and for exports. In the US, the improvement in real activity continued, but uncertainty regarding its budget problems increased.
3. **The assessment of real domestic activity**, particularly if, and to what extent, there was an additional slowdown in the rate of expansion of activity beyond that recorded in the second half of 2011.
4. **Housing market:** In the second quarter of the year, there was some uptick in the housing market and renewed home price increases (home prices are not included in the CPI). These developments presented another consideration for the Committee to take into account in its interest rate (reduction) decisions.
5. **The fiscal situation** was uncertain, in relation to meeting the fiscal policy objectives for the coming years, and with regard to the impact of advancing the elections on government expenditure in 2013.

In light of these developments, the Monetary Committee reduced the interest rate by 0.25 percentage points for July, for November, and for January 2013, reaching a level of 1.75 percent for January. In parallel with reducing the interest rate for November, and against the background of the increase in transactions and the increase in home prices, and the marked increase in the balance of housing credit, the Supervisor of Banks published a directive limiting the loan-to-value ratio of new mortgages. The interest rate for February 2013 remained unchanged at 1.75 percent.

Following are the main developments which were considered in the policy decisions of the Bank of Israel's Monetary Committee.

a. The global environment

As a small and open economy, Israel is greatly impacted on by developments in the global environment. These developments impact directly on domestic activity, Israel's exports, and domestic price levels and capital markets.

(1) Real activity, prices, and policy

The debt crisis in Europe continued to be the main risk to global growth. This risk moderated after the ECB announced its OMT (outright monetary transactions) program in September. During the half year reviewed, the contraction in activity in Europe continued, reaching even Germany and France, leading economies in the eurozone (Figure 1). In the US, there was an improvement in activity, though concerns about the country's budget problems weighed down on it. In Japan, there was sharp negative growth in the third quarter, in parallel with continued deflation in prices. In major emerging markets, the slowdown continued, with growth rates below trend, though in the fourth quarter there was improvement in China.

Against the background of the global slowdown, and forecasts for continued deterioration, the inflation environment world wide moderated slightly (Table 1). Global food prices were stable over the past year (Figure 2), and energy prices increased by 1.4 percent[3] over the course of the year, though they were quite volatile—rising sharply in the first and third quarters, due to, among other reasons, the geopolitical tensions in the Middle East, and declined in the second and fourth quarters.

Against the background of these developments, expansionary monetary policy continued worldwide—along with interest rate reductions (Figure 3), quantitative easing programs were expanded, and other programs were added.

Advanced economies

Eurozone

In light of the debt crisis in the eurozone, fiscal restraint measures were taken in order to reduce the volume of debt and to return the economies to a path of sustainable growth in the medium to long term. In Portugal, Greece, and Spain, austerity budgets were presented which deepened the slowdown and threatened political stability. Italy, in contrast, met its deficit targets, and adopted expansionary measures and announced tax cuts. In the third quarter of 2012, there a contraction of 0.2 percent in growth in the eurozone, after a contraction of 0.7 percent in the second quarter (in annual terms). The unemployment rate increased to 11.5 percent, and in Spain and Greece unemployment levels reached over 25 percent. Activity in most of the PIIGS countries—Portugal, Ireland, Italy, Greece, and Spain—continued to contract, and along with that there was a marked slowdown in growth in Germany and France, the two leading economies in Europe.

During the half year reviewed, inflation moderated to 2.2 percent in 2012 compared with 2.7 percent in 2011. This development is consistent with the ECB's current objective to maintain the inflation rate slightly below 2 percent in the medium term. In light of these developments, the ECB reduced the interest rate for July to a record low of 0.75 percent. Following the worsening of the crisis in the banking system in Spain, a €100 billion loan[4] to banks there was authorized, and it was decided to establish pan-European banking supervision, led by the ECB. In addition, it was decided to formulate a plan to purchase government bonds with 1–3 years to maturity, unlimited in quantity or time frame, of debt-laden countries (the OMT program).

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[3] The December 2012 average compared to the December 2011 average.

[4] By the end of the half year reviewed, about €39 billion of the funds were utilized.

This aid was made contingent on the receiving countries formally submitting a request to the European aid funds[5] and at the same time implementing recovery plans. The details of the program, particularly whether the aid would be recorded as government debt, have not yet been agreed upon, and requests for aid have not yet been received. With that, bond yields of Spain and Italy declined markedly from their record highs registered in the beginning of the half year reviewed, and the probability of a return to global financial crisis declined.

The US

In the third quarter of 2012, the US economic recovery continued, though later on there were increasing concerns about the impact of the large deficit and the lack of a credible fiscal program which would lead to a sustainable path of debt. In the third quarter, growth was 3.1 percent, after growing by 1.6 percent (in annual terms) in the first half. The unemployment rate, which was 8.1 percent for most of the year, declined toward the end to 7.7 percent. However, this development took place in parallel to high volatility in the rate of new jobs and to the decline in the labor force participation rate. In the half year reviewed, there was a recovery in the US real estate market, which was reflected in rising prices, in higher numbers of construction starts and home sales, and in an increase in the home builders' confidence index. In contrast, concerns increased about the US budget problems (the "fiscal cliff") and the recession they were liable to cause in 2013. The term "fiscal cliff" refers to the sharp cut in the government deficit as a result of tax benefits expiring at the end of 2012 together with reduced budget expenditures. On the last day of 2012, a partial framework was agreed on to avoid "falling off the fiscal cliff".

Against the background of these developments, and in light of moderating inflation in the beginning of the half year reviewed (Table 2), the Federal Reserve extended its Operation Twist until the end of the year. This program is intended to ease the pressure on financial markets, by selling short term bonds and buying longer term ones, actions which lead to a reduction in long term yields. In addition, in September, the Fed began to implement an additional program to purchase mortgage-backed securities (MBS), and at the same time it announced that the federal funds rate is expected to remain at its low level until 2015. At the end of the half, the Fed announced that it will purchase $45 billion of long term bonds per month, and will conduct open-ended activity in the MBS market, as long as unemployment remains above 6.5 percent and the inflation rate does not rise above 2.5 percent, which is 0.5 percentage points above its long term target.

