



BANK OF ISRAEL
Office of the Spokesperson and Economic Information

September 10, 2012

**Report to the public on the Bank of Israel's discussions prior to setting the
interest rate for September 2012**

The discussions took place on August 26 and 27, 2012

General

In the process of making the monthly interest rate decision by the Monetary Committee, 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 three members of the Monetary Committee from the Bank—the Governor, the Deputy Governor and the Senior Advisor to the Governor—and the three members of the Monetary Committee from the public. Other participants in the discussion are the Directors of the Research and Market Operations Departments, and economists from various departments who prepare and present the material for discussion. The data, estimates and assessments in this report are those that were available at the time of the discussions.

In the narrow forum, which consists of the Monetary Committee and the Directors of the Research and Monetary Operations Departments, the two Departmental Directors present their recommendations regarding the interest rate. An open discussion follows, which ends with a vote on the level of the interest rate. According to the Bank of Israel Law, 5770-2010, (section 18(c)), 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. THE BROAD-FORUM DISCUSSION—THE STATE OF THE ECONOMY

1. Developments on the real side

General assessment

Indicators of real economic activity that became available this month support the assessment that the economy is growing at a rate similar to that of recent quarters, a rate which is in line with the Bank of Israel's growth forecast for 2012, of 3.1 percent. According to a preliminary estimate of National Accounts figures for the second quarter of the year (annualized, seasonally adjusted), GDP increased by 3.2 percent, compared with 2.8 percent in the previous quarter; business sector product increased by 3.7 percent, compared with 2.2 percent in the previous quarter; private consumption increased 5.4 percent, compared with 6.2 percent in the previous quarter; fixed capital formation declined by 1.1 percent, compared with an increase of 3 percent in the previous quarter; and exports (excluding diamonds) increased 9.8 percent, compared with 4.9 percent in the previous quarter.

Monthly indices of the economic situation

The Composite State of the Economy Index for July increased by 0.2 percent, though the forecast of real activity as reflected in various surveys is for a slowdown in activity in the economy.

The labor market

Second quarter data from the Labour Force Survey, in its new format, indicate continued growth in employment and an unusual increase in the participation rate (0.8 percentage points), which was reflected in an increase in the employment rate (59.1 percent in the second quarter compared with 58.5 percent in the previous quarter), and an increase in the unemployment rate for the second quarter to 7 percent. At the same time, there was an increase in the rate of workers employed full time. In contrast, survey figures for the month of June indicate a slight decline in the employment rate compared with May, and National Insurance data show that in July, there was an increase of more than 10 percent in the number of new claims for unemployment benefits (seasonally adjusted), compared with the previous month. Compared with July of last year, the increase is about 17 percent. Nominal wages of Israelis increased by 1 percent in March–May, seasonally adjusted, compared with the preceding three months, and real wages increased by 0.3 percent. Health tax receipts, which provide an indication of total wage payments, were 6 percent higher in July in nominal terms than in July 2011 (excluding the effect of legislative changes), a rate of change similar to that in previous months.

Budget data

Actual budget expenditure figures indicate a domestic deficit, excluding net credit granted in the year to date through July, of NIS 9.3 billion, compared with a deficit of NIS 3.6 billion in the corresponding period of 2011. The deficit in 2012 is projected to be between 3.5–4 percent of GDP, primarily due to lower than expected revenues for the first half of the year.

In order to reduce the expected deficit in 2012 and to meet the deficit target for 2013 set by the government, 3 percent of GDP, the government and Knesset decided this month on several steps to increase tax rates, some already taking effect in 2012 and the remainder beginning in January 2013. Decisions on government expenditure in the coming year have not yet been reached; specifically, whether a budget for 2013, which will require significant cuts in accordance with the "automatic pilot" in order to remain within the expenditure rule, will be passed soon, or if instead -- if the Knesset does not approve a budget for 2013 before the start of next year -- a transition budget which allows monthly expenditure of 1/12 of the 2012 budget, which would reflect considerable restraint, will be managed.

2. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) increased by 0.1 percent in July, in line with forecasts, and below the seasonal path consistent with achieving the inflation target. The main factors which stood out this month were the increase in the housing index and the decline in the food and energy components. The rate of inflation over the previous twelve months was 1.4 percent, compared with 1 percent the previous month. On a seasonally adjusted basis, inflation since the beginning of the year has been 0.9 percent in annual terms.

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

Forecasts of the inflation rate over the next twelve months based on the average of forecasters' inflation predictions, on expectations calculated from the capital markets (break-even inflation), and on inflation expectations based on over-the-counter CPI futures contracts offered by banks, increased this month, and range from 2.3 percent to 2.6 percent, compared with 1.6–2 percent in the previous month. The increase this month came after several months of decline in inflation expectations, and apparently derives from planned increases in indirect taxes, increased global commodity prices which are expected to have an effect on local prices as well, and from the depreciation of the shekel. According to forecasters, prices are expected to increase by 1.3 percent over the next three months. Inflation expectations for two years and longer increased slightly and currently range between 2.3 percent and 2.4 percent. Expectations for the Bank of Israel interest rate one year from now, derived from the Telbor (Tel Aviv Inter-Bank Offered Rate) market, as well as those based on the average projection of

forecasters, range between 1.9–2.1 percent. Half of the forecasters predict that the Bank of Israel interest rate for September will be unchanged, but that the interest rate will be reduced by 0.25 percentage points in the next three months, while half the forecasters expect the interest rate to be reduced by 0.25 percentage points this month.

The housing market

The housing component of the CPI (representing rents) increased by 1 percent in July. In the twelve months ending in July it increased by 4 percent, compared with an increase of 3.4 percent in the twelve months to June. Home prices, which are published in the Central Bureau of Statistics survey of home prices but are not included in the CPI, increased in May–June by 0.1 percent, after increasing by 0.4 percent in April–May. In the twelve months ending in June, home prices increased by 1.2 percent, compared with an increase of 1.7 percent in the twelve months to May. Activity in the construction industry is strong compared with its levels in the past decade. Although building starts are below the record level of the middle of 2011, they remain high and are expected to continue to be reflected in an increased inventory of homes. There were 42,319 building starts in the twelve months to May, compared with 43,927 in the twelve months to April. In June, the stock of vacant homes available for sale was 20,600, maintaining the stable level of the past year. According to a Ministry of Finance publication, preliminary figures for July indicate an unusual increase in the number of home purchases. With that, it is likely that this increase derives from, among other things, purchases brought forward due to expectations for an increase in VAT.

The makam and bond markets

Yields on unindexed government bonds followed the global trend with an increase of up to 40 basis points, primarily in short to medium term maturities, as investors shifted funds during the month toward the indexed segment due to an increase in inflation expectations. On the CPI-indexed curve, yields declined by up to 20 basis points in the short to medium terms. *Makam* yields increased by about 10–25 basis points along the entire curve, with one year yields increasing to 1.97 percent during the period.

The yield spread and differential between Israel and abroad

The yield gap between 10-year Israeli government bonds and equivalent 10-year US Treasury securities declined by 20 basis points, to about 245 basis points.

The monetary aggregates

In the twelve months ending in July, the M1 monetary aggregate (cash held by the public and demand deposits) increased by 6.3 percent, and the M2 aggregate (M1 plus unindexed deposits of up to one year) increased by 8.7 percent.

