BANK OF ISRAEL
Office of the Spokesperson and Economic Information

12 April 2010

Report to the public of the Bank of Israel's discussions prior to setting the interest rate for April 2010

The discussions took place on 25 and 28 March 2010

General

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

In the broad-forum discussion, the relevant background economic conditions are presented, including real, monetary and financial developments in Israel's economy, and developments in the global economy. Participants in this discussion include the Governor, the Deputy Governor, the directors of the Research and Market Operations Departments of the Bank and economists from various departments who prepare and present the material for discussion. The data, estimates and assessments in these minutes are those that were available at the time of the discussions.

In the narrow forum, the directors of the Research and Market Operations Departments and two other participating members of management present their recommendations regarding the interest rate and, following a discussion, the Governor makes his decision.

A. THE BROAD-FORUM DISCUSSION—THE STATE OF THE ECONOMY

1. Developments on the real side

General assessment
Data that became available since the previous interest rate discussions indicate the upward trend in economic activity continued. Growth continued in the first quarter of 2010, albeit slightly more slowly than in the two previous quarters. Nevertheless, initial findings from the Bank of Israel Companies Survey for the first quarter of 2010 show that activity continued to expand, and even accelerated in some industries compared with the rate in the previous quarter. As was announced in January, the Bank of Israel expects GDP growth in 2010 to reach 3.5 percent.

The National Accounts
The National Accounts figures for the fourth quarter of 2009 were revised upwards at the beginning of March, giving a rate of growth of 4.9 percent for that quarter (all rates in this paragraph are rates of change compared with the previous quarter, in

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annual terms, seasonally adjusted). The increase in exports was revised upwards to 42.1 percent, and private consumption, was amended to 5.5 percent, compared with the previously published figure of 4.4 percent. The 7.2 percent reduction in fixed investment in the last quarter of 2009 reflects a reduction in nonresidential investment and a small increase in residential investment.

GDP grew at an annual rate of 3.3 percent in the second half of 2009 (compared with the first half), following its 1.5 percent decline in the first half. Growth in 2009 as a whole was 0.7 percent, compared with the original growth figure of 0.5 percent. The level of GDP in 2009:Q4 was about one percent higher than before the outbreak of the crisis (in 2008:Q3).

The composite state-of-the-economy index

The Bank of Israel's composite state-of-the-economy index for February rose by 0.2 percent, and the rate of change of the index over the three previous months was adjusted upwards to a cumulative increase of 1.4 percent, compared with the original estimate of 0.8 percent. The increase in the index for February resulted from a 2.7 percent rise in manufacturing production in January (compared with December, seasonally adjusted), a 0.6 percent increase in imports of consumer goods and a 5.1 percent increase in imports of factor inputs in February, a 3.5 percent increase in trade and services revenue in January, and a 5.7 percent increase in services exports in February, partially offset by a 3.7 drop in goods exports in February, following a 3.6 percent increase in January.

The labor market

Indicators that became available during the month show continued recovery in the labor market. According to figures from the Labor Force Survey for the last quarter of 2009, the unemployment rate (seasonally adjusted) fell to 7.4 percent, reflecting a decline from the previous quarter of about 9,000 in the number of unemployed. The number of employees increased by some 28,000 in 2009:Q4.

The nominal wage per employee post remained stable in the fourth quarter of 2009 (compared with the previous quarter, seasonally adjusted), and the real wage per employee post fell by 1.1 percent in that quarter, as a result of price increases. The number of employee posts in the business sector increased in 2009:Q4 by 0.5 percent (compared with the previous quarter, seasonally adjusted).

Foreign trade

Goods exports (excluding ships, aircraft and diamonds) declined by about 5.1 percent in February from their January level (in dollar terms, seasonally adjusted). Exports of goods of all levels of technological intensity declined. In the three months December–February these exports expanded at an annual rate of 3.9 percent (in dollar terms, seasonally adjusted) from their level in the previous three months, September–November.

Goods imports (excluding ships, aircraft and diamonds) fell by 8.1 percent in February from their January level (in dollar terms, seasonally adjusted). The reduction was mainly a reflection of the 35 percent drop in imports of fuel products. In the three months December–February these imports increased at a rate of 11 percent (in dollar terms, seasonally adjusted) from their level in the previous three months.

The balance of payments

In the last quarter of 2009 the surplus on the current account of the balance of payments reached $2.7 billion, and in the whole of 2009 it was $7.2 billion. The increase in the surplus from the level in the third quarter was due to an improvement in the services account and an increase in capital income, while the goods account and current transfers remained steady.

