Bank of Israel

MONETARY POLICY REPORT

January-June 2014

41

August 2014

CONTENTS

Section 55(a) of the Bank of Israel Law, 5770–2010, establishes the publication of this report, which is submitted to the government and the Knesset Finance Committee twice yearly. The report includes a survey of developments in the economy during the period covered by the report, and of the policy required, in the view of the Monetary Committee, to maintain the inflation rate within the range set by the government and to achieve the other objectives of the government's economic policy. A review of financial stability appears in the Financial Stability Report for the surveyed period.

The Monetary Policy Report for the first half of 2014 was prepared by economists in the Research Department, under the guidance of the Bank of Israel Monetary Committee, the forum that decides on monetary policy. This report is based on data referring to the surveyed period and that were available up until July 28, 2014, the date of the decision on the interest rate for August 2014. The report does not discuss the economic effects of Operation Protective Edge.

SUMMARY

- **Monetary and macroprudential policy**: During the first half of 2014, the Monetary Committee reduced the interest rate, for March, by 0.25 percentage points, to 0.75 percent. During this period, the Bank of Israel also continued its foreign currency purchases, which totaled about $4.15 billion, of which about $1.75 billion was part of the program to offset the current account effects due to natural gas production. Despite the risks implicit in a low interest rate environment, the Committee members assessed that no significant financial imbalance is developing. In the view of the members of the Committee, the main financial risk exists in the housing market, and the steps taken by the Supervisor of Banks in recent years have helped to reduce this risk. With respect to the beginning of the second half of 2014, the interest rate was left unchanged for July and was reduced by 0.25 percentage points for August, to 0.5 percent.

- **Inflation and inflation expectations**: The CPI was unchanged during the first half of 2014, and on a seasonally adjusted basis declined by 0.2 percent. During the last 12 months, the CPI increased by only 0.5 percent, which is below the lower bound of the inflation target range (1.0 percent). The low rate of inflation derived primarily from tradable goods, the prices of which were affected by the continuing appreciation of the exchange rate and the low inflation abroad. Expectations of inflation for the coming year, from various sources, were relatively stable during most of the half year surveyed and were below the midpoint of the target range. Toward the end of the period, they moderated and moved toward the lower bound of the target range. The medium-term forward expectations (for two to five years) are at the center of the target range and the longer-term expectations are somewhat above the midpoint.

- **Domestic real economic activity**: Growth during the surveyed period continued to be moderate. During the first quarter of the year, GDP grew by 2.9 percent while business sector product grew by only 1.8 percent (annual terms, seasonally adjusted). The slowdown during this period was reflected in the weakening of the components of domestic demand: consumption and gross capital formation. Exports in fact expanded during the first quarter at a respectable rate—following two years in which the rate of increase slowed—primarily due to the increase in services exports; however, there were indicators of a slowdown in exports during the second quarter. There were mixed indicators in the labor market: unemployment was low and the participation rate was high, but other indicators pointed to weakness, such as the real wage, the number of employee posts in the business sector and the number of job vacancies in the business sector.

- **The global environment**: The slow recovery in growth continued in advanced economies while in developing countries the rates of growth are slowing, though they remain higher. Monetary policy remained highly accommodative worldwide. The US Federal Reserve continued its quantitative easing program but began tapering its scope, and the federal funds rate remained close to zero. The European Central Bank (ECB) reduced its interest rate towards the end of the period, which included lowering the interest rate on excess reserves of the commercial banks to a negative level, and announced its intention to inject liquidity through asset purchases.

- **The exchange rate**: During the surveyed period, the shekel appreciated by 1.9 percent in terms of the nominal effective exchange rate, by 1.5 percent relative to the dollar and by 2.2 percent relative to the euro (the average in June 2014 relative to the average in December 2013). The rate of appreciation of the shekel thus moderated relative to 2013. The real exchange rate was relatively stable during the period and appreciated by 0.2 percent. The relative stability of the exchange rate was partially the result of the foreign exchange purchases by the Bank of Israel.

- **The housing market**: Home prices continued to increase. During the 12 months ending in May, home prices rose by 8.8 percent. Since the end of 2012, they have increased by an annual rate of between 7 and 10 percent. At the same time, there was a significant decline in the number housing transactions during the first half of the year, in part due to the expected implementation of the government's plan to reduce VAT to zero for eligible home buyers and to encourage building at target prices.

- **The financial markets**: Stock market indices rose during the surveyed period at similar rates to those in other advanced economies. There was a decline in the economy's risk level, as measured by the CDS premium on five-year external debt. During the surveyed period, the downward trend continued in real and nominal long-term yields. In the credit market, there was a contraction of credit to the nonfinancial business sector, with a narrowing of corporate bond yield spreads. Total outstanding credit to households, led by housing credit, continued to grow at a rate that was characteristic of the last two years. However, the risk characteristics of new mortgages moderated.

- **Fiscal policy**: The deficit in domestic government activity (excluding net credit) totaled NIS 2.3 billion during the first half of the year and expectations during the surveyed period were that the government would not exceed the deficit ceiling set for 2014 (i.e., 3.0 percent of GDP). The deficit during the first half of the year was lower than the seasonal path consistent with meeting the deficit ceiling. This is because the level of expenditure was lower than the path consistent with full performance of the budget.

- **The forecast**: According to the forecast published by the Research Department at the end of June this year, inflation during the next four quarters is expected to be 1.6 percent, which is in the lower part of the target range, and is expected to be only 0.4 percent for 2014. The low forecast is the result of the following factors: a lack of indicators pointing to inflationary pressure from domestic demand, continued moderation in the rate of increase in the housing component (rent) of the CPI, the effect of the appreciation of the shekel and the low inflation environment worldwide against the background of surplus production capacity. GDP is expected to grow by 2.9 percent in 2014. Accordingly, the Research Department expects that the interest rate will be 0.75 percent in the last quarter of 2014. These forecasts are lower than those that were available to the Monetary Committee during the surveyed period.

The factors considered in monetary policy decisions

The Bank of Israel Law, 5770–2010, defines three objectives of the Bank: to maintain price stability as its central goal—stability which has been defined as an inflation rate within a range of 1–3 percent per year; to support the stability and orderly operation of the financial system; and to support other objectives of the government's economic policy, especially growth, employment, and the reduction of social gaps, provided that they do not negatively impact price stability.

In formulating monetary policy, the Monetary Committee uses a number of tools, chiefly the monthly decision on the appropriate level of short-term interest rates. In addition, the Bank of Israel occasionally intervenes in the foreign exchange market, and the Supervisor of Banks uses macroprudential tools.

There were several factors that influenced the decision making process of the Committee: 1) The inflation environment moderated. The rate of inflation declined during the surveyed period and was located below the lower bound of the target range at the end of the period. Inflation expectations, based on various sources, were relatively stable for most of the period and were below the midpoint of the target range; though toward the end of the period they also moderated. 2) There was weakness in real economic activity. Until April, the rate of growth was moderate though stable and there were signs of recovery, even though there were doubts as to the extent to which recovery could occur without an acceleration in the global growth rate. Starting in May, with the release of the National Accounts data for the first quarter of the year, growth was even more moderate, primarily with regard to domestic demand. 3) Monetary policy remained very accommodative worldwide. The Fed continued its quantitative easing while tapering its scope and the interest rate remained near to zero. The ECB lowered the interest rate toward the end of the surveyed period and reduced the interest rate on excess reserves of the commercial banks to a negative level. It also announced its intention of injecting liquidity through asset purchases. Worldwide, there was slow recovery in growth in advanced economies, while growth slowed in developing economies, although its level was higher than in advanced economies. 4) The exchange rate of the shekel against major currencies was relatively stable during the surveyed period, although its level was low. 5) Home prices continued to increase in parallel with a decline in risk characteristics of new mortgages, which was the result of limitations imposed by the Supervisor of Banks. 6) The forecasts of growth in real economic activity for the remainder of 2014 and for 2015 were stronger than the relatively weak data that became available during the course of the surveyed period.

