BANK OF ISRAEL
Office of the Spokesperson and Economic Information

July 23, 2018

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

The discussions took place on July 8 and 9, 2018.

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 Market Operations), who prepare and present the material for discussion.

In the narrow forum—which consists of the Monetary Committee and the Director of the Research Department—the Research and the Market Operations 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. If the vote is tied, the Chairperson (the Governor) has an additional vote.

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 July 9th, 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 for the economy. 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 increasing the interest rate to 0.25 percent.

The discussion focused on several main issues: (1) real economic activity; (2) inflation, (3) the global environment and the exchange rate, and (4) the housing market.

Main points of discussion

In their discussion on economic activity, the Committee members analyzed several estimates indicating that the economy is growing at a solid pace, among others the second estimate of first quarter National Accounts data, which showed a growth rate of 4.5 percent in annual terms. In contrast, activity indicators for the second quarter point to some slowing in the growth rate. For example, preliminary data from the Companies Survey indicate that the second quarter growth rate is around the potential rate. The Committee members assessed that the slowing that is becoming apparent in the second quarter is expected to have derived from a decline in vehicle imports, a correction to an anomalous increase in the first quarter. Thus, the Committee members added that looking at the first half overall, it appears that growth is in line with the potential growth rate. Further on, they referred to the continued decline in residential construction, the moderation in the rate of growth of services exports and the decline in goods exports. The Committee referred to the labor market data indicating that it remains tight—record high employment and participation rates, a low in unemployment, and wages continuing to increase at a rapid pace, led by wages in the business sector.

The Committee noted that the inflation environment continues to increase gradually, supported by the accommodative monetary policy, and is approaching the target range. They noted that with the publication of the CPI reading for June, the inflation rate as measured over the preceding 12 months is expected to enter the target range defined as price stability, and that 1-year inflation expectations from the various sources, particularly those derived from the capital market, increased sharply since the last interest rate decision. The Committee members said that although based on indices that exclude transitory effects, the inflation rate increased slightly in the past period, it is still in the environment in which it has ranged for a long time, indicating that structural inflation rose at a moderate pace. The Committee members discussed factors that support the entrenchment of inflation within the target range. They noted that in recent years, companies absorbed the wage increase without raising prices as it was offset by the decline in prices of other manufacturing inputs, such as oil. However, currently, with oil prices having increased, the rise in wages is expected to be reflected in an increase in the inflation rate. In addition, the exchange rate, which in recent years was a main factor in the low inflation rate, stabilized, which supports an increase in inflation. The Committee members noted that various factors are likely to lead to a delay in the return of the inflation rate to the target, including (1) a decline in oil prices, (2) enhanced competition, and (3) renewed shekel appreciation. In the Committee's view, these factors do not reflect weakness in demand. The Committee members discussed the meaning of the entrenchment of the inflation environment within the target range, with regard to the forward guidance that the Committee provides to the public. It was noted that the Committee does not specifically mean that the inflation rate will be in the middle of the target range when it refers to the issue of entrenchment. However, as inflation tends to be volatile, a situation in which the inflation environment is expected to be very close to the lower bound of the target range does not constitute entrenchment of inflation within the target range, but at the same time the trend of inflation needs to be taken into account. Likewise, most Committee members noted that to establish that the inflation environment is entrenched within the target, they will want to be sure, to the extent possible, that the return of inflation to within the target range will not only last for a few months.

In their discussion on the global economy, the Committee members said that the data continue to be positive, although it appears that the growth is losing momentum, particularly in Europe and Japan. The US economy is close to full employment, inflation continues to converge to its target, and the Federal Reserve is expected to continue raising the interest rate. In Europe, activity shows signs of moderating, the ECB is not expected to raise the interest rate until the fall of 2019, and it is only expected to end its bond purchases at the end of 2018. Regarding world trade, the Committee members said that its growth rate has slowed in recent months. The Committee members noted that the risk of a trade war has heightened in recent weeks, and they expressed concern that it is likely to have a negative effect on world trade and to adversely impact demand for Israeli exports. They emphasized that it is not an immediate threat, but rather a longer term one.

The Committee members noted that although the shekel has weakened, from a historical perspective it remains appreciated. They added that the strengthening of the dollar in the world, against the background of the Fed's interest rate increase, supported the recent weakening of the shekel.

With regard to the housing market, the Committee noted that the data indicate a decline in prices, which has moderated in the past two months, against the background of the increase in supply in recent years. The Committee members said that investment in residential construction declined apparently in response to moderation of demand. They noted that there is a difficulty in understanding the picture related to supply of new homes, as there aren't updated data on the stock of new homes for sale, which weighs on the analysis of the reasons for the halt in building starts. In parallel, some acceleration is apparent in the rate of increase of rents, as the decline in relative supply of housing services creates pressure on those prices.

As noted, five Committee members were of the opinion that the interest rate should be kept at its current level. These members claimed that the inflation environment is approaching the target but that the interest rate should be kept at its low level to support its entrenchment within the target range. They added that if the interest rate rises before inflation is entrenched within the target range, it is liable to delay the entrenchment of the inflation environment and ultimately to slow the path of interest rate increase. One of the Committee members was of the opinion that the interest rate should be increased to 0.25 percent, in view of the trend of increase in the inflation rate, and the CPI over the past 12 months still being impacted by the anomalous decline in the CPI for June 2017. This is in particular against the background of the GDP growth rates, the increase in wages at a solid pace, prices levels in Israel being higher than those in countries with a similar GDP per capita, and the financial risks inherent in a low interest rate for an extended period of time.

Participants in the narrow-forum discussion:

Members of the Monetary Committee:
Dr. Karnit Flug, Governor of the Bank and Chairperson
Dr. Nadine Baudot-Trajtenberg, Deputy Governor
Mr. Andrew Abir, Director of the Market Operations Department
Prof. Reuben Gronau
Prof. Moshe Hazan
Prof. Zvi Hercowitz

Other participants in the narrow-forum discussion:
Eddy Azoulay, Chief of Staff to the Governor
Ari Kutai, Economist in the Research Department
Shulamit Nir, Economist in the Research Department
Esti Schwartz, Secretary of the Monetary Committee
Yoav Soffer, Bank of Israel Spokesperson
Prof. Michel Strawczynski, Director of the Research Department