2. Budget data

The domestic deficit excluding credit was NIS 2.4 billion in February 2010, compared with a deficit of NIS 2.7 billion in February 2009. In the first two months of 2010 there was a cumulative surplus of 0.2 percent of GDP. The total deficit excluding credit was about NIS 3 billion below the seasonal path consistent with the budget deficit ceiling. The deviation from the seasonal path reflects the continuation of the trend of acceleration in tax revenues, underspending in January, and faster expenditure in February to the rate consistent with the seasonal path.

3. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) for February declined by 0.3 percent, a slightly more moderate decline than the fall predicted by private forecasters and than that expected by the Bank of Israel. The decline in the index in February was due mainly to a large seasonal decline in the clothing and footwear component, the reduction in electricity prices in mid-February, and the cut in the VAT rate in January. In contrast, fruit and vegetable and food prices increased.

In the last twelve months the CPI rose by 3.6 percent, 0.5 percentage points of which were attributable to government actions (mainly changes in the VAT rate and the water surcharge). The housing component of the CPI dropped by 0.2 percent in February further to its decline in the previous two months. The rate of increase of that component over the previous twelve months has slowed from about 15 percent in mid-2009 to 5.1 percent in February.

House prices, measured in the house price survey, which are not included in the CPI, continued upwards, and increased by 1.6 percent in the period December 2009–January 2010 (the latest month for which data are available) and in the previous twelve months by 21 percent.

The CPI (seasonally adjusted) and excluding the effects of government intervention (the reduction in VAT) rose in February by 0.25 percent.

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

Following the publication of the CPI for February, the private domestic forecasters predict that inflation in the next twelve price indices (the indices from March 2010 to February 2011) will be 2.6 percent, an increase of 0.3 percent in their expectations in the previous month. They also predict that the rate of inflation will decline, and that in 2010 as a whole it will be 1.8 percent. For the three months from March to May 2010 they forecast, on average, a cumulative rise in the CPI of 1.1 percent.

One-year-forward inflation expectations derived from the capital market ("break-even inflation") remained close to 3 percent also after the publication of the February CPI. This reflects an upward trend in expectations, from about 2.5 percent at the beginning of 2010 and 2.8 percent in February.

Inflation expectations for up to seven years forward rose slightly, while those for longer terms, up to ten years ahead, declined slightly, so that the range of expectations over all those years is from 2.5 percent to 2.6 percent a year.

With regard to the interest rate, the Israeli forecasters assess on average that the Bank of Israel's rate will not change for April, and that it will increase slightly in the next two months (average forecasts are 0.16 percent for May and 0.13 for June). They forecast that the rate in twelve months' time will be 2.9 percent.

The slope of the *makam* yield curve indicates that the capital market expects the Bank of Israel interest rate one year forward to be about 2.5 percent.

The makam and bond markets

The yield to maturity on CPI-indexed five-year government bonds fell in March (to the 23rd of the month) to an average of about 1.2 percent, from about 1.3 percent in February. The yield on 5-year unindexed government bonds remained almost unchanged in March from the level in February—an average of about 3.9 percent. The yield on one-year *makam* increased to about 2 percent in March, from about 1.9 percent in February.

The gap between yields on corporate bonds in most industries and ratings, in particular unrated and low-rated bonds, and those on government bonds continued to contract.

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

Prior to the current interest rate decision, the Bank of Israel interest rate was 1.0–1.25 percentage points higher than the US federal funds rate, and 0.25 percentage points higher than the ECB rate.

In March the downward trend in the gap between the yield on unindexed five-year shekel government bonds and that on US government and euro bonds halted, and they stood at 161 basis points and 177 basis points respectively. The yield gap on ten-year bonds contracted a little in March, to 145 basis points vis-à-vis the US bonds, and 197 basis points vis-à-vis the euro. The gap between real interest in Israel and the US continued along its downward path in March, as real yields declined in Israel and rose in the US.

The expected real interest rate

The Bank of Israel interest rate *minus* twelve-months-forward inflation expectations derived from the capital markets in March, prior to these discussions, averaged *minus* 1.7 percent, slightly lower than its level of *minus* 1.5 percent in February.

The monetary aggregates

In the twelve months up to and including February 2010 the rate of increase in the monetary base and the M1 monetary aggregate (cash held by the public and demand deposits) and the M2 aggregate (M1 plus unindexed term deposits of up to one year) continued to slow, against the background of the increases in the interest rate since September 2009.

In the twelve months up to and including February 2010 M1 increased by 32 percent, compared with an increase of 44 percent in the twelve months to January and more than 60 percent in the twelve months to September 2009. M2 grew by 7.4 percent in the twelve months to February, compared with an increase of about 20 percent in the twelve months to September 2009.