Taking into consideration all the various developments, the Monetary Committee reduced the interest rate for March by 0.25 percentage points, to 0.75 percent, and kept the interest rate unchanged during each of the other five months of the surveyed period. In parallel to the interest rate decisions, the Bank of Israel continued to purchase foreign exchange through swap transactions, in addition to the purchases within the framework of the program to offset the effect of natural gas production on the exchange rate.

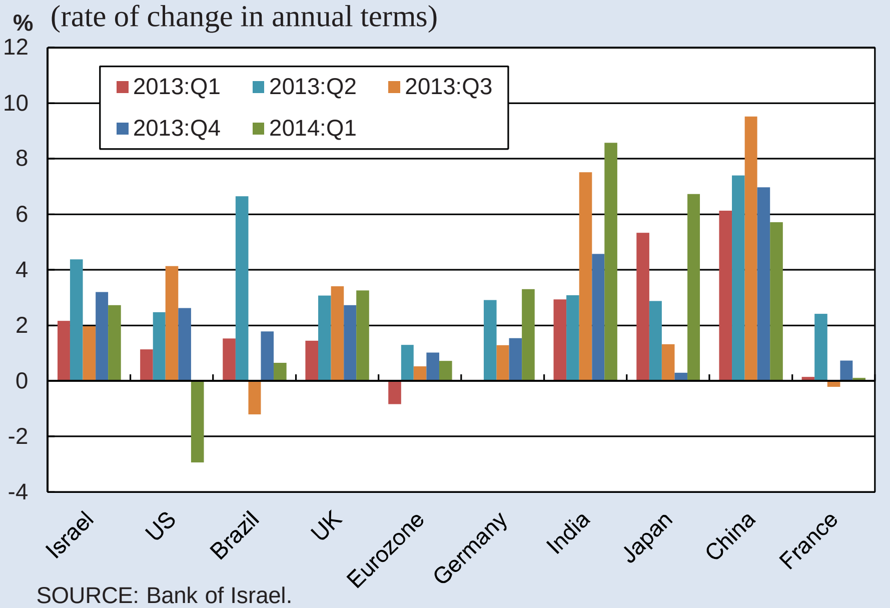
a. The global environment

Developments in the global environment have a major effect on a small and open economy such as Israel's. These developments influence the main variables of the domestic economy, including the level of economic activity, exports, price levels and the financial markets.

1) Real activity, prices and policy[1]

There were signs of recovery for real economic activity in advanced economies, while the rate of growth in developing

Figure 1
Growth rates in selected countries, 2013:Q1–2014:Q1
(rate of change in annual terms)

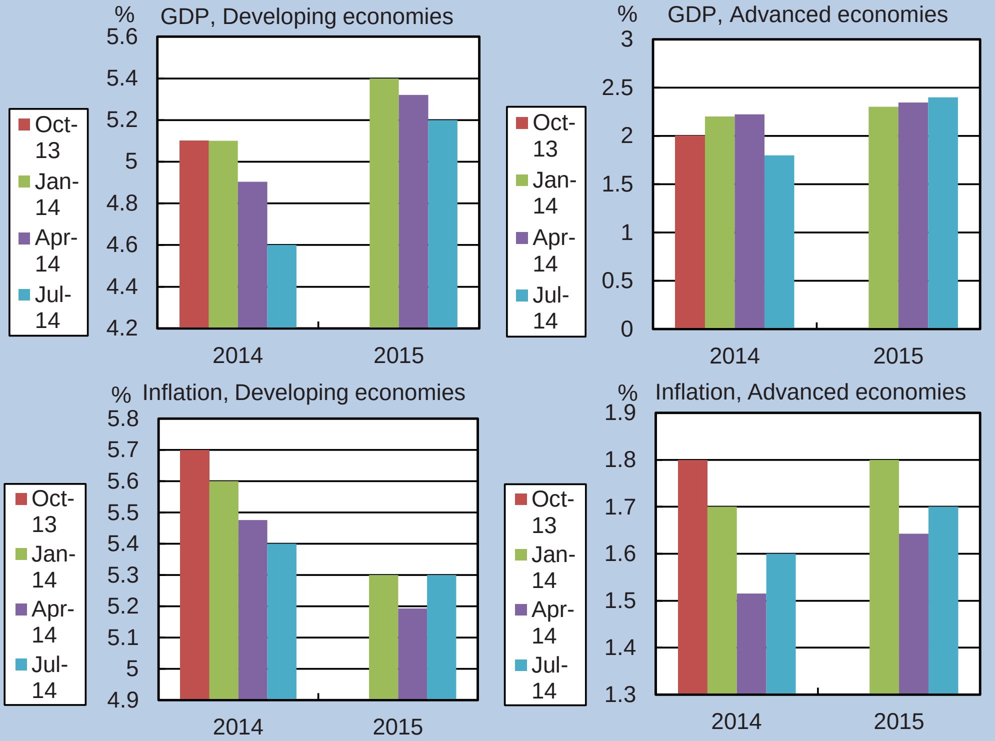


SOURCE: Bank of Israel.

[1] The forecasts in this section are taken from World Economic Outlook Update, July 2014, International Monetary Fund.

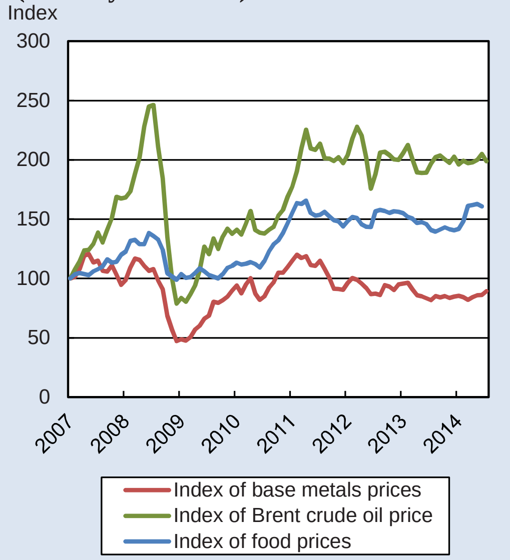
economies weakened. Signs of a recovery could be seen in advanced economies, following low growth rates in 2012 and 2013, which in some cases were even negative. The US economy is leading the advanced economies' recovery, although in the first quarter there was a temporary contraction due to the severe winter and the effect of inventories that had accumulated during 2013. In Europe, growth is still fragile and depends primarily on Germany. The rate of growth in developing economies is higher but is experiencing a downtrend. Growth in developing economies is concentrated in Southeast Asia. Growth rates are relatively low in Brazil, Russia and the developing countries in Europe, ranging from 1.3 to 2.8 percent in 2013. The IMF expects that global growth will continue to be unbalanced, such that growth in advanced economies is expected to rise to 1.8 percent in 2013, in contrast to 1.3 to 1.4 percent during the previous two years, while in emerging economies, growth is expected to be 4.6 percent in 2014, which is slightly lower than the rates observed during the previous two years (4.7 to 5.0 percent). It should be noted that the growth forecast for the developing economies has been in a downtrend during the last year (Figure 2).