Japan

The slowdown in Japan deepened in the third quarter, with negative growth of 3.5 percent (in annual terms) recorded, after a virtual standstill in second quarter activity. These developments occurred against the background of (1) weakening government incentives to support consumer activity after the earthquakes in 2011; (2) an increase in imports, particularly of energy products, following the decision to close the nuclear reactors after the Fukushima disaster; and (3) the negative impact on imports due to the strong yen and the slowdown worldwide. At the same time, price deflation continued, and prices declined by 0.1 percent in 2012. These developments, as well as the need to support financial sector activity and stability, and to strive toward a path of sustainable growth, led to a continuation and strengthening of the accommodative monetary policy—the central bank expanded the bond purchase plans, as well as programs of loans to financial institutions for terms of to 4 years, four times a year—twice each half. In January 2013, along with additional expansionary plans, the inflation target was increased from 1 percent to 2 percent. In addition, the new government is expected to introduce fiscal

[5] This refers to the EFSF, which already existed, and the ESM, which is expected to begin activities in 2013.

incentive plans.

The developing countries

In the third quarter, growth rates in major emerging market economies continued to be below trend; along with recoveries in China and Brazil, a slowdown continued in India. In the third quarter, GDP in China grew by 7.4 percent, continuing an increase of 7.6 percent in the second quarter. Against the background of continued slowdown, and a decline in the inflation rate to 1.7 percent[6], at the beginning of the half year, the central bank lowered its monetary interest rate twice, to a level of 6 percent, and the Chinese government announced a $156 billion government aid plan which will focus on infrastructure. In the fourth quarter, several indicators pointed to an additional improvement, which was seen in, among other things, improved figures on activity reported in the Purchasing Managers Index (PMI). The improvement appeared against the background of interest rate reductions and against the background of additional expansionary plans which were adopted during the half year reviewed. In contrast, there was a significant slowdown in Chinese exports in the fourth quarter, after improvement in the third quarter.

(2) Global financial markets

In the period reviewed, the level of risk inherent in global financial markets, particularly in heavily indebted countries, declined. This was primarily against the background of the announcement by the ECB of its OMT program, increased fiscal discipline, and calming declarations about efforts to keep the eurozone intact. With that, the level of risk remained higher than its level before the outbreak of the global crisis at the end of 2008. Evidence of the decline in risk was reflected in the narrowing of CDS[7] spreads (Figure 4), which reflect the long term risk level, as well as declines in the volatility indices (Figure 5), which reflect the short term risk level.

The 10-year yield to maturity on government bonds in heavily indebted countries declined in the half year reviewed (Figure 6), influenced by the decline in the risk level. In Portugal and Ireland, the decline in returns reflected the continuation of a trend from the beginning of the year. In contrast, the development of yields in Italy came after stabilization at a high level of around 5.5 percent in the first half of the year. In Spain, the decline reflected a turnaround, since in the first half of the year returns increased following the banking system crisis and the fiscal crisis. In leading economies in the eurozone, yields to maturity were stable in the half year reviewed. In contrast, yields increased slightly in the US and UK. In the US, they increased against the background of increased concern over the impact of the "fiscal cliff" and the large deficit. In the UK, yields increased against the background of an austerity budget made necessary by the recession and against the background of the leveraged financial industry.

In parallel with the decline in the risk level, major stock market indices increased around the world, primarily in the third quarter of 2012 (Figure 7). With that, at the end of 2012 the level of major stock market indices was still lower than their level right before the market declines in August 2011. An exception is the FTSE Index in the UK, which returned to its pre-decline level, and the S&P 500 Index in the US, which is higher than its level of August 2011.

(3) The forecast

In light of these global developments, forecasts of growth, world trade, and inflation were systematically revised downward (Figure 8). This trend continued at the end of half year reviewed. The

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[6] Compared with 3.7 percent on average in 2006–11.

[7] A CDS (credit default swap) is a financial instrument used to hedge against a country's credit risk. The CDS spread is the premium that the CDS seller demands for his commitment to pay the debt should the debt issuer be in default.

IMF's forecasts from October 2012 and from January 2013 assumed that policy makers would reach agreement on the core problems in Europe and the US.

b. Real economic developments in Israel[8]

In order to formulate appropriate monetary policy, the state of real economic activity must be evaluated—both because the level of activity and changes in it have an impact on prices, and because the policy is intended to, among other things, support growth and employment. However, an assessment of the state of the real economy is complicated, since such an assessment is based for the most part on quarterly National Accounts data, as well as on a wide range of monthly indicators of the level of activity; these are published with a lag[9], and revised retroactively. In addition, monthly indicators, which are published earlier than National Accounts data, do not always present a uniform view.

In assessing the development of real activity in the second half of the year, one of the primary issues was whether, and to what extent, was there an additional slowdown in the rate of economic expansion, beyond that which was registered beginning from the second half of 2011.

In the first three quarters of 2012, the moderate GDP growth of around 3 percent in annual terms continued (Table 2 and Figure 9). However, the development of uses was not uniform over the course of the year: in the first quarter of 2012, there were increases in private consumption and in gross domestic investment, along with a sharp increase in imports. In the second and third quarters, there was some moderation and even some decline in some of the uses, at the same time as a decline in imports—possibly indicating that the moderation in economic activity worldwide was trickling in to Israel's economy. The Composite State of the Economy Index also indicated a slowdown in activity: the average monthly rate of change beginning in August declined to 0.1 percent, from 0.2 percent in the first seven months of the year. At the end of the half year reviewed, the Bank of Israel assessed that in the fourth quarter of 2012 the growth rate will have declined due to continued weakness in global markets and the slowdown in global trade and due to the effect of Operation Pillar of Defense.

Compared with 2011, in 2012 there was slowdown in private consumption, which was expressed in a moderation of current consumption and in the consumption of durable goods component. In the first quarter, private consumption increased by 7.5 percent—an upward revision from the reading in July, which estimated an increase of 3.9 percent (Figure 10)—but the growth rate moderated to 1.6 percent in each of the second and third quarters (Table 2). The slowdown in private consumption in the third quarter stands out in the consumption of durable goods component, against the background of its high level in 2011, the effects of the general business cycle, and the VAT increase on this component. At the same time, monthly consumption indicators[10] pointed to, beginning in August, weakness in both actual demand and expected demand, while in the second quarter they improved somewhat.