The credit market

The outstanding debt of the business sector increased in June by 0.2 percent, to NIS 792 billion. The increase in the debt derived primarily from the depreciation of the shekel, which increased the shekel value of foreign currency denominated debt. Total outstanding credit to households increased in June by 0.4 percent, to NIS 375 billion, within which the balance of outstanding housing credit was NIS 267 billion. The total volume of new mortgages granted in July was NIS 4.9 billion, compared with NIS 3.9 billion in June. It should be noted that there is usually an increase in new mortgages granted during June and July, and it is likely that the volume of mortgages taken out in July was affected by purchases brought forward ahead of the expected VAT increase. Total new mortgages granted in the twelve months ending in July increased by 2 percent compared with the twelve months ending in June, and the decline in this figure which began in May of last year ended. Mortgage interest rates continued to decline this month on all indexation tracks, primarily in the unindexed, floating rate, segment, continuing their decline of recent months.

The Bank of Israel Research Department assessment (staff forecast)

The Bank of Israel Research Department's most recent macroeconomic forecast was formulated in June. GDP growth in 2012 was projected to be 3.1 percent, and the forecast for 2013 was 3.4 percent. The inflation rate over the 4 quarters ending in the second quarter of 2013 is expected to be 2.4 percent. Based on developments since the end of June, it is likely that the growth rate projection for 2013 will be revised downward in the September update to the forecast.

3. The foreign currency and stock markets

The foreign currency market

From the previous monetary policy discussion held on July 22, 2012, through August 24, 2012, the shekel depreciated against the dollar by 0.7 percent, and depreciated by 2.9 percent against the euro. The shekel's weakness against the dollar stood out compared with the appreciation of most major currencies against the dollar. In terms of the nominal effective exchange rate the shekel depreciated by about 1.6 percent.

The capital market

From the previous monetary policy discussion held on July 22, 2012, through August 24, 2012, the Tel Aviv 25 Index increased by about 3.4 percent, in line with the global trend, against the background of increased monetary easing in major markets worldwide. Israel's sovereign risk premium as measured by the five year CDS spread increased by about 7 basis points this month to 163 basis points, in contrast to CDS spread declines in many other economies around the world. The Tel-Bond 20 Index and the Tel-Bond 40 Index were mostly unchanged by the end of the period, with increases of only 0.1 percent and 0.2 percent, respectively.

4. Global economic developments

Some easing was felt in markets this month, against the background of the announcement by the ECB president of a new plan for intervention by the central bank in the market for government bonds of countries prepared to adopt recovery plans, expectations of further expansionary plans worldwide, and the improvement in some US economic data during the past month. This easing was reflected in declines of yields on government bonds of Spain and Italy, and by an increase in stock market indices around the world. With that, second quarter growth figures published this month indicate reduced activity in the eurozone and a marked slowdown in Germany. Weak data on real economic activity were also released in the UK and Japan. In emerging market economies, particularly China, macroeconomic data continued to indicate a slowdown in the rate of growth. In contrast, a slight improvement was recorded in US economic activity this month. Investment houses revised downward their 2013 forecasts for global growth, to 3.3 percent from 3.4 percent; for US growth, to 2.1 percent from 2.2 percent; and for growth in Europe, to 0.1 percent from 0.3 percent. In commodity markets, oil prices continued to increase and the agricultural commodities index was unchanged at the high level it reached in the past two months. Inflation rates in most major economies continued to moderate. After a series of monetary expansion steps by central banks in some economies recently, there were no changes in the past month in the monetary policy of those economies.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR SEPTEMBER 2012

Main points of discussion

The six members of the Monetary Committee participating in the discussion decide on the appropriate rate of interest for the economy. After the discussion on the interest rate for September 2012, the Committee members voted unanimously in favor of keeping the interest rate unchanged at 2.25 percentage points.

The discussion focused on five main issues which served as the background to the interest rate decision for September: (1) the real economic environment; (2) the inflation environment; (3) the global environment and the geopolitical situation; (4) the government budget; and (5) the housing market.

Committee members agreed that National Accounts data for the second quarter (which were affected by the opening of a large factory) are consistent with continued growth of around 3 percent, and members pointed to the growth of private consumption and exports of goods and services. In contrast, it was noted that based on data from various surveys (the Central Bureau of Statistics Business Tendency Survey and the Purchasing Managers Index), an additional slowdown in the growth rate is expected in coming quarters.