Figure 2
IMF forecast of growth rates and inflation for advanced and developing economies, 2014 and 2015



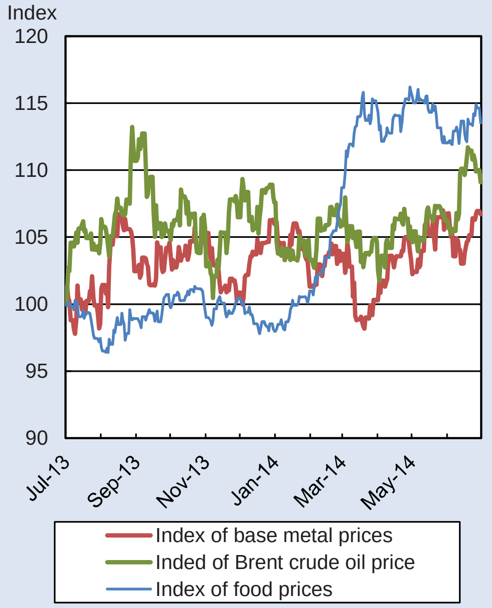
SOURCE: International Monetary Fund.

Figure 3a
Price indices of base metals, crude oil, and food, January 2007 to June 2014 (January 2007=100)



SOURCE: Bloomberg.

Figure 3b
Price indices of base metals, crude oil and food, daily data, July 2013 to June 2014 (July 1, 2013=100)



SOURCE: Bloomberg.

Global growth is providing support for the expansion of world trade. Against the background of the recovery in the advanced countries, world trade volume increased by 3.1 percent during 2013, and the IMF expects this growth to accelerate to 4.0 percent in 2014 and 5.3 percent in 2015. The recovery in the global economy and the expansion of world trade are factors that positively affect Israel's exports and therefore its domestic economy as a whole.

Global inflation is moderate, primarily in advanced economies, and is expected to remain so in 2015. The recovery in the advanced economies is still proceeding at a slow pace and is characterized by a low level of economic activity and surplus productive capacity, and as a result prices are increasing at a slow rate. Accordingly, the IMF's forecast of inflation in 2014 in the advanced economies is in a trend of decline, and was only 1.6 percent in July (Figure 2). Meanwhile, the inflation rate in developing countries is higher. Global energy and metal prices were stable during the surveyed period, apart from a minor increase in energy prices in June. Food prices increased sharply in the first half of the surveyed period, against the background of severe weather conditions in the US and Brazil, and stabilized during the latter part (Figure 3).

Monetary policy remained accommodative worldwide. The monetary policies of the advanced economies remained accommodative, against the background of moderate levels of economic activity and inflation. The Fed continued its quantitative easing but started to taper its scope, while in Europe the pace of monetary expansion accelerated. The ECB declared a negative rate of interest starting from June on excess reserves of the commercial banks and announced its intention of injecting liquidity through asset purchases. In contrast, several countries, most of them developing, raised the interest rate during the surveyed period as a result of the sharp depreciation in their exchange rates (Figure 4).

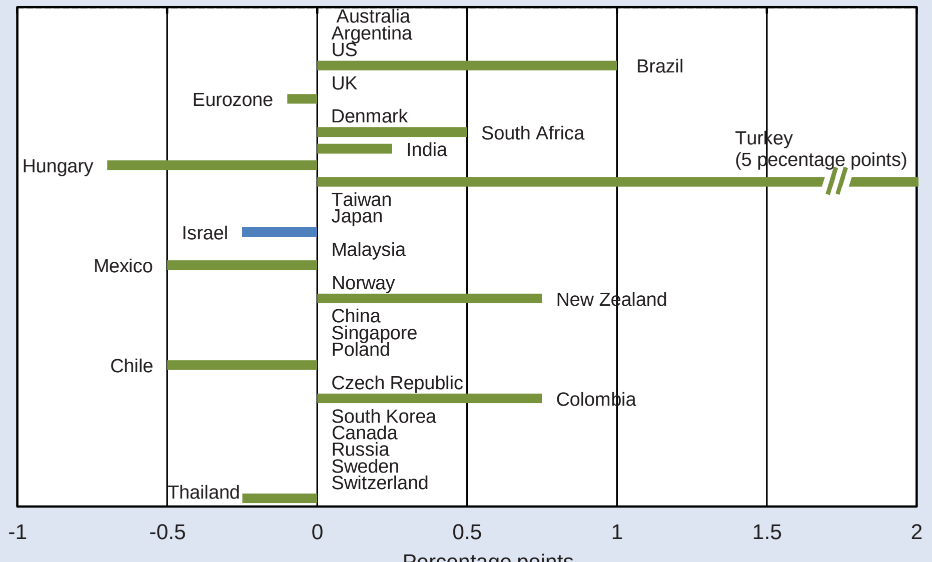
The US

There were signs of improvement in the US economy although economic activity remained below its potential. After relatively good performance in 2013, the US experienced negative growth, of -2.9 percent, in the first quarter of 2014. However, it is assessed that this was the result of temporary factors: the severe winter in North America, the effect of inventories that had accumulated in 2013 and lower than expected demand in the health sector. The positive trend in the labor market continued, with unemployment declining consistently since the end of 2009, to a level of 6.1

percent in June. This is significantly lower than the record 10 percent reached in October 2009; however, it is still high and reflects US labor market weakness. For the sake of comparison, the highest rate of unemployment reached in the previous business cycle was 6.3 percent (in June 2003). Additional evidence of weakness can be found in the long duration of unemployment, the high proportion of part-time jobs, the low participation rate and the moderate rate of growth in wages. The weakness in real activity is reflected in the low rate of core inflation (about 1.5 percent in May), which is below the long-term target of 2 percent. At their meeting in June, members of the Federal Open Market Committee were of the opinion that core inflation would be between 1.5 and 1.6 percent in 2014.

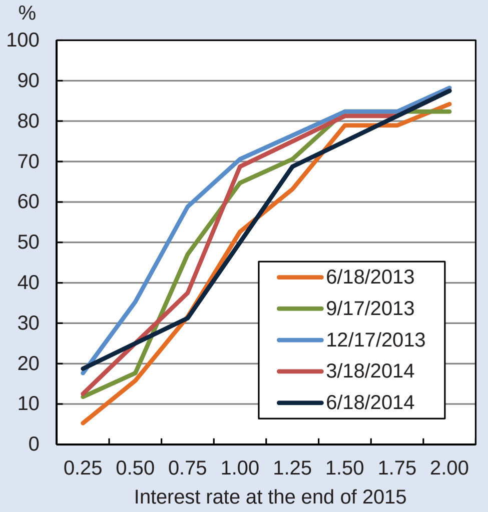
During the first six months of 2014, the Fed reduced its total purchase of assets and the estimated date for the interest rate being raised was brought closer. In February, the Fed began tapering its program of quantitative easing, from $85 billion monthly in January to $35 billion in July. It should be noted that this is a reduction in the intensity of the expansion of monetary conditions since the Fed is continuing to use the funds it receives from maturities for the purchase of new assets and therefore its balance sheet continues to expand. With respect to the interest rate, during the second half of 2013 the members of the Federal Open Market Committee delayed the date on which, in their opinion, the background conditions of the US economy will support an increase in the interest rate. This led to a leftward

Figure 4
Changes in central bank interest rates, January 2014 to July 2014



SOURCE: Bloomberg.