In 2012, exports increased but the rate of growth slowed in the third quarter. Export data (excluding start-up companies and diamonds) for the first half of 2012 were revised upward during the second half of the year, but it should be noted that the sharp increase in exports in the second quarter was affected to a large extent by Intel's new facility. In contrast, in the third quarter, monthly indicators of foreign trade pointed to a decline in goods exports. Against the background of monthly foreign trade data, and taking Operation Pillar of Defense into account, the Bank assessed that exports, excluding diamonds, declined in the fourth quarter.

In the third quarter of 2012, the decline in civilian imports (excluding diamonds, ship, and

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[8] Figures in this section are presented on a yearly basis, seasonally adjusted.

[9] A preliminary estimate of National Accounts data is published with a lag of about 6 weeks after the end of the quarter.

[10] These indicators include the Consumer Confidence Indicator of the Central Bureau of Statistics, the index of demand based on Google searches, calculated at the Bank of Israel Research Department, and VAT receipts.

aircraft) strengthened, continuing the decline in the second quarter. This, after a sharp increase which was recorded in the first quarter. Monthly import data from foreign trade for the fourth quarter indicated stability.

Fixed capital formation, after two years of rapid growth, declined moderately in the first half of the year, a decline which strengthened in the third quarter. This decline may be explained by, among other things, the completion of the high investment in Intel's new facility. The fourth quarter forecast indicates stability in this component, against the background of the increase in import volume of investment products as opposed to the low level of the Purchasing Managers Index.

The labor market

In the third quarter of 2012, the improvement in employment and the increase in the participation rate continued, albeit at a more moderate pace than recorded in the second quarter (Figure 11). The unemployment rate and real wages remained stable throughout the year.[11] At the same time, there was a deterioration in forecasts of employee recruitment expected in the half year reviewed, against the background of the continued slowdown worldwide. The employment rate between ages 25–64 increased from 73.3 percent in the last quarter of 2011, to 74.5 percent in the third quarter of 2012. Nonetheless, the main increase in employment in the third quarter was in public services.[12] Despite the relatively low unemployment rate, the real wage remained stable, similar to previous years—and compared with the first three quarters of 2011, it only increased by 1 percentage point (Figure 11). An analysis of the unit cost of labor shows that this figure declined over the past year, and so the wage development did not lead to an increase in inflation. The absence of pressures on higher wages reflects, apparently, a decline in the structural unemployment rate.[13] Among the forces acting to moderate wage increases in recent years were the globalization process and the openness of Israel's economy, which increased competition with the rest of the world; the path of reducing income taxes; the increase in the labor force participation rate among sectors of the population which in the past had low rates; and the increase in the number of non-Israeli workers which reduces the negotiating power of Israeli workers in some industries. In addition, the global crisis and slowdown increase the uncertainty regarding future employment status, and thus moderates wage demands by employees.

The Business Tendency Survey by the Central Bureau of Statistics projected an increase in employee recruitment in the beginning of the period reviewed, stability in the middle of the period, and a decline toward the end of the period.

c. The exchange rate

At the end of the year, the nominal effective exchange rate of the shekel was similar to its level at the beginning of the half year reviewed and at the beginning of the year, though its development was not uniform, with depreciation in the third quarter and appreciation in the fourth quarter (Figure 12). At the beginning of the third quarter, the shekel depreciated against the background of concern over a deterioration in the debt crisis in Europe. The concern led to strengthening of currencies considered as safe havens for investors—currencies such as the dollar and yen—and to depreciation of the euro and most other currencies, including the shekel. Later on, Europeans displayed a commitment to maintaining the eurozone and to dealing with the debt crisis, and this commitment led to a decline in

[11] For a review of the switch to new methodology used in the Central Bureau of Statistics Labour Force Survey, please see the Box which appears in Recent Economic Developments No. 133 (June 2012).

[12] On this point, it is worth noting that the new methodology used in the Labour Force Survey makes historical comparison with its data difficult, but these difficulties will ease with time.

[13] An expanded discussion appears in the Bank of Israel 2011 Annual Report, Chapter 5, Box 5.1.

concern of a crisis breaking out there, and to weakness of the dollar against most major currencies. However, along with the relative improvement in Europe, there was an increase in regional geopolitical risks, the flow of capital out of the economy continued, and the shekel exchange rate remained depreciated. In the fourth quarter, the shekel again appreciated. This, against the background of a decline in security concerns, some increase in nonresident investments in short-term shekel investments (government debt securities)—an increase which occurred after large sales since the middle of 2011, and a switch to a current account surplus (seasonally adjusted) in the third quarter, after three consecutive quarters of deficit (Figure 13).

Overall, in the half year reviewed, the shekel appreciated by 2.4 percent in terms of the nominal effective exchange rate, in contrast to a depreciation of 1.7 percent in the first half of the year.

d. Financial developments

In the first half of the year, there was a decline in the risks to Israel's economy, and the decline continued during the half year reviewed, similar to the worldwide trend. With that, the level of risk remains high. The level of risk in the economy, as expressed in five-year CDS contracts for Israel (Figure 4), declined from about 170 basis points in the beginning of the half year reviewed to about 140 basis points at the end; that is, to the level of July 2011, prior to the worsening of the debt crisis in Europe and the US. Short term risks (up to one month), reflected in the VIX index[14], (Figure 5) also declined during the half year reviewed, though they increased temporarily around Operation Pillar of Defense.

Domestic stock prices were stable in the third quarter of 2012, and in September–October they increased sharply, similar to major global financial markets, even eclipsing some (Figure 7). The stability in stock market prices in the third quarter reflected improved global investor sentiment. However, shares affected by domestic market conditions—the finance, communications, and real estate industries—declined. In the fourth quarter, global stock prices were stable, while domestic markets turned around, and there was an increase in domestic share prices, led by the finance and real estate industries.