Committee members noted that despite the fact that actual inflation in recent months has been low, inflation expectations increased markedly this month, primarily reflecting expectations—based mainly on supply factors: higher prices of food and energy, and higher VAT—for increased prices.

There is considerable uncertainty regarding the development of the crisis in Europe, and the possibility that a solution to the crisis will not be found cannot be ruled out. With that, Committee members assessed that there is a strong commitment to finding a solution to the crisis, an assessment reflected as well in the positive returns in financial markets around the world during the recent period. The geopolitical situation in the Middle East also contributes to the uncertainty in the economy.

Another topic discussed was the effect of fiscal policy on developments in the economy in the near term. The Committee was of the view that until the outlook for the budget becomes clear, it cannot be determined how monetary policy will be affected by fiscal developments.

The low annual rate of change in home prices, 1.2 percent, was noted in a discussion on the housing market. With that, in light of the increase in the number of new mortgages granted, Monetary Committee members agreed that there is still a risk of a renewed trend of price increases.

In its announcement, the Bank highlighted the following main considerations underlying the decision:

- Inflation over the previous 12 months was 1.4 percent, and on a seasonally adjusted basis, inflation since the beginning of the year is below the lower bound of the target range. However, inflation expectations which had declined in recent months, increased markedly this month as a result of an increase in prices of commodities and energy, and changes in indirect taxes.
- Indicators which became available this month support the assessment that the economy is growing at a rate similar to that of recent quarters, of around 3 percent. With that, data from surveys of economic activity indicate expectations of a slowdown in the rate of growth. Likewise, a continued trend of moderation in world trade is liable to lead to a decline in the economy's growth rate. At the same time, the recent weakness of the shekel is expected to aid the economy in dealing with the negative developments abroad which are expressed in reduced demand for Israeli exports.
- Over the past 12 months, there has been a moderation, and even a halt, in the increase in home prices. With that, there was an increase this month in new mortgages granted, though it is too early to tell if there has been a change in trend in the housing market.
- The level of economic risks from around the world, due to the developments in Europe, remains high—leading to concerns of negative effects on the domestic economy. Second quarter macro figures which became available this month

indicate continued deterioration in the state of the economies in the eurozone, the UK, Japan, and emerging markets. In contrast, there was a slight improvement in US economic activity this month.

- Most economies did not change their monetary policy this month, and interest rates at major economies remained low. In addition, markets are not pricing in any increases in interest rates this year by any of the leading advanced economies' central banks. This month, the ECB president announced a new program for intervention by the central bank in government bond markets, though concrete steps to implement the policy have not yet been taken.

The Bank of Israel will continue to monitor developments in the Israeli and global economies and in financial markets, particularly in light of the increasing uncertainty in the global economy. The Bank will use the tools available to it to achieve its objectives of price stability, the encouragement of employment and growth, and support for the stability of the financial system, and in this regard will keep a close watch on developments in the asset markets, including the housing market.

The decision was reached and announced on August 27, 2012.

Participants in the narrow-forum discussion:

Members of the Monetary Committee

Prof. Stanley Fischer, Governor of the Bank of Israel, Chairperson

Prof. Alex Cukierman

Dr. Karnit Flug, Deputy Governor of the Bank of Israel

Prof. Reuben Gronau

Prof. Rafi Melnick

Mr. Barry Topf, Senior Advisor to the Governor on Monetary Policy Issues

Other participants in the narrow-forum discussion:

Mr. Andrew Abir, Director of the Market Operations Department

Prof. Nathan Sussman, Director of the Research Department

Mr. Eddy Azoulay, Chief of Staff to the Governor

Dr. Yossi Saadon, Advisor to the Governor and Bank of Israel Spokesperson

Mr. Daniel Nathan, Economist in Research Department

Ms. Esti Schwartz, Monetary Committee Secretary