Figure 5
The federal funds rate appropriate for US market conditions at the end of 2015 according to assessments of FOMC members, cumulative distribution June 2013 to June 2014



SOURCE: Based on the US Federal Reserve.

shift of the distribution of their estimates of the optimal interest rate at the end of 2015 (Figure 5). However, this trend reversed itself during the first quarter of 2014. According to the median forecast, the interest rate that conditions of the US economy will support at the end of 2015 stands at 1 percent. With respect to the end of 2014, all the members of the Federal Open Market Committee, apart from one, agreed that the interest rate should remain at its current level.

The Eurozone

The eurozone is slowly recovering. Following a period of six straight quarters—from the end of 2011 until the beginning of 2013—in which GDP contracted, the European economy started to slowly expand and this trend continued during the surveyed period. However, growth was concentrated in Germany while other important economies, such as France and the Netherlands, are still showing weakness. A similar trend could also be observed in the unemployment rate.

The inflation rate in Europe is low (between 0.5 and 1.0 percent) and to the extent that additional monetary expansion is required, it can be assumed that it will involve quantitative easing. The decline in euro-denominated prices of commodities, primarily petroleum and food, contributed about 80 percent of the decline in eurozone inflation since the end of 2011. Part of the decline was a result of lower global prices, primarily those of food, and part was due to the stronger euro. However, one of the reasons for low inflation is the process of price adjustment relative to other countries, as a result of the debt crisis. In the absence of a monetary union, the currencies of those countries in crisis would experience a real depreciation through the adjustment of the nominal exchange rate; however, for countries that belong to the eurozone, the depreciation is manifested in a decline in domestic prices relative to other countries. Since inflation is low in any case, the adjustment of relative prices leads to virtually zero inflation and even to a drop in prices in countries that are experiencing a crisis. Thus, in June core annual inflation stood at 0.2 percent in Portugal, -0.1 percent in Spain and -1.4 percent in Greece. The nominal rigidities lead to a situation in which the adjustment process is of a long duration.

The ECB is preparing for quantitative easing in the eurozone. The ECB interest rate is close to zero and the interest rate on the excess reserves of the commercial banks is even negative (-0.1 percent starting from June 11th). In recent months, the ECB has been signaling that it is considering quantitative easing measures and in June it announced that it is preparing to purchase asset-backed securities. A discussion of the ECB's expansionary measures appears in a text box in this report.

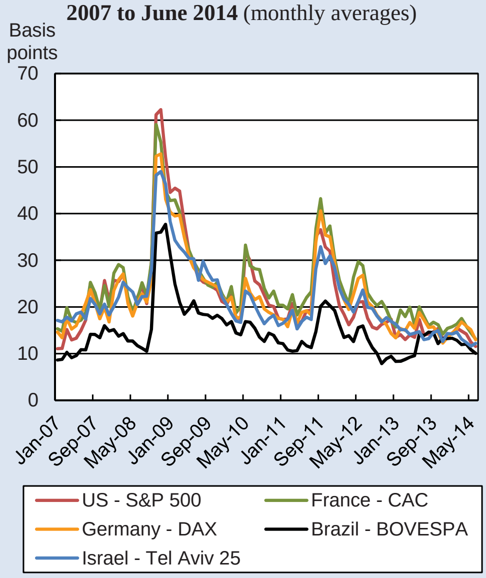
Emerging economies

Growth in the emerging economies was slower than in previous years and growth forecasts were revised downward. As the global financial crisis worsened in 2008, economic activity in the emerging economies was primarily influenced by a drop in demand in advanced economies, which had an adverse effect on their export sectors. During the past year, in contrast, the growth rate has slowed even though advanced economies were recovering, the result of, among other things, structural factors and greater reliance on growth based on domestic demand. It can be assumed that the recovery in the advanced economies will provide support for economic activity in the emerging economies; however, growth forecasts during the past year have been revised downward (Figure 2) and point to relative stability in the rate of growth. Sharp depreciations in several counties led some central banks, including those of India, Turkey and South Africa, to raise their interest rates (Figure 4).

(2) The financial markets

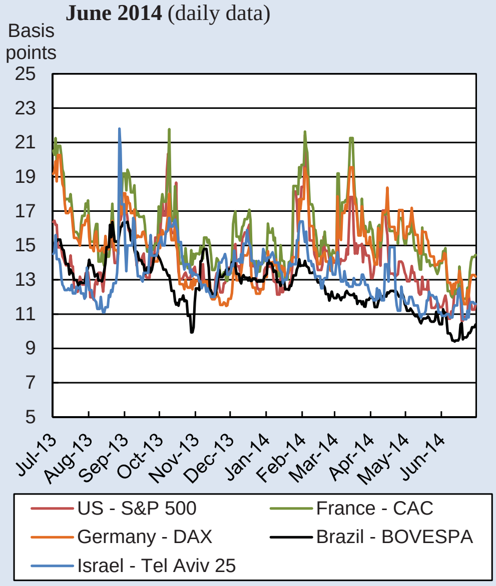
During the first half of 2014, there was a decrease in volatility in the financial markets, share prices rose and yields fell. In general, the surveyed period was characterized by relative calm in the global financial markets, primarily in the developed economies. The volatility in the markets, as measured by the VIX index, continued its downward trend (Figure 6) and CDS spreads narrowed (Figure 7). At the same time, long-term government bond yields continued to decline and stock market indices increased (Figures 8 and 9). The main geopolitical event during the surveyed period was the crisis in Ukraine; however it appears that for now at least its main impact on the financial markets has been localized. Thus, the CDS spreads of Russia and Ukraine widened significantly and there was a sharp depreciation in their exchange rates as the crisis deepened. Meanwhile, there was stability in the CDS spreads of, for example, Germany and France and in the exchange rate of the euro.

Figure 6a
Implied volatility in prices of options on stock market indices (VIX), January 2007 to June 2014 (monthly averages)



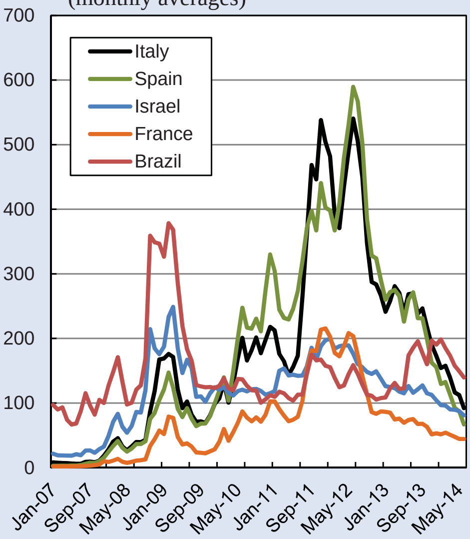
SOURCE: Based on Bloomberg.

Figure 6b
Implied volatility in prices of options on stock market indices (VIX), July 2013 to June 2014 (daily data)



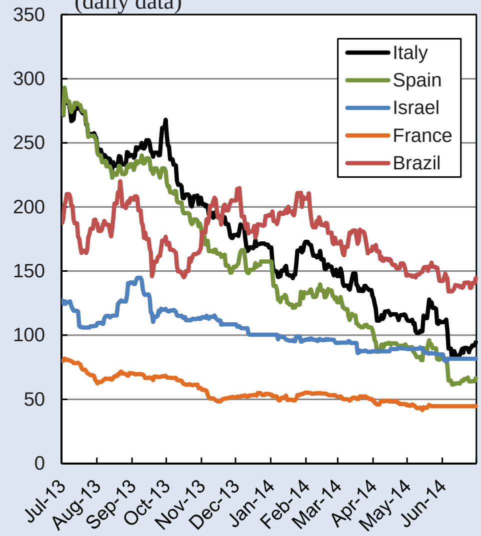
SOURCE: Based on Bloomberg.