Nominal and real yields to maturity on government bonds increased in August–September, similar to the worldwide trend. Later, however, yields declined, in contrast to the trend worldwide (Figure 14). The gaps between the Bank of Israel interest rate and the US federal funds rate narrowed to 1.5 percentage points, and the gap with the ECB interest rate narrowed to 1.0 percentage point (Figure 15). This occurred with the reductions in the Bank of Israel interest rate for July and November, and for January 2013, at the same time as a reduction of 0.25 percentage points in the ECB interest rate in July, and the federal funds rate in the US remaining unchanged. In July, yields declined following the Bank of Israel interest rate reduction and due to nonresident investors moving into the government bond market. In August, yield curves became steeper. In September, as geopolitical tensions increased, the yield curves rose along their entire length, rising more for unindexed bonds following an increase in inflation expectations. The curves declined in October, carrying over into November. The decline took place against the background of geopolitical concerns dissipating, the decline in risk of the eurozone breaking up, and the Bank of Israel interest rate reduction for November. In December, the curve continued to fall, among other things against the background of the Ministry of Finance's announcement of reduced issuance volume in the coming quarter and the reduction of the Bank of Israel interest rate for January. The differential between 10-year Israeli government bonds and equivalent US securities declined from 270 basis points in June to 230 basis points at the end of December—around the level in the second quarter of 2011.

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[14] Based on Bank of Israel calculations.

Credit

In non-bank credit to the business sector, indices of risk levels indicated an increase in the third quarter and a decline in the fourth quarter. The risk level was seen in bond market spreads (Figure 16), issuance volume, and the share of debt trading at high yields (Figure 17).

In the third quarter of 2012, yield spreads between corporate and government bonds widened, against the background of an increase in risk of borrowings attributable to the large business groups in the economy. Similar to the decline in risks worldwide, particularly in Europe, spreads declined in the fourth quarter. Until that quarter, yield gaps were high and weighed on bond issuances, and only companies with high ratings raised debt. Toward the end of the year, with the decline in yields, there was a moderate improvement in the amount of funds raised.

The balance of credit to the business sector, which includes the banking sector, was stable throughout the year. In the first half, there was an increase in non-bank loans, and it continued during the half year reviewed. Credit from the public (through tradable bond issues) expanded as well in the second half of the year; these expansions were offset by a decline in credit from abroad. Against the background of stability in the level of credit, the question arose if the business sector is facing a credit crunch, particularly in light of the requirement by the Banking Supervision Department to increase core capital. Data from the Business Tendency Survey indicate slight funding difficulties via bank credit in all industries.[15] Marked financing difficulties were reported in non-bank credit in the services industry, in medium-sized companies.

During the half year reviewed the balance of credit to households increased by about 2 percent. Nearly all of the increase in the balance of credit derived from housing credit, the share of which in total household credit is about 70 percent. A marked increase in the volume of credit for housing was recorded in July–August, apparently in light of expectations of a VAT increase (which went into effect in September), and in light of a revival in the housing market which occurred in the second quarter of the year. As of the publication of this report, it is too early to examine the effect of limitations on mortgages imposed by the Supervisor of Banks at the end of the year.

e. Fiscal policy

The fiscal situation during the period reviewed featured a deficit which was greater than targeted in 2012, and significant threats to the 2013 budget framework. In 2012, the government deficit was NIS 39 billion, which is 4.2 percent of GDP. This is a deviation of more than 2 percent of GDP from the original target set at the end of 2010, and a deviation of 0.8 percent of GDP from the deficit projected at the beginning of 2012. The large deficit in 2012 derived primarily from lower-than-forecast tax receipts, but also from a shortage in non-tax receipts, and from expenditure which was greater by 0.2 percent of GDP than originally budgeted.[16]

Tax receipts were below forecast despite growth which was in line with forecasts, primarily due to wage increases in 2011–12 which were more moderate than expected. This development is reflected in an increase in the structural—that is, cyclically adjusted—deficit.

In the beginning of the half year reviewed, the Bank of Israel forecast for the 2012 deficit was 3.7 percent, a higher rate than the revised Ministry of Finance projection of 3.4 percent. In July, the

[15] In the Business Tendency Survey, companies are asked to rate their funding difficulties on a scale of 0 to 4. A rating of 0 indicates no funding difficulty, and a rating of 4 indicates especially severe funding difficulty. In the period surveyed, the level was not higher than the levels in previous slowdowns over the past decade.

[16] The expenditure level being greater than originally budgeted is not a breach of the budget law, and is allowed though the transfer of unutilized surpluses from previous years.

government raised the deficit target from 1.5 percent to 3 percent for 2013. However, lack of clarity regarding the measures that would be taken in order to meet the new target raised concerns of erosion in the credibility of fiscal policy, which was a central pillar in the economy successfully dealing with the recent crisis. In August, the government decided to increase taxes, which was approved by the Knesset. It was decided that some of the tax increases would go into effect in 2012 (led by a 1 percentage point increase in the value added tax (VAT), which went into effect in September), and the rest would go into effect beginning in January 2013. These increases reduced the expected deviation from the deficit target. In addition, actions to increase tax compliance and a path to collect taxes on "trapped profits" were decided on, though it is difficult to know what the actual amount raised through these two paths will be, as the Knesset has not yet legislated the laws necessary to support deeper tax collection.

Since the budget for 2013 has not been approved, the government will operate, until it is approved, within the framework of a transition budget, which allows monthly expenditure of 1/12 of the total 2012 budget, including debt repayment. This framework does not serve as a significant limitation on government expenditure, since the government's expected debt repayments in 2013 are lower than those in 2012, which will allow an increase in other expenditures, and because expenditures in the beginning of the year are low due to seasonal factors. Following Operation Pillar of Defense, a one-time addition to defense expenditure is likely, but it is still too early to assess if this will have an effect on the overall budget.

f. Inflation

Actual inflation

During the course of the full year, the annual inflation rate fluctuated around the bottom part of the target range (Figure 18). In the second half of 2012, the CPI increased by 0.7 percent, and for the full year it increased by 1.6 percent. On a seasonally adjusted basis, the CPI increased by 1.0 percent in the second half of the year, and by 0.7 percent in the first half.

