BANK OF ISRAEL

Office of the Spokesperson and Economic Information

September 12, 2018

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

The discussions took place on August 28 and 29, 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 August 29th, 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) the inflation environment, (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 deliberated on National Accounts data. It was noted that although there was a decline in growth in the second quarter, it was apparently fluctuation around the potential growth rate. It was noted in this context that growth in the first half of the year was 4 percent. Several indicators of economic activity, such as the Composite State of the Economy Index and the Business Tendency Survey, point to the economy continuing to grow at a solid pace. Current private consumption in this quarter continued to grow at a high rate, and the decline in growth derived mainly from fluctuations in vehicle imports. With that, the continued decline in investment in residential construction, and the decline in goods and services exports in the second quarter were noted. The Committee referred to labor market data indicating that it remains tight—employment and participation rates around record highs, an increase seen in the number of job vacancies, and wages continuing to increase, particularly in the business sector.

The Committee noted that the inflation environment continues to increase, supported by the accommodative monetary policy, and is it apparently beginning to become entrenched within the target range. In the past two months, the inflation rate has been in the target range and most of its components have been positive. It was noted that for almost a year, there has been an upward trend in the CPI excluding energy, fruit and vegetables, and price reductions initiated by the government, and that for the first time in quite some time the rate of inflation in prices of tradable goods has been positive, affected by the increase in energy prices and by the depreciation of the shekel. One-year inflation expectations are in the lower part of the target, medium-term expectations are becoming entrenched in the target, and longer term expectations are anchored within the target. The Committee members discussed factors that support the entrenchment of inflation within the target range, including the increase in wages, a process that until now has been accompanied by a moderate acceleration of inflation; increased demand; and the relative stability of the shekel against major currencies. The main risk to the continued entrenchment is the possibility of renewed appreciation of the shekel.

The Committee members noted that the global economy is on a positive trend, despite the moderation in the growth rate of world trade, the tightening of financial conditions in developing economies, and the slight slowing of growth in Europe and Japan. These trends were reflected in the forecast published by the IMF: It kept its forecast for the global growth rate unchanged and slightly reduced the forecast for the growth rate in Europe and Japan. The US economy continues to grow, inflation continues to firm up at the target, and the Federal Reserve is expected to increase the federal funds rate another two times in 2018. Monetary policy in Europe and Japan is expected to remain accommodative. The Committee members said that the moderation in world trade is apparently impacted by the change in the structure of China's economy and by concern of the trade war that has been developing recently. They noted that it is not an immediate threat to the Israeli economy but rather a longer term one.

The Committee members noted that the shekel continues to remain relatively stable against major currencies, despite an appreciation of approximately 2 percent in effective exchange rate terms. The shekel appreciation derives mainly from the weakening of the Turkish lira and of emerging market currencies. The Committee assessed that the contraction of the current account surplus will be a force that will moderate the appreciation pressures, but noted that from a historical perspective the shekel remains appreciated, and that renewed appreciation against major currencies, should it occur, is liable to delay the entrenchment of inflation within the target range.

The Committee noted that housing market data indicate that the past year's trend of decline in prices has halted. Investment in residential construction declined in the past five quarters and a decline is apparent in building starts and completions. In contrast, there has been an increase in new mortgage volume and in borrowers' LTV ratios while the mortgage interest rate has remained stable.

As noted, five Committee members were of the opinion that the interest rate should be kept at its current level. Of the five, four Committee members claimed that although it appears that the inflation environment is moving toward entrenchment within the price stability target range, and that there is room to begin preparing the markets for the possibility of a measured increase in the interest rate, nonetheless in order to support the entrenchment the interest rate should be kept at its current level for now. They expressed varying opinions regarding the various parameters of inflation and of inflation expectations for different horizons that will be required in order to change the policy, and emphasized the uncertainty regarding the developments of inflation in the coming months. They agreed that if the interest rate begins to rise before the inflation rate is entrenched within the target range, it is liable to delay the entrenchment of the inflation environment and ultimately to slow the path of increasing the interest rate. Another Committee member claimed that the current interest rate is not in line with the state of the economy, and that it would be proper to increase the interest rate to 0.25 percent; however, as the possibility for such a step has not yet been internalized by the financial markets, he supports keeping the interest rate unchanged in the current decision. Another Committee member claimed that the interest rate should be raised to 0.25 percent. He emphasized that the inflation rate has been on an upward trend for some time, and that its low level does not indicate weakness in demand. As such, the low level of the interest rate is not appropriate for the economic conditions.

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
Sefi Bahar, Economist in the Research Department
Ari Kutai, 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