Figure 7a
CDS spreads of Israel and selected countries, January 2007 to June 2014
(monthly averages)



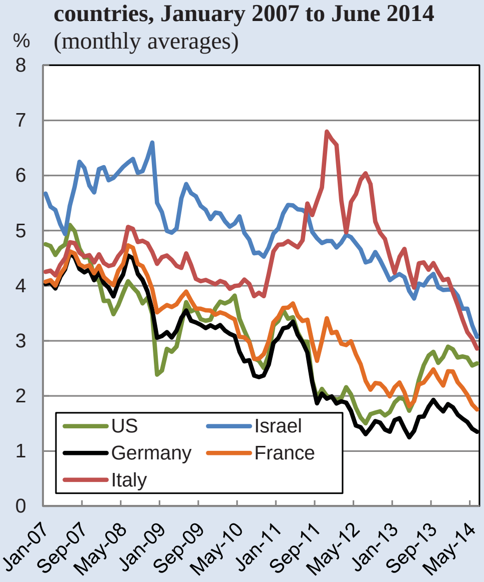
SOURCE: Bloomberg.

Figure 7b
CDS spreads of Israel and selected countries, July 2013 to June 2014
(daily data)



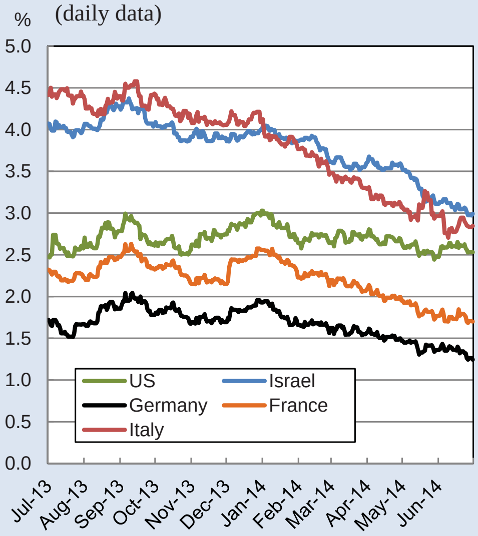
SOURCE: Bloomberg.

Figure 8a
Ten-year yields to maturity on unindexed government bonds, Israel and selected countries, January 2007 to June 2014
(monthly averages)



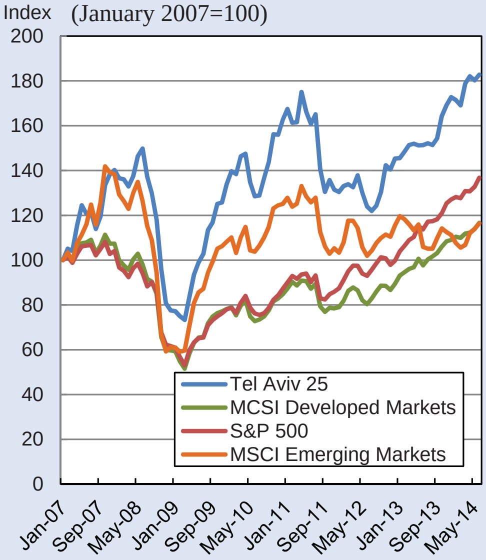
SOURCE: Bloomberg.

Figure 8b
Ten-year yields to maturity on unindexed government bonds, Israel and selected countries, July 2013 to June 2014
(daily data)



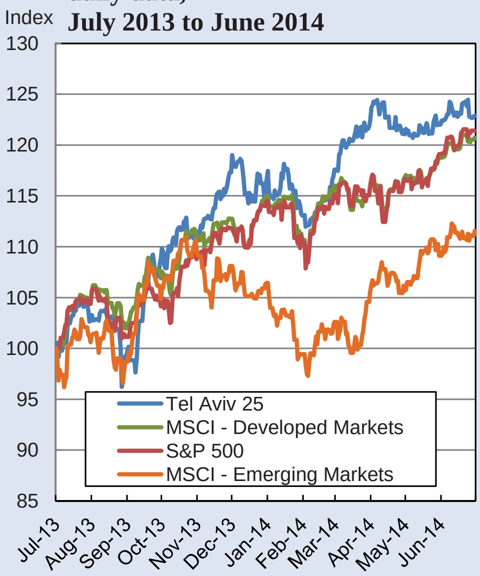
SOURCE: Bloomberg.

Figure 9a
Global share indices (in dollar terms), monthly averages, January 2007 to June 2014
(January 2007=100)



SOURCE: Bloomberg.

Figure 9b
Global share indices (in dollar terms), daily data, July 2013 to June 2014



SOURCE: Bloomberg.

The ECB's Targeted Longer-Term Refinancing Operations

In a near-zero interest rate environment, central banks look for creative ways to stimulate the economy. This will be illustrated in this box by describing a new program declared by the European Central Bank (ECB).

In June 2014, the ECB decided on a package of measures designed to encourage real economic activity and to increase the inflation rate. The first measure included the reduction of the ECB short-term interest rates. The central bank's monetary interest rate (that on the MRO—Main Refinancing Operation) was reduced by 10 basis points, to 0.15 percent. The interest rate at the central bank's lending window was reduced by 35 basis points, to 0.40 percent. The interest rate on the deposits of the commercial banks at the central bank was reduced by 10 basis points, to a negative level of -0.10 percent. The ECB president, Mario Draghi, announced that the short-term interest rates had essentially reached their lower bound.[1]

In addition to this measure, the ECB decided to institute a program for the provision of medium-term credit called Targeted Longer-Term Refinancing Operations (TLTRO).[2] As part of this program, the ECB provides loans to the commercial banks at low interest rates for a term of up to 4 years, in accordance with the amount of credit they will provide to the private sector.[3] From this point of view, the program differs from other monetary policy measures, which are not aimed at any particular sector of the economy.

[1] ECB, Introductory statement to the press conference (with Q&A), Mario Draghi, President of the ECB, Frankfurt am Main, June 5, 2014. Accessed on July 10, 2014 from the following site: http://www.ecb.europa.eu/press/pressconf/2014/html/is140605.en.html

[2] ECB, Press Release, June 5, 2014, "ECB announces monetary policy measures to enhance the functioning of the monetary policy transmission mechanism". Accessed on July 10, 2014 from the following site: http://www.ecb.europa.eu/press/pr/date/2014/html/pr140605_2.en.html.

[3] Here and below, the intention is to credit given to private nonfinancial entities, not including housing loans.

The program is meant to have an effect on both the demand for loans and their supply. On the demand side, the program is designed to lower medium-term interest rates and thus encourage the private sector to consume and invest. On the supply side, the program is meant to encourage banks to provide credit to the private sector, since the banks are reluctant to lend—or they demand a high risk premium—due to the fear of default by private borrowers. As part of the program, the banks will receive cheap credit only on condition that they increase their loans to the private sector.