In the final 8 months[17] of 2012, projections of professional forecasters and of the Research Department were higher than the published CPI by about 0.3 percentage points, on average. The CPI surprised to the downside for five months (May, June, September, October, and November), while the CPI surprised to the upside in two months, August and December.

The increase in the CPI in the half year reviewed primarily reflected higher prices in the food, housing, household maintenance, and clothing and footwear components (Figure 19). In the fourth quarter, part of the increase reflected the rise in VAT and the increased tax on tobacco and tobacco products. In contrast, declines in the communications and education components moderated the increase. The increase in housing prices (representing rents), which led the CPI increase over the past 5 years, began to moderate during the course of the year. In contrast, the food component stood out with its strong positive contribution in the half year reviewed, sketching a picture which was the reverse of its development in the second half of 2011. The CPI excluding food and energy increased by only 0.8 percent from the beginning of the year, and in the second half of the year it increased by only 0.1 percent. This development is consistent with the moderation of domestic demand and in line with the moderation of inflation worldwide.

Food prices: Against the background of the social issues protests, food prices declined in the second

[17] The Consumer Price Index is published 2 weeks after the end of the month. For example, the May CPI is published in the middle of June, and serves as an assessment of the inflation environment in the framework of the monetary interest rate decision for July.

half of 2011.[18] However, beginning in August 2012, the food prices component of the CPI increased considerably, and in the half year reviewed they increased by 3.6 percent, leading the increase in headline CPI. The increase in the second half of the year was due to an increase of about 20 percent in the prices of agricultural commodities world wide, among other things following a drought in the US, and it was accelerated due to the effective shekel depreciation during that period. Beginning in September, there was a cumulative decline of about 7 percent in the price of agricultural commodities. However, it appears that the decline in the price of agricultural commodities has not yet fully impacted on food prices, due to the gradual transmission mechanism from global agricultural commodity prices to domestic prices.[19]

The energy component of the CPI: In the half year reviewed, energy prices increased by 1.2 percent. The increase in energy prices derives from the increase in global energy prices (Figure 2). In the third quarter, energy prices increased by 18 percent worldwide. This increase, together with the shekel depreciation which occurred, was reflected in an increase in fuel prices (for transport and industry) and in household expenditure, as they appear in the dwellings maintenance component, under electricity, gas, and home heating oil. In the fourth quarter, there was a decline of about 4 percent in global energy prices, together with shekel appreciation, and these were reflected in a decline in the energy component.

Communication prices: Communication prices declined by 5.7 percent in the half year reviewed, following a decline of 1.5 percent in the previous six months. The decline in the half year reviewed derived mainly from the structural measures which led to increased competitiveness in the mobile communications industry through the entrance of additional operators and easing of limitations on the import and sale of mobile devices.

Education: This component stood out in its contribution to moderating the increase in prices in the half year reviewed, while it was unchanged in the first half of the year. The Trajtenberg Committee recommended free education for 3–4 year olds in public kindergartens. In September, following the implementation of the recommendations, there was a decline of 17 percent in the "Pre-primary education: public and private kindergartens and homecare" component. This decline contributed about -0.3 percentage points to the general CPI. Based on a government decision from the beginning of 2012, the implementation of the Free Education Law will be gradual, and spread over 3 years. In addition, expanding public afternoon daycare services is planned. Thus, additional declines in this component are expected in the coming 2 years.

The housing market

The housing component of the CPI: In 2012, the increase in the price of housing (rent) moderated. In 2012, the housing component of the CPI increased by 3.3 percent, compared with 5.1 percent in 2011. The rate of increase of the housing component moderated from 3.8 percent in the first half of the year to 2.4 percent in the second half, in annual terms (Figure 19). An analysis by the Research Department indicates that the moderation in the housing component increase is explained primarily by an increase in the supply of residential housing. Although the level of building starts has declined from the record it reached in the middle of 2011, it remains high, and is expected to continue, over the next two years, to reduce rent levels. In contrast, at the end of the half year, there was a marked decline in construction permits and in marketing of land by the Israel Land Administration

[18] A detailed discussion appears in the Bank of Israel's Monetary Policy Report for the second half of 2011.
[19] A detailed discussion appears in Box 1 of the Bank of Israel's Monetary Policy Report for the first half of 2012.

(Figure 20). In the center of the country, the decline in marketing land derived from a decline in the number of housing units offered: Between January and August 2012, land for 2,200 units was sold, compared with about 5,900 in the corresponding period of 2011. In the periphery areas (North and South), in contrast, the decline was reflected primarily in underperformance of auctions, reaching about 40 percent in the North and about 60 percent in the South.

Home prices (which are not included in the CPI) were essentially unchanged in the first quarter of the year, and in March-April through October-November they increased by a cumulative 5.4 percent, with some renewed activity in the number of transactions (Figure 21). Home price data which were published in June (referring to March-April) indicated a sharp increase of 1 percent in prices, though in the subsequent 2 months the monthly rate of increase moderated to an increase of 0.4 percent and a decline of 0.1 percent, respectively. Thus, it was not clear if the trend of price increases had renewed. With that, additional indicators pointed to possible heating up of the housing market. In May–December 2012, new mortgage volume increased to a monthly average of about NIS 4 billion (Figure 22), compared with about NIS 3 billion between September 2011 and February 2012. The number of new mortgages taken out were very volatile. In July and August there were record new mortgage volumes of NIS 4.9 billion and NIS 5.8 billion, respectively—apparently against the background of an expected increase in VAT and as a possible correction to the low number of transactions in the first quarter of the year. The decline in September and October can be explained as, among other things, a seasonal decline deriving from the fewer work days during those months. It is also likely that part of the decline derived from transactions brought forward in the two months prior. In November and December, there was renewed increase in mortgage volume, explained at least partly by the bringing forward of transactions against the background of the limitation imposed by the Banking Supervision Department on the loan-to-value ratio of a housing loan (see below). The development of home transactions, as reported in purchase tax and betterment tax records (Figure 22), was similar to that of the number of mortgages. There was a mixed trend in interest on mortgages during the half year reviewed, following their decline in the first half of the year. Interest rates on CPI-indexed mortgages stayed stable during the half year, except for a 0.2 percentage point decline in variable rate interest in July. Interest rates on variable rate, unindexed mortgages increased in the third quarter and declined toward the end of the half year (Figure 23). Home prices which referred to July-November strengthened impression that they were warming up.

