BANK OF ISRAEL
Office of the Spokesperson and Economic Information

June 8, 2020

Report on the Bank of Israel's discussions prior to deciding on the interest rate

The discussions took place on May 24 and 25, 2020.

General

The Monetary Committee sets the interest rate in a process that includes two discussions—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 the real and financial-monetary developments in Israel's economy, and developments in the global economy. Participants in this discussion include the members of the Monetary Committee, senior representatives from the various departments of the Bank, and economists from the economic departments (Research and Markets), who prepare and present the material for discussion.

In the narrow forum—which consists of the Monetary Committee and a representative of the Markets Department—the Research and the Markets Departments present their views of the main considerations that should guide the setting of the monetary policy. An open discussion on monetary policy follows, which ends with a vote on the level of the interest rate. According to Section 18(c) of the Bank of Israel Law, 5770–2010, the decision on the interest rate is reached by majority vote of the members of the Monetary Committee who participate in the voting.

A summary view of the economic situation available at the time of the Committee's discussion is presented in the notice regarding the interest rate decision, which was published on May 25th, and in the data file that accompanied the notice.

THE NARROW-FORUM DISCUSSION

The members of the Monetary Committee participating in the discussion decide on the appropriate rate of interest. After the discussion, it was decided to keep the interest rate unchanged at 0.1 percent. Five Committee members supported the proposal to keep the interest rate unchanged, and one Committee member supported the proposal to reduce it to 0 percent.

The discussion focused primarily on the effects of the coronavirus crisis on Israel's economy in the short and long terms, and on the policy required to reduce the scope of the adverse economic impact on businesses and households and to support an economic recovery that is as rapid as possible.

Main points of discussion

The significant negative impact on the economy as a result of the coronavirus crisis that began in March, and the process of economic recovery due to the gradual removal of the limitations imposed by the government on economic activity, were the focus of the Monetary Committee's discussions.

The Committee was presented with updates regarding the coronavirus crisis's development around the world and its expected economic ramifications. The Committee members discussed the assessments of international institutions and investment houses, which forecast a contraction of global output in 2020 and a sharp decline in the scope of world trade. The assessments were revised downward and they indicate that the recession will reach its peak during the second quarter and that the service sector will be the most adversely impacted. Due to the easing of limitations in various countries, a process of global economic recovery is expected to begin, though the level of uncertainty in the forecasts is particularly high. The Committee analyzed the risks existing in the global economy and under the various scenarios published by the international institutions.

The Committee discussed the main policy measures by central banks and governments worldwide. The significant fiscal expansionary steps taken around the world include extensive plans for expanding public expenditure, compensation for those negatively impacted by the crisis, and the extension of credit to the business sector. Central banks have taken unprecedented monetary policy steps and interest rates are expected to remain low for a prolonged period of time. Central banks' balances sheet increased markedly due to a range of accommodative steps and the provision of liquidity to markets, which apparently led to an easing in financial terms, and thus to the sharp declines in equity markets being partly offset and government bond markets around the world stabilizing.

The Committee referred to the picture of the real economic situation. Based on the first estimate of National Accounts data, GDP contracted by 7.1 percent in the first quarter, due to the shutdown of the economy beginning in the middle of March. It was noted that in view of the difficulty in assessing the changes in activity during the crisis period, the exact numbers should be referred to with caution, though there is no doubt that the negative impact on the economy is significant. The Committee attempted to assess the extent of the economy's recovery, as indicated by the quantitative assessment of the impact of the health-related limitations on the contraction of activity in various industries, and by various indicators of activity and its components and by the qualitative information provided by business surveys conducted by the Central Bureau of Statistics. The Research Department assessed that due to the removal of the limitations, the share of the economy's shutdown declined markedly since the peak of the crisis, from 36 percent of economic activity shut down in the first half of April to approximately 19 percent of economic activity shut down in the middle of May. Rapid indicators of economic activity, such as credit card expenditures, the public's mobility, and electricity usage, point to recovery in some industries, though the level of activity remains low, and in industries in which the main limitations have not yet been removed, activity is still close to the lowest point. Regarding the housing market, preliminary indicators were presented, showing a marked decline in the scope of transactions in March–April.

The Committee discussed the magnitude of the negative impact in the labor market and the effect of removing the limitations on the developments in it, but concluded that it is difficult to quantify the developments precisely, as the administrative reports regarding employment become available with a lag and it is difficult to receive from the Central Bureau of Statistics surveys a precise picture of the scope of the effect of the crisis on actual employment. The Committee emphasized the importance of the rapid handling of unemployment and labor market problems. The Committee also referred to the crisis's effect on households in various deciles—it adversely impacted households from the lower deciles notably more significantly, as the probability of those households remaining without a wage-earner is higher.