The credit markets

The outstanding balance of bank credit declined in January due to the continued reduction in credit to the business sector. Total credit to the business sector fell by 1 percent, while credit to households increased moderately, ending the upward trend in the latter. Housing credit continued to rise, but other credit declined.

Corporate bond issues, which had fallen in January, increased again to a high level in February. As in the last few months, low-rated and unrated bonds constituted a larger share of new issues.

The econometric models[1]

The assumptions underlying the various scenarios of economic development in the next year examined using the Bank of Israel's econometric models were similar to those in the previous month: an increase of 4.1 percent in business sector product in 2010 (consistent with the Bank of Israel's forecast of about 3.5 percent growth in GDP); a modest rise in interest rates around the world from their current very low levels; continued increases in prices of imported consumer goods and inputs till the second quarter of 2010; and an increase of 7.0 percent in world trade.

According to the baseline scenario of both of the econometric models used by the Bank—the DSGE (dynamic stochastic general equilibrium) model and the Error-Correction (EC) model—inflation is expected to moderate during 2010, and to be slightly below the midpoint of the target inflation range a year from now. This is accompanied by an upward path of the Bank of Israel rate of interest to 3.4 percent in the first quarter of 2011 according to the DSGE model, and to 2.6 percent according to the EC model. The faster increase in the interest rate in the DSGE model is obtained with appreciation of the shekel to a rate of NIS 3.64 to the dollar, whereas the EC model gives slow depreciation, to NIS 3.8 to the dollar at the beginning of 2011.

Based on the results of the models, other indicators and economic forces not reflected by the models, the assessment of the Bank of Israel Research Department is that inflation will moderate in 2010. However, the high degree of uncertainty

[1] The Bank of Israel uses econometric models to test various scenarios. Due to their nature, including the fact that their results naturally depend on certain assumptions about relevant variables, the scenarios should be viewed as one input among several in the discussions on the interest rate. In the abnormal conditions prevailing in the global financial markets since the outbreak of the worldwide financial crisis, and bearing in mind that the models do not directly reflect such events, the weight that can be attached to the forecasts derived from the models is reduced.

regarding the rate of recovery of global economic activity, and the pace of increases in import prices and of world trade, increase the uncertainty with regard to the realization of this assessment.

4. The foreign currency market and the share market

The foreign-currency market

During the period since the previous interest rate discussions (i.e., from 21 February to 25 March), the shekel appreciated by about 0.3 percent against the dollar, and by about 1.3 percent against the euro. Measured by the nominal effective exchange rate of the shekel, calculated as the trade-weighted average shekel exchange rate against 28 currencies (representing 38 of Israel's trading partners), the shekel appreciated by about 0.5 percent.[2] The euro was notably weak against most other currencies in this period.

The share market

The Tel Aviv 25 share price index on 25 March was about 4.7 percent higher than on 22 February, back to its peak level. The Tel Aviv 100 index rose by 4.6 percent in that period, in line with the trend in the leading stock markets around the world.

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

Israel’s risk premium, as measured by the five-year credit default swap (CDS) spread, declined slightly between the previous and the current interest rate discussions, at 1.16 percentage points. The CDS spreads of other countries also showed a slight downward tendency.

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

Most macroeconomic data published in the course of the last month indicate that the global economic recovery was continuing. Nevertheless, there is still uncertainty about the ability of the global economy to sustain growth without governmental support, together with concern over the fiscal position of many countries. Greece's debt crisis in particular continues to give cause for concern, as do potential debt problems in other European countries.

Inflation in the advanced economies remains low, against the persistently wide output gaps. In contrast, the emerging market countries are starting to show signs of inflation.

Stock indices around the world have returned to upward paths, supported by favorable macroeconomic data and relative calm regarding the Greek debt crisis. Low interest rates also buoy share prices.

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[2] The weight of the dollar in the effective exchange rate is about 24 percent, and that of the euro, about 35 percent.

Leading central banks—the Fed, the ECB, the Bank of England and the Bank of Japan—are maintaining very low rates of interest, and are expected to do so for some months. Nevertheless, some important central banks are continuing to reduce their use of unconventional instruments of monetary accommodation, while other central banks have already started to increase interest rates.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR APRIL 2010

In the narrow-forum discussion, four members of management make recommendations to the Governor regarding the appropriate rate of interest for the economy. In the discussions on the interest rate for April, all the participating members of management recommended that the Governor increase the rate by a quarter of a percentage point to 1.5 percent.