A Research Department analysis indicates that the increase in home prices during the half year reviewed reflects the decline in the unemployment rate, and the shortage in homes, as reflected in the ratio of population to stock of homes, as well as a lagged response to the decline in interest rates in the economy—the process of reducing the Bank of Israel interest rate since October 2011 and the decline in real interest rates for various terms.

The renewed uptick in home prices, along with the accelerated growth in the housing credit portfolio on banks' balance sheets and the correlation between it and the construction and real estate credit portfolio, led to the Supervisor of Banks, in November 2012, imposing a limitation on the loan-to-value ratio of a housing loan. This was further to the limitation on the variable rate component of a new housing loan which was imposed in May 2011, and which moderated the transmission mechanism of monetary interest to home prices.

Development of inflation expectations

One-year inflation expectations, measured by various sources, ranged within the inflation target range. At the beginning of the half year reviewed, expectations were around the midpoint of the

target range, and increased until the middle of the period, and toward the end they declined to slightly below the midpoint.
Monitoring inflation expectations is important, as they serve as an input into corporate decisions regarding the pricing of products, and thus impact on the rate of inflation in the economy.
In the beginning of the half year reviewed, 1-year inflation expectations derived from the capital markets (breakeven inflation) were 2.0 percent (Figure 25). Later on, they increased gradually, up to an average of 2.4 percent in October, and toward the end of the year they declined to near the midpoint of the inflation target range. The increase in expectations, through October, occurred despite surprises to the downside in the CPI (except the August CPI) and was affected by, among other things, the effective shekel depreciation and the increase in regional geopolitical risks. Tax increases as well, those that were actually imposed and those that were expected in the beginning of 2013, contributed to inflation expectations. It should be noted that tax increases have a direct transitory effect on prices. The later decline can be explained primarily by the global and domestic slowdowns, the appreciation trend of the shekel, and in diminishing geopolitical concern.

Expectations derived from the capital market are calculated as the difference between the nominal 1-year yield (*makam*) and the real 1-year yield; however, since in effect there are no CPI-indexed bonds for terms of exactly 1 year, the real yield for 1 year is calculated as a weighted average of bonds with terms that are not 1 year. As a result, the computed yield is liable to include some degree of seasonality (inherent in the CPI), and thus, inflation expectations for 1 year are also likely to reflect that.[20] After correcting for the seasonality bias, expectations derived from the capital markets ranged near the midpoint of the inflation target range for most of the year, and at the end they declined to 1.7 percent (Figure 24).

The average of professional forecasters' inflation expectations for the coming year developed much the same as expectations derived from the capital markets—they increased to 2.6 percent in September and declined to 1.8 percent at the end of the year. A similar picture emerged from expectations calculated on the basis of banks' internal interest rates[21] and from expectations measured from CPI forward contracts which the banks offer over the counter.

Expectations for medium and long terms ("forward") maintained stability during the second half of the year, and indicated the credibility of monetary policy (Figure 25). For periods of 2–3 years, expectations declined slightly from 2.5 percent in July to 2.4 percent in December; for periods of 8–10 years, expectations increased from 2.2 percent in July to 2.4 percent in December. Inherent in these expectations is an inflation risk premium as well, and thus the expectation of inflation is lower. Likewise, these expectations serve as an indicator of the extent of the central bank's credibility over these horizons. The expectations' being located within the inflation target range, slightly above its midpoint, thus reflects credibility of monetary policy.

[20] Further details can be found in Stein, R., "The effect of seasonality in the CPI on inflation expectations", Discussion Paper 2012.06 (Bank of Israel).

[21] The internal interest rate is the internal marginal price that each bank assigns to raising funds (deposits) or to allocation of uses (credit). The interest rates for customers are based on a bank's internal interest rate plus a risk margin (on credit) and a marketing spread. (That is a spread related to the relative market strength of the bank vis-à-vis the different types of customers and other considerations related to the bank's activity vis-à-vis the sectors.) Various banks call the internal interest rate the "shadow interest rate", "transition prices", or "retail prices" as well. Inflation expectations for a year, derived from internal interest rate of the five major banks, are the gap between the average internal unindexed interest rates for 1 year and the corresponding average 1 year CPI-indexed internal interest rates.

2. MONETARY POLICY

The Bank of Israel reduced the monetary interest rate for the months of July, November, and January 2013 by 0.25 percentage points each time, reaching 1.75 percent for January 2013. The interest rate reductions were intended to support economic activity and price stability. In most of the half year reviewed, Monetary Committee members were of the opinion that the risks of moderating activity were greater than inflationary risks. The interest rate reductions occurred against the background of the absence of inflationary pressures, the slowdown in world wide economic activity—in particular, the expansion of the slowdown in Europe, and interest rate reductions and quantitative easing programs around the world, and increasing signs of moderation in domestic activity, especially in the second part of the half year reviewed, and expectations of additional slowing. In contrast, the upturn in the housing market presented the Committee with a consideration that it had to take into account when deciding upon (reducing) the interest rate. This was in light of the accelerated increase in the housing credit portfolio. In November, together with reducing the interest rate, the Supervisor of Banks instructed banks to limit the loan to value ratio of new housing loans. For February 2013, the Bank of Israel kept the interest rate unchanged at 1.75 percent.

Similar to the previous half of the year, the question of the development of the pace of growth arose again this period—is the growth rate stable, ranging around the level it reached at the end of 2011, or is it declining? In addition, the Committee considered the developments in the housing market, in light of the uptick it registered in the second quarter of the year.