The Committee members discussed the ramifications of the strengthening of the shekel since the previous interest rate decision, and its return to a level similar to that prior to the crisis (in effective exchange rate terms). They raised the concern that it would weigh on a recovery of exports, particularly in view of the decline in global demand, and on the return of inflation to the target range.

The Committee referred to the decline in the inflation environment in recent months, during the crisis and in continuation of that trend. In April, 12-month inflation was negative 0.6 percent, primarily due to the notable negative contribution of the energy component, but even in 12-month inflation measured by the change in the CPI excluding energy and fruit and vegetables, the downward trend continued, and in April it was 0.2 percent. The housing component in the CPI declined by 0.2 percent in April. One-year inflation expectations are still below the target, while expectations for medium and long terms are within the target range. It was emphasized that in view of the crisis, there is a methodological difficulty in calculating the CPI and in analyzing the meaning of the measured change in prices.

The Committee discussed the developments in capital markets in Israel, where sharp declines in equity markets were partly offset and government bond markets stabilized. The Bank of Israel's activity in financial markets markedly reduced the yield on government and corporate bonds in Israel, despite the growth of the government deficit and in business credit risk.

The Committee discussed credit market developments. Bank credit increased during the crisis, primarily in view of the growth in business credit and in mortgages, but in general, the scope of credit to small businesses and consumer credit contracted, partly due to the decline in activity and in demand for credit and partly against the background of the increased risk of small businesses that are active in industries that were negatively impacted by the crisis. The Business Tendency Survey also indicates an increase in companies' financing difficulties. In contrast, the banks deferred, for several months, loan repayments for nearly half a million businesses and households, at a total scope of NIS 6.2 billion. The activity of the funds for extending partially government-guaranteed credit to small and medium sized businesses led to a decline in the average interest rate charged to small businesses. After a halt in bond market issues in March, there was a recovery in the scope of issues in April and May.

The Committee members discussed the special update to the Research Department's macroeconomic staff forecast, which was published in April, and that now forecasts contraction of 4.5 percent in 2020 GDP (compared to a contraction of 5.3 percent in the April forecast) in view of the rapid removal of the limitations, relative to the assessment in April. The forecast projects a growth rate of 6.8 percent in 2021 (compared to 8.7 percent in the April forecast), due to the assessment of the slower recovery due to social distancing, and limitations such as the Purple Badge, which were not fully assessed in the April forecast. The unemployment rate in the second half of 2020 is expected to increase to 8.5 percent (compared to 8 percent), and to be 5.5 percent at the end of 2021 (compared to 4 percent). The Research Department also presented a more pessimistic scenario than the baseline one, which reflects a second wave of infection in Israel and abroad. The Committee discussed the exceptional uncertainty regarding the health-related and economic scenarios expected in Israel and abroad, and the uncertainty regarding the fiscal policy expected to be adopted in a case of the crisis being extended.

The data and assessments that were available to the Committee indicated, as noted, that the economy entered a severe crisis in view of the coronavirus outbreak, a crisis that was reflected in difficulties in the capital markets and in the notable economic distress among businesses and households. They emphasized that the Bank of Israel took determined steps at the outbreak of the crisis in order to support the orderly conduct of the capital market and the functioning of the government bond, corporate bond and foreign exchange markets, and that there is a need to continue to follow these markets and to adopt new activities or to expand the existing activities, as needed.

Five Committee members were of the opinion that the interest rate should be kept at its current level of 0.1 percent. They noted that the low interest rate, together with the additional monetary tools operated by the Bank of Israel, at this time support convenient credit terms all along the curve.

One Committee member voted in favor of reducing the interest rate to 0 percent. He was of the opinion that an interest rate lower than 0.1 percent is more appropriate due to the magnitude of the crisis and the adverse impact, anomalous in its magnitude, on the employment level.

The Committee members emphasized that they will expand the use of existing tools including the interest rate tool, and will operate additional ones, to the extent that they assesses that the crisis is lengthening and that it is necessary in order to achieve the monetary policy goals and to moderate the negative economic impact created as a result of the crisis.

Participants in the narrow-forum discussion:

Members of the Monetary Committee:
Prof. Amir Yaron, Governor of the Bank and Chairperson
Mr. Andrew Abir, Deputy Governor of the Bank of Israel
Prof. Reuben Gronau
Prof. Moshe Hazan
Prof. Zvi Hercowitz
Prof. Michel Strawczynski, Director of the Research Department

Other participants in the narrow-forum discussion:
Mr. Uri Barazani, Spokesperson of the Bank
Mr. Tal Biber, Head of the Markets Division, Markets Department
Dr. Golan Benita, Chief of Staff to the Governor
Mr. Arad May, Secretariat of the Monetary Committee
Mr. Yoav Soffer, Advisor to the Governor
Mr. Nimrod Cohen, Research Department
Ms. Esti Schwartz, Secretary of the Monetary Committee