As was stated in the report of the discussions prior to the previous decision (of the interest rate for March) decisions on the Bank of Israel interest rate are part of a gradual process of bringing the rate back to a more "normal" level intended to bring inflation into the target inflation range and to maintain it there, and to support the continued recovery in economic activity, while maintaining financial stability.

In the discussion, participants spoke of the progress of real activity in Israel against the background of global developments, of the inflation environment, and of changes in asset prices, as factors that should affect the decision on the interest rate for April within the framework of that process.

Real activity continues to expand, but some indicators suggest that it is doing so at a somewhat slower pace. The point was made that activity expanded rapidly in the last quarter of 2009, but attention was also drawn to the slower increase in exports and the risks facing the continued recovery of economic activity in light of global economic developments from the first quarter of 2010. Nonetheless, initial findings from the Bank of Israel's Companies Survey for the first quarter of 2010 show further expansion of economic activity and expectations that this would continue in the next quarter. The current assessment is that the expected path of economic activity is consistent with a gradual upward interest-rate path.

The participants noted that the econometric models used by the Bank indicate that inflation measured over the previous twelve months is expected to be close to the midpoint of the target range in a year's time, alongside a gradually rising interest-rate path. Other forecasts—those of other forecasters as well as those derived from the capital market, whose predictions of the inflation and interest-rate paths are similar to the Bank's—are consistent with a gradual increase in the interest rate.

The participants in the discussion also spoke of the changes in asset prices, in particular of house prices. They referred to the effect of the low rate of interest on these prices, the impact of the increase in the interest rate, and the need to monitor and relate to developments in them. Moreover, mention was made of the issuance of low-rated and unrated corporate bonds, and the question arose as to whether the spreads at which they are issued fairly reflect the company risk.

It was noted that following the previous increase in the interest rate in January, the rate had remained unchanged for two months, and that an increase of the interest rate would be part of the gradual process of returning interest to a more "normal" level. One view expressed emphasized the wide gap between the current interest rate and a "normal" rate when nominal GDP is expected to grow by more than 5 percent in 2010.

Arguments made in favor of leaving the interest rate unchanged this month included the danger an increase would present for continued recovery, and the desire to prevent a widening of the gap between the interest rate in Israel and those in the major central banks, a gap likely to act to strengthen the shekel.

After considering all the points raised in the discussion, especially the real economic activity environment, the expected development in inflation, and the analysis of the development of asset prices, including house prices, the Governor decided to increase the interest rate for April by 25 basis points to 1.5 percent.

In its announcement of the decision, the Bank of Israel stressed the following:

- Forecasters' inflation expectations for the next twelve consumer price indices average 2.6 percent; inflation expectations for the next twelve months calculated from the capital market are close to the upper limit of the target inflation range. According to the forecasters, inflation measured over the previous twelve months is expected to come into the target inflation range in one month's time.

- Most indicators, including initial findings from the Bank of Israel Companies Survey for the first quarter of 2010, suggest that real activity continued to expand in that quarter. Uncertainty exists, however, over the strength of the recovery.

- Interest rates of the leading central banks around the world are very low, and are expected to remain so during the coming months. Nonetheless, some leading central banks are continuing to reduce their use of special instruments of monetary accommodation, and some central banks have started to increase their interest rates..

The Bank of Israel will continue to act to achieve its objectives of price stability, the encouragement of employment and growth, and support for the stability of the financial system.

The decision was made and published on 28 March 2010.

Those participating in the narrow-forum discussion:
Prof. Stanley Fischer, Governor of the Bank of Israel
Prof. Zvi Eckstein, Deputy Governor of the Bank of Israel
Dr. Karnit Flug, Director of the Research Department
Mr Rony Hizkiyahu, the Supervisor of Banks
Dr. Edward Offenbacher, Member of Management and Head of the Monetary and Finance Division, Research Department
Mr. Barry Topf, Director of the Market Operations Department

Mr. Eddy Azoulay, Chief of Staff to the Governor
Dr. Yossi Saadon, Advisor to the Governor and Bank of Israel Spokesperson
Dr. Sigal Ribon, Head of Monetary Analysis Unit, Research Department

Appendix: Major Global Economic Developments

US

The general picture emerging from the most recent data published in the US was generally positive. GDP data for the fourth quarter of 2009 showed an increase of 5.9 percent (annual rate), compared with an increase of 5.7 percent in the previous estimate. Growth forecasts (investment houses average) are for growth in the US of 3.3 percent in 2010, and about 3 percent in 2011.

Other indicators show an improvement with regard to economic activity: a greater utilization of production capacity, a favorable surprise in data of private consumption and retail sales, an increase in credit to consumers for the first time since the outbreak of the crisis, and a decline in inventories.