Monetary policy impacts on economic activity, and through it, on inflation as well. In particular, the monetary interest impacts on individuals' consumption and savings decisions, on the size of investments in the economy, as well as on the exchange rate[22], so that it impacts on exports and imports, too. However, the interest rate transmission mechanism may be different for each channel. Reducing the interest rate acts to increase economic activity, including the construction industry. Beyond that, the activity in the housing market is more sensitive to interest rates than in other channels. Furthermore, the low interest rates in the economy over recent years, a result of the global crisis, is liable to contain risks to the stability of the financial system, as it increases the system's exposure to housing credit. Therefore, in order to balance the interest rate's effect on various channels, other macroprudential tools, not just monetary interest, should be considered. Accordingly, over recent years, the Bank of Israel has imposed limitations on new mortgages.[23]

It should be noted that since October 2011, when the Monetary Committee began to operate, though the publication of this report, members have not been unanimous when deciding to change the interest rate. Committee members were divided in their opinions regarding the pace and the timing of changing the interest rate. Such differences of opinion are typical of Monetary Committees around the world[24]—an early monetary step, before the picture of the situation becomes clear, is liable to moderate future risks and to improve the state of the economy, as economies react with a lag to policy. However, such a policy is liable to exact a price if the picture of the economy's situation, as it becomes clearer, is not in line with the preliminary assessment and a turnaround in policy is called for. The differences of opinion between Committee members thus reflect the different assessments of the current state of the economy and of future risks, as well as the different weight assigned by each one to the considerations noted

[22] The effect of the interest rate on the exchange rate has a direct effect on price levels in the economy as well.

[23] A detailed discussion of the measures taken until the period reviewed appears in the Monetary Policy Report (Inflation Report) for the first half of 2011,

[24] See, for example, Ehrmann, M. and M. Fratzcher, (2007), "Communication by Central Bank Committee Members: Different Strategies, Same Effectiveness?", Journal of Money, Credit and Banking 39, pp. 509–541.

above.

The following is a review of monetary policy, on a monthly basis, and the Research Department's staff forecast which was known at the time. The forecast is one of the important inputs guiding the Monetary Committee in its interest rate decisions. The forecast is updated on a quarterly basis, and is based on a wide range of sources of information on the global and domestic economies. The forecast also reflects the judgments of those who prepare them, and is formulated with the aid of a structural macro-econometric model developed in the Research Department. The model provides a framework for analyzing the forces affecting the economy, and serves as well to examine the effect of interest rate changes on the economy, and to analyze risks.[25]

In June, the monetary interest rate was 2.5 percent. Ahead of the decision on the interest rate for the month of July, the May CPI surprised to the downside, and 1-year inflation expectations derived from various sources declined to around the midpoint of the target range. This was, among other things, against the background of the worldwide decline in prices of commodities, primarily crude oil. These developments strengthened the assessment that inflationary pressures were not expected. At the same time, most indicators pointed to the fact that the growth rate of economic activity would continue to be moderate, and would remain at a level similar to that of the first quarter. With regard to the world, in the eurozone and in emerging markets there was a further decline in real activity, and in the US there was some moderation in activity. A number of central banks around the world reduced their monetary interest, and the US Federal Reserve announced the continued operation of its quantitative easing programs.

At the same time, the Research Department revised the macroeconomic forecasts for 2012–13.[26] The growth forecast for 2012 did not change, remaining at 3.1 percent. In light of the downward-revised growth forecasts world wide, the growth forecast for 2013 declined by 0.1 percent, to 3.4 percent. The forecast for inflation over the coming four quarters was also revised downward, from 2.6 percent to 2.4 percent, slightly above expectations of 2.1 percent derived from the capital market (net of seasonal effects inherent in the CPI) and of 2.0 percent based on private forecasters' projections. In light of the decline in the forecasts for inflation and for growth, the forecast for the interest rate was revised lower, to 2.25 percent by the beginning of 2014, similar to expectations derived from the capital market and to private forecasters' projections. The main risk to the forecast was a deterioration in the financial crisis in Europe.

In light of these developments, **the Monetary Committee decided to reduce the interest rate for July by 0.25 percentage points, to 2.25 percent**. This was in order to strengthen the ability of the economy to deal with the possible negative effects of developments in the global economy.

In August, September, and October the interest rate remained unchanged. During these months, the deterioration in global developments continued. However, in Israel, National Accounts estimates for the first quarter were revised upward, inflation expectations increased, and housing market indicators pointed toward revitalization. In July, several central banks around the world, including the ECB and the Bank of China, reduced their interest rates (the ECB to a record low of 0.75 percent). In August, the deterioration in the eurozone, Japan, and emerging markets continued. In September, major central

[25] An explanation of the Research Department's macroeconomic forecasts, as well as a review of the models on which they are based, appears in Inflation (Monetary Policy) Report 31 for the second quarter of 2010, Section 3-C.

[26] A press release presenting the forecast is published in tandem with the notice of the interest rate decision. The notice regarding the forecast is issued at the end of each quarter.

banks announced quantitative easing measures. The Fed even announced that its interest rate was expected to remain at its low level until the middle of 2015. In accordance with developments worldwide, various surveys continued to indicate that a moderation in domestic activity was expected.

In July, the uncertainty increased relative to the growth rate of real domestic activity, following a sharp decline in export figures for June—a decline which encompassed most industries. Nonetheless, National Accounts data for the first half of the year, which were published in September, were revised upward and indicated a continued moderate rate of growth of 3 percent. The uncertainty with regard to developments in the economy was affected as well by the deepening of the government deficit, the actual deficit, and the expected deficit, in light of the slowdown in activity and the increased government commitments.

In contrast, inflation expectations for the coming year increased over those months to the upper part of the target range. This was due to supply factors—an increase in global commodity and energy prices in July and August and the expected tax increases that were announced in August. In addition, prices of homes increased at a rapid pace relative to the virtual standstill in the first quarter of the year, though it was still too early to tell if there was a change in the trend. Later on, there were marked increases in new mortgage volume and in the number of home purchase transactions. All these strengthened the concern of a renewed upward trend in home prices. In light of these developments, the interest rate was kept unchanged in August, September, and October, as noted.

At the end of September, the Research Department staff forecast was updated. The growth forecast for 2012 was revised upward, to 3.3 percent, following the revisions to National Accounts data. However, the forecast for 2013 was revised downward, to 3 percent, as a result of the deterioration in Europe's economy. The inflation forecast for the year ending in the third quarter of 2013 increased, due to supply factors and the shekel depreciation, to 2.6 percent, a rate which was 0.4 percentage points above expectations derived from the capital market (net of seasonal factors inherent in the CPI) and 0.2 percentage points above private forecasters' projections. The interest rate forecast was for no change through the end of 2013, similar to expectations derived from the capital market, and slightly above private forecasters' projections of 2.1 percent for the coming year.