The program will be implemented in two stages. During the first stage, in September and December 2014, the commercial banks will be able to obtain loans from the central bank for up to 7 percent of their total loans to the private sector. In the second stage, between March 2015 and June 2016, the banks will be able to borrow an additional amount of up to three times the total excess new loans that they provided to the private sector since April 2014. The amount of the excess new loans will be determined by the ECB according to a benchmark that it will calculate for each bank.[4] The redemption date for all the loans will be in September 2018 and the interest on them will be set at 10 basis points above the short-term interest rate (on the MRO) which prevailed at the time the loan was provided. The value of the credit that will be provided in the first stage is about €400 billion.

In order for the program to be effective, the interest rate offered by the ECB must be lower than that prevailing in the market. On the assumption that the interest rate on the MRO does not change in the near future, the interest rate that the banks will have to pay for a 4-year loan is 0.25 percent per year. For the sake of comparison, we can look at the yield on 5-year AAA-rated government bonds which stood at 0.56 percent per year in May 2014.[5] If the banks issue bonds for a similar term, they will have to pay an interest rate that is higher than that paid by a country with an AAA credit rating. Therefore, it can be said that the interest rate that the ECB is offering as part of the program is significantly lower than that prevailing in the market. The program can therefore be viewed as quantitative easing that effectively flattens the interest rate curve in the medium term.

As noted, this program differs from the ECB's previous LTROs in that it attempts to direct the credit received by the banks for the purpose of lending it to a particular segment, i.e., the private sector. Previous LTROs did not manage to achieve an outcome in which the banks increased their credit to the private sector, and instead the banks used the cheap credit they had received in order to improve their balance sheets and to buy government bonds. In the new program, the provision of cheap credit is conditional on the banks increasing the amount of credit they provide to the private market. In order to ensure this, the ECB will add supervisory and reporting mechanisms, the details of which will be announced at a later stage. One of the mechanisms will deal with loans provided in the first stage of the program. If the banks do not increase their loans to the private sector relative to their benchmark, they will have to return the loans they took as part of the TLTRO already in September 2016, two years before the original date for redemption.

[4] An explanation of the manner of calculating the benchmark, correct as of July 2014, can be found in the following publication: ECB, Press Release, July 3, 2014, ECB announces further details of the targeted longer-term refinancing operations. Accessed on July 22, 2014 from the following site: http://www.ecb.europa.eu/press/pr/date/2014/html/pr140703_2.en.html

[5] ECB, Monthly Bulletin, June 2014, p. S45.

The TLTRO program is similar in its characteristics to the Funding for Lending Scheme (FLS) of the Bank of England.[6] About two years after the implementation of that program, the Bank announced that it had succeeded in improving credit conditions for the private sector and had stopped the downward trend in total loans to the sector. However, since the main improvement occurred among households, rather than small and medium-sized businesses, the Bank changed the terms of the program so as to focus on the business sector.[7]

[6] Bank of England, July 12, 2012, News Release, "Bank of England and HM Treasury announce launch of Funding for Lending Scheme". Accessed on July 10, 2014 from the following site: http://www.bankofengland.co.uk/publications/pages/news/2012/067.aspx

[7] Bank of England, June 19, 2014, News Release, "Bank of England and HM Treasury Funding for Lending Scheme—2013 Q4 Usage and Lending data and Initial Allowance data for the Scheme Extension". Accessed on July 10, 2014 from the following site: http://www.bankofengland.co.uk/publications/Pages/news/2014/040.aspx

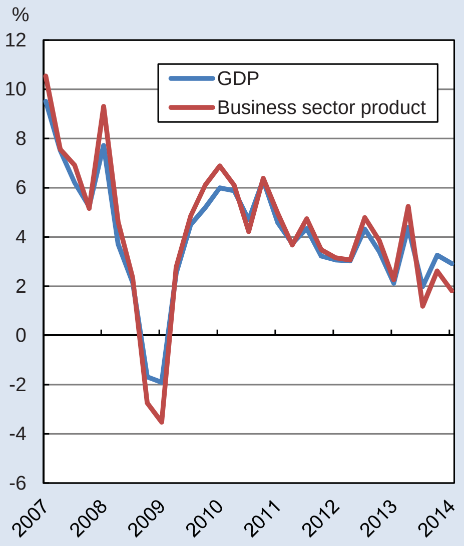
b. Real economic developments

GDP and uses[2]

During the first quarter of the year, moderate growth continued. Since the beginning of 2011, there has been a noticeable slowdown in the rate of GDP growth, and during the second half of 2013 this was particularly true of business sector product (Figure 10). Growth slowed during the past year despite the positive contribution of the production of natural gas from the Tamar reservoir. During the first quarter of the year, GDP grew by 2.9 percent while business sector product grew by only 1.8 percent. The slowdown during this period was reflected in the weakening of the components of domestic demand: private consumption and investment in fixed assets. In contrast, exports expanded at a respectable rate starting from the fourth quarter of 2013, primarily due to the increase in services exports, following two years in which their rate of growth slowed.

There was noticeable weakness in private consumption and indications of its intensity were mixed. National Accounts data for the first quarter of 2014 indicate that total private consumption remained stable relative to the previous quarter, as a result of a small increase in the consumption of durable goods and the lack of change in current consumption. The virtual standstill in current consumption is an uncommon phenomenon and indicates fear of a long-term drop in income. Nonetheless, this degree of weakness in consumption is not consistent with other indicators,

Figure 10
GDP growth rates, 2007:Q1 to 2014:Q1
(seasonally adjusted quarterly data in annual terms)



SOURCE:Central Bureau of Statistics.

[2] The data in this section are expressed in annual seasonally adjusted terms.

some of which also showed weakness in private consumption, though not of that intensity. For example, the import of consumer goods and credit card purchases by private consumers expanded at a respectable rate while measures of consumer confidence and sales of the retail chains were somewhat weak during the first quarter, though not exceptionally so. Early indications for the second quarter of 2014, including retail sales and credit card purchases by private consumers showed a certain degree of weakness in consumption alongside a recovery in the index of consumer confidence and continued expansion of imports of consumption goods.

Fixed capital formation declined. During the first quarter of the year, fixed capital formation declined by about 15 percent. On the other hand, it should be noted that investment in machinery and equipment, which have a direct effect on the economy's productive capacity, grew by a respectable rate of 21.5 percent during the first quarter, which was a continuation of the trend during the second half of 2013. Foreign trade figures for the import of capital goods in the second quarter painted a less optimistic picture, with a decline in the investment in machinery and equipment.

Table 1
GDP, imports and uses
(Seasonally adjusted data, quantitative rates of change compared to previous period, in annual terms)

	2011	2012	2013	2012:Q4	2013:Q1	2013:Q2	2013:Q3	2013:Q4	2014:Q1
GDP	4.6	3.4	3.3	3.4	2.1	4.4	2.0	3.3	2.9
Business sector product	4.7	3.4	3.4	3.9	2.3	5.2	1.2	2.6	1.8
Imports excluding defense imports, ships, aircraft and diamonds	8.9	5.2	-2.9	-13.0	2.3	3.0	7.6	0.4	5.5
Private consumption	3.8	3.2	3.5	3.1	4.7	5.4	3.9	1.7	0.0
of which: Private consumption excluding durables	3.4	3.5	3.5	3.1	2.8	5.8	3.3	2.1	-0.1
Public consumption	2.5	3.2	3.2	9.6	-5.2	9.9	4.7	3.1	1.7
of which: Public consumption excluding defense imports	2.3	2.8	3.1	7.9	-3.2	8.3	2.9	3.6	2.4
Gross domestic investment	15.3	6.3	0.4	5.0	-11.9	1.8	15.0	-12.0	7.9
of which: in fixed assets	15.7	3.5	1.2	-8.8	6.6	5.3	12.3	4.0	-14.7
Exports excluding diamonds	6.2	5.1	0.2	-13.0	13.6	6.5	-31.7	59.4	6.5
of which: Exports excluding diamonds and startups	6.6	4.1	-0.9	-14.0	4.4	-1.1	-20.8	56.8	13.4

SOURCE: Based on Central Bureau of Statistics.

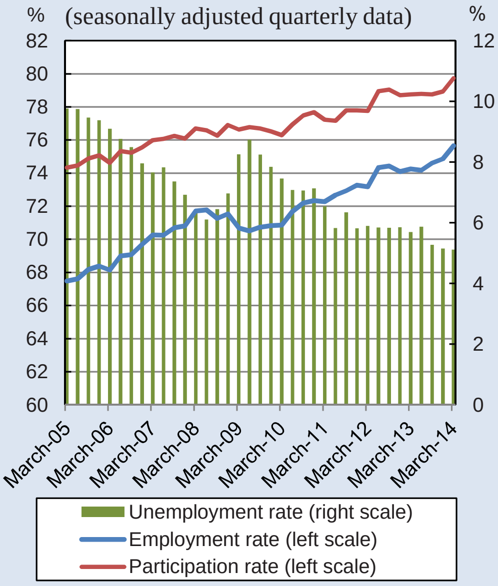
Public consumption slowed. Public investment excluding defense imports rose during the first quarter by 2.4 percent, which means that its rate of expansion moderated relative to the second half of 2013. This is primarily the result of a drop in defense acquisitions in the domestic market.

Exports rose significantly during the first quarter of the year but there were signs of a slowdown during the second quarter. During the first quarter of the year, expansion in services exports continued. This trend continued despite the appreciation and even though world trade has been stagnant for the last three years. The expansion of services exports reflects the relative advantage of Israel in computer and R&D services. Goods exports, in contrast, are more vulnerable and continued to show weakness and large fluctuations. According to the National Accounts figures, total exports (excluding diamonds) rose by 6.5 percent in the first quarter, continuing their upward trend of 2013. In contrast, indicators for the second quarter show a slowdown in exports and perhaps even a decline.

The labor market

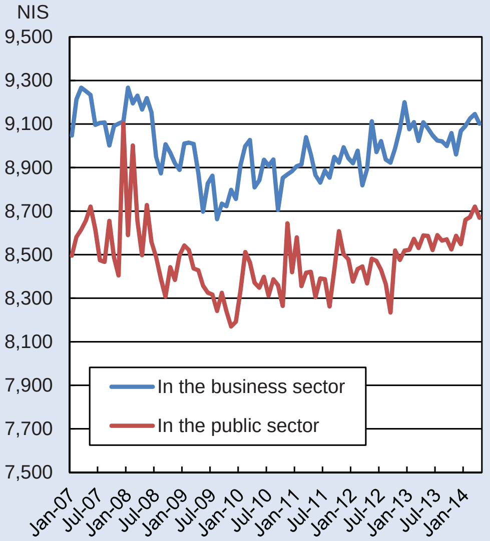
The indicators in the labor market were mixed: unemployment is low but other indicators signaled weakness. The unemployment rate remained low, despite the weakness in economic activity, and during the first quarter it reached a low of 5.8 percent. At the same time, employment and participation rates reached record highs of 60.4 and 64.1 percent, respectively (Figure 11) and there has been some downtrend in the proportion of employees in part-time jobs. Thus, the low unemployment rate is not the result of workers leaving the workforce or an increase in part-time employment. These figures are consistent with the long-term developments in the labor market and therefore do not provide clear indications as to the stage of the business cycle. Other indicators are signaling weakness in the labor market. Thus, the seasonally adjusted real wage rose by only 0.1 percent during the first quarter in contrast to 0.8 percent in the corresponding quarter in 2013. The growth in jobs during the last two years has occurred primarily in the public services sector rather than the business sector and during the surveyed period the number of jobs in the business sector shrank somewhat. The number of job vacancies in the business sector, which is an indicator of the demand for labor, has remained unchanged since 2011.

Figure 11
Employment, unemployment and participation rates, ages 25–64, 2005:Q1 to 2014:Q1
(seasonally adjusted quarterly data)



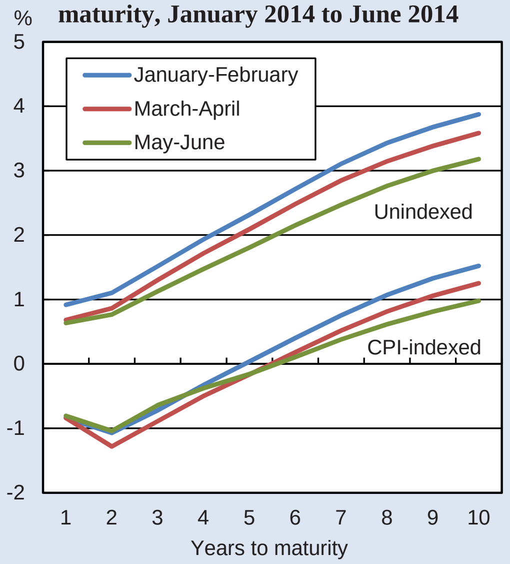
SOURCE: Central Bureau of Statistics Labor Force Survey.

Figure 12
Average real wage per employee post, January 2007 to April 2014
(seasonally adjusted monthly data, in 2013 prices)



SOURCE: Central Bureau of Statistics.

Figure 13
Yield curves of CPI-indexed and unindexed government bonds, bimonthly averages, by term to maturity, January 2014 to June 2014



SOURCE: Bank of Israel.

c. Financial developments[3]

Prices and yields

Stock market indices increased during the surveyed period, similar to the increases in advanced economies (Figure 9). However, the trend was not uniform during the period and the price increases were recorded during the months of March and April.

Government bond yields declined, apart from real short-term yields, and the real yield curve flattened. During the surveyed period, the trend of decline in long-term nominal and real yields continued. This trend is consistent with the developments in yields worldwide during the first half of the year, which occurred despite the gradual reduction of quantitative easing in the US during this period. It should be mentioned that the expectation that tapering would begin during the second half of 2013 led to an increase in yields both in Israel and worldwide. In Israel, however, this had a more moderate effect (Figure 8). The trend of real short-term yields was not uniform during the surveyed period. At first, yields declined, but starting in April they rose as a result of reduced expectations of inflation. However, they are still at negative levels (about -0.8 percent in June, on average). The real yield curve became flatter during the first half of the year.

During the surveyed period, the estimated level of risk in the markets declined. The economy's level of risk, as measured by the CDS premium on five-year external debt, fell continuously during the first half of the year, which was a continuation of its trend from 2012. The CDS premium stood at about 80 basis points on average, its lowest since the beginning of the crisis (Figure 7). The short-term risk in the stock market, as measured by the VIX index, showed a similar trend and is at a historically low level (Figure 6).

The credit market

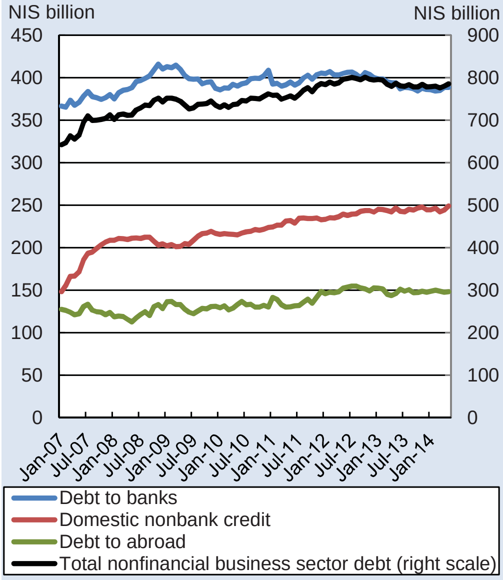
Total credit to the nonfinancial sector has shrunk during the last two years and yield spreads on corporate bonds have narrowed. Since 2008, there has been relative stability in total credit provided by the banking system to the business sector and the growth in credit has been primarily due to nonbank domestic loans (Figure 14). However, from the end of 2012 onward, there has been no growth in total nonbank credit, and bank credit has

[3] Further discussion appears in the Financial Stability Report, Bank of Israel, June 2014.

shrunk somewhat, and as a result total credit has contracted. This reflects the slowdown in real economic activity. In parallel, the average yield spreads on corporate bonds continued to decline for all ratings (Figure 15). This trend is an indication that the contraction in credit is primarily due to the drop in demand for loans, which in turn is the result of the weakness in economic activity. At the same time, it is possible that the low level of spreads is also evidence of the underpricing of risk in the market.

Total credit to households continued to increase during the first half of the year at a rate similar to that during the previous two years. This was led by housing credit, although the risk characteristics of new mortgages have moderated. When home prices began to increase at the end of 2007, the growth rate in housing credit began to accelerate. This component accounts for about 70 percent of credit to households and since 2010 it has grown faster than nonhousing credit. In view of the rapid expansion in housing credit and its implicit risk, the Supervisor of Banks has issued several directives in recent years that are meant to reduce the risk to financial stability from this type of credit. Starting from 2011, the rate of growth in housing credit slowed and during the last two years it has been relatively stable. Meanwhile, new mortgages have been characterized by less risk (Figure 16). It should be mentioned that although total credit has grown in recent years, the ratio of household debt to household income has remained stable (Figure 17) and is low in absolute terms relative to the advanced economies.

Figure 14
Credit to the nonfinancial business sector, January 2007 to May 2014 (monthly data)



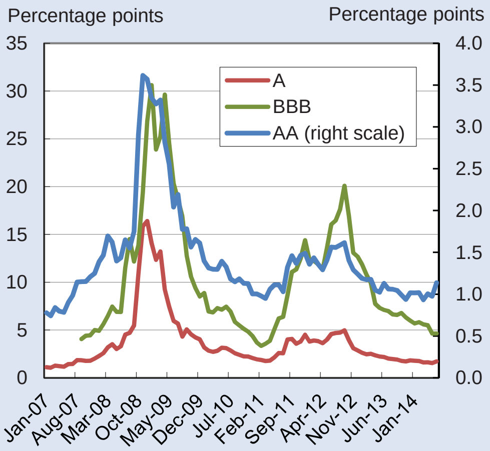
SOURCE: Bank of Israel.

d. Fiscal policy

During the first half of the year, the deficit path was consistent with the deficit target for 2014. The government's domestic deficit (excluding net credit) was NIS 2.3 billion during the first half of the year, which was smaller by about NIS 4.5 billion than the deficit under the seasonal path consistent with meeting the deficit ceiling for 2014, i.e., 3 percent of GDP. The fact that the deficit is below its path reflects the situation of the expenditure path, which is below the level consistent with full budget performance. Thus, the government's domestic expenditure from the start of the year was lower by about NIS 5.5 billion than the level of expenditure consistent with the seasonal path. Total tax revenues were similar to the seasonal path and other income was lower by about NIS 1 billion.

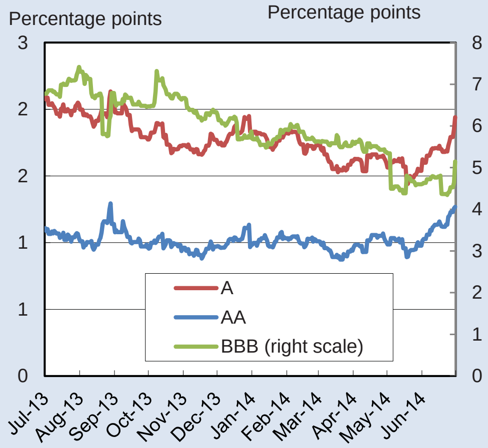
During the surveyed period, the Bank of Israel estimated that in order to meet the deficit target in 2015, contractionary policy measures will be required. As of the end of July 2014, the deficit ceiling for 2015 is 2.5 percent of GDP. During the

Figure 15a
The yield spread[a] between CPI-indexed corporate bonds and CPI-indexed government bonds, excluding structured and convertible bonds, by rating,
January 2007 to June 2014 (monthly average)



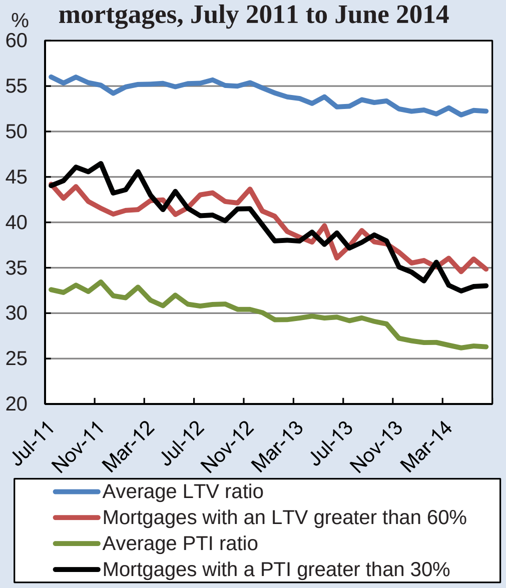
[a] Weighted average.
SOURCE: Based on Tel Aviv Stock Exchange.

Figure 15b
The yield spread[a] between CPI-indexed corporate bonds and CPI-indexed government bonds, excluding structured and convertible bonds, by rating, July 2013 to June 2014
(daily data)



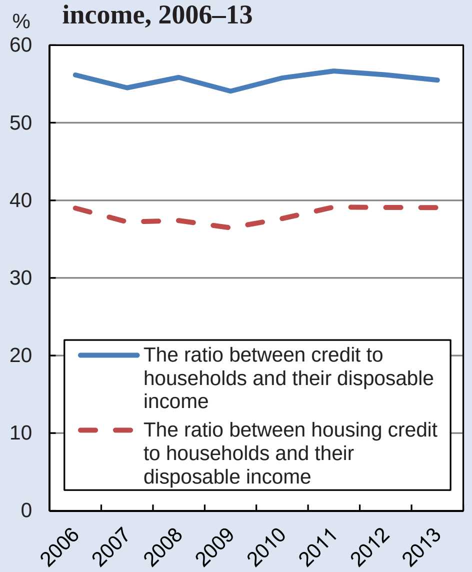
[a] Weighted average.
SOURCE: Based on Tel Aviv Stock Exchange.

Figure 16
Risk characteristics of new mortgages, July 2011 to June 2014



SOURCE: Bank of Israel.

Figure 17
The ratio between credit to households and their disposable income, 2006–13