Positive signs were evident also in the labor market: job losses were lower than anticipated, employment of temporary workers increased, the rate of participation in the labor force rose, and the number of dismissal notices fell. Nevertheless, as the Chairman of the Fed noted, recent growth was dependent on fiscal support, and on the process of building stocks, factors expected to weaken during the year. He also stated that sustainable growth depends on consumer demand.

The housing market continues to be the weak link in the recovery. New home sales reached an all-time low, and sales of existing homes fell particularly rapidly, and building starts and building permits also continued to decline. House prices, which had recovered slightly in the third quarter of 2009, fell again in the last few months, and are expected to continue downwards in light of the large number of forfeiture proceedings and the expected increase in interest on mortgages.

The US budget deficit reached an unprecedented level of $220 billion in February, and the Congressional budget office forecast that the deficit would significantly exceed the planned levels in each of the next few years.

The CPI remained unchanged in February, and the increase over the previous twelve months was 2.1 percent.

The Chairman of the Fed, in his testimony to the House of Representatives, described the exit process from the use of special tools operated at the peak of the crisis, and noted that the use of Term Asset-Backed Security Loan Facilities (TALF) would be wound down at the end of March, and would end completely at the end of June. The use of Commercial Mortgage-Backed Securities (CMBS) would halt at the end of March. In its mid-March decision, the Fed left its interest rate unchanged at 0 to 0.25 percent, and noted that it expected the economic conditions to support keeping the low interest level for some time.

Europe

The main developments in Europe recently related to those in Greece. Overall there was some slight easing of concern over a debt crisis there, particularly after Greece announced a program of cuts and managed to raise € 5 billion (out of € 25 billion it needs to raise in the next two months), and S&P withdrew its threat to downgrade Greece's debt rating further. The capital raised, however, was at a very high interest level of 6.3 percent.

On the macroeconomic front, the information from Europe was mixed. Companies reported increased profits and a decline in their debt ratios. Purchasing manager indices (PMIs) are settling above 50 points. Unemployment, too, that declined this month contrary to expectations, provided a positive indicator. Investment houses predictions of European growth in 2010 were revised downwards to an average 1.3 percent, and for 2011, remained at 1.8 percent. This, following contraction of 4 percent in GDP in 2009.

The rate of inflation in the EU measured over the previous twelve months is 0.9 percent, and it is expected to remain in that vicinity in 2010. The ECB in its last interest rate decision at the beginning of March left its rate at 1 percent, and the President of the ECB noted in his statement that there are no inflationary pressures, and that growth is expected to continue, albeit with high variation between the various member countries.

The UK, despite positive GDP growth in the last quarter of 2009 and a rise in the consumers' confidence index, also faces the risk of a debt crisis. The UK has a relatively high debt ratio (among the advanced economies second only to Japan's), and a significant part of its debt is to foreign investors. Following the elections due to take place in May, the UK will have to take steps to deal with this, and in order to avoid the risk of a downgrade of its rating by the credit rating agencies.

The annual rate of inflation to February 2010 was 3 percent. At its meeting at the beginning of March, the Bank of England left its interest rate at 0.5 percent, and decided to keep the stock of bonds it had purchased at ₤200 billion, in accordance with its decision in November 2009.

Japan

Most of the data published this month were positive. Despite a downward adjustment to the figure for GDP in the fourth quarter of 2009 from 1.1 percent to 0.9 percent, that is still a good figure for growth in Japan, as it is based also on consumption and not only on exports. Other indicators such as retail sales, car production and sales, exports, manufacturing production and consumer confidence indices also paint a positive picture.

The problem of deflation continues to cast a shadow over Japan, and despite the positive expectations regarding the next few quarters, there is concern that the economy may experience another recession as early as next year, in light of the its structural problems. In its announcement of its interest rate decision, the Bank of Japan referred to its battle against deflation, and doubled its three-month loan program to ¥20 trillion.

The emerging markets

The emerging markets continue to show strong performances, but alongside their rapid growth, inflation is also rising.

In China there is growing concern over too rapid growth accompanied by accelerating inflation and even the development of a bubble in asset prices. The heavy injection by the government in the last year supported the increase in demand, and currently an effort is being made to restrain that acceleration by reducing the extent of loans planned for this year. The data show a drop in loans in February to half of their

January level, and a slowdown in the growth of manufacturing production. That said, house prices are still rising and inflation over the previous twelve months has risen to 2.7 percent.

In South America, positive developments in Brazil support the assessment that it will increase its interest rate. There were no positive changes regarding Eastern European countries, except for the successful issue of bonds by Hungary following significant budget cuts made by the government.