In October, the assessment that there was some moderation in the growth rate strengthened, and various surveys continued to indicate that a further moderation was expected. The development of actual prices indicated additional moderation in the inflation environment, with continued moderation in the increase in the housing component of the CPI (rents). Most inflation expectations for the year ahead ranged around the midpoint of the target range. This, against the background of the decline in commodity prices while, at the same time, increases in domestic food prices were expected. The level of risks from the rest of the world remained high. Macro data in the US and Europe were mixed, and most surprised to the upside, but this was relative to low expectations. Inflation worldwide continued to be moderate. The IMF revised downward its global growth forecasts for 2012 and 2013, and many central banks reduced interest rates.

The increase in home prices continued. The increase, and the continued growth in credit for housing as a result of low interest rates in the mortgage market, increased concern of a possible negative impact to the stability of the financial system.

In order to support economic activity, and in the absence of inflationary pressures, **the Committee decided to reduce the interest rate for November by 0.25 percentage points.** This reduction surprised markets, and was sooner than projected by private forecasters—who, although they did forecast an interest rate reduction, did not expect it in the coming 3 months. The reduction was also in contrast to the interest rate derived from the *makam* curve ("forward"), which indicated a stable interest rate in the coming year. At the same time, the Supervisor of Banks instructed to limit the loan to value ratio of new mortgages. This was in order to support the stability of the banking system against the background of the accelerated growth in the housing credit portfolio on banks' balance sheets, and the correlation between it and the credit portfolio to the construction and real estate industry.[27] This directive applies to housing loans which were approved in principle from November 1, 2012 and on. The directive establishes that the mortgage should not be for more than 75 percent of funding for a first home; not more than 50 percent of funding for an investment (second or additional) home; and not more than 70 percent in other cases.

In November, most indicators continued to support the assessment that moderate growth in activity continued, and various surveys continued to indicate pessimism and expectations of further moderation in activity. Committee members agreed that apparently significant fiscal restraint is not expected in early 2013, despite the shift to a limited budget, due to the 2013 budget not being passed. The reason is a decline in expenditures on debt repayment compared with 2012. Likewise, the Bank of Israel assessed that Operation Pillar of Defense was not expected to markedly affect current or future growth rates.

Risks from around the world remained high, and included the worsening of economic activity in Japan and continued recession in Europe. In contrast, there was moderate improvement in the US and China, though concern grew over the "fiscal cliff". Against the background of the interest rate reduction the previous month, **the Committee decided that leaving the interest rate unchanged in December was consistent with the level of economic activity and inflation environment in the economy.**

In December, the decline in the inflation environment continued. This decline was reflected in the accumulated downward surprises in the CPI—5 out of the 7 recent CPI readings surprised to the downside—and in inflation expectations for the coming year declining to below the midpoint of the inflation target range. This development is liable to indicate weakness in domestic demand and further moderation in the growth rate. In addition, the shekel appreciated in the past two months following depreciation in the months before.

Macro data in the US and in China surprised to the upside, though the level of risks from around the world remained high—macro data in Europe, especially in leading countries, indicates a widening slowdown and entry into recession; and there was increased uncertainty about the "fiscal cliff" in the US and the debt crisis in Europe, which led to increased concern over entering another recession. The Fed announced that it will continue its quantitative easing program and that the quantitative easing programs and near zero interest rates will continue as long as the unemployment rate is above 6.5 percent, and provided that inflation expectations for 1–2 years are not above 2.5 percent—0.5 percentage points above the target.

Home prices continued to increase. It should be noted that at this point it is too early to assess the effect of the limitations on the loan to value ratio of new mortgages which were imposed by the Supervisor of Banks. This is because they came into effect on November 1, and they are expected to have a gradual effect in the beginning of 2013 as well.

[27] Details appear in the announcement which was published in tandem with the notice of the interest rate reduction for November 2012.

At the end of December, the Research Department's staff forecast was revised. The growth forecast for 2013, net of the effect of expected gas production from the Tamar field, was revised downward, to 2.8 percent, from 3 percent in the previous forecast. The forecast including gas production was 3.8 percent. In the short term, gas production is not expected to have an effect the development of employment and unemployment levels in the economy.

The downward revision in the growth forecast reflected the deterioration in activity worldwide, which is expected to continue, and the continued negative effect of Operation Pillar of Defense on incoming tourism. According to the forecast, developments in the global economic environment are expected to weigh down on growth of uses at least until the middle of 2013. The inflation forecast for 2013 was revised downward by about 0.4 percentage points, to 1.8 percent. Forces acting to restrain the increase in the rate of inflation are the recent shekel appreciation, the continued slowdown in global economic activity and the moderation of global commodity prices, the continued moderation of the increase in rent levels, the continued roll out of free education for 3–4 year olds as planned, and the continued effects of the reform in the mobile communications market. In contrast, the forces contributing to accelerating the inflation rate are the tax increases expected in 2013, the expected increase in real public sector wages in 2013, and the increase in electricity rates for private consumption—expected to go into effect in the second quarter of 2013—following the halt to gas deliveries from Egypt.

According to the staff forecast, which was published at the end of December, (the next update will be at the end of March 2013), the interest rate is expected to be 1.75 percent throughout 2013. The main risk to the forecast is the debt crisis in Europe. With that, there is a low probability of an extreme scenario taking place. Domestic risks include geopolitical and diplomatic risks, and uncertainty regarding continued administration of responsible fiscal policy after the elections. An additional risk is a continuation of the shekel appreciation which occurred in the fourth quarter of 2012, which would be liable to lead to a slowdown in activity and an additional slowdown in inflation. Finally, a risk can be seen as well in US fiscal restraint, though it has declined considerably.

Against the background of the need for additional support of economic activity, and against the background of the absence of inflationary pressures, **the Committee decided to reduce the interest rate by 0.25 percentage points, to a level of 1.75 percent for January 2013**. **The interest rate for February remained unchanged at 1.75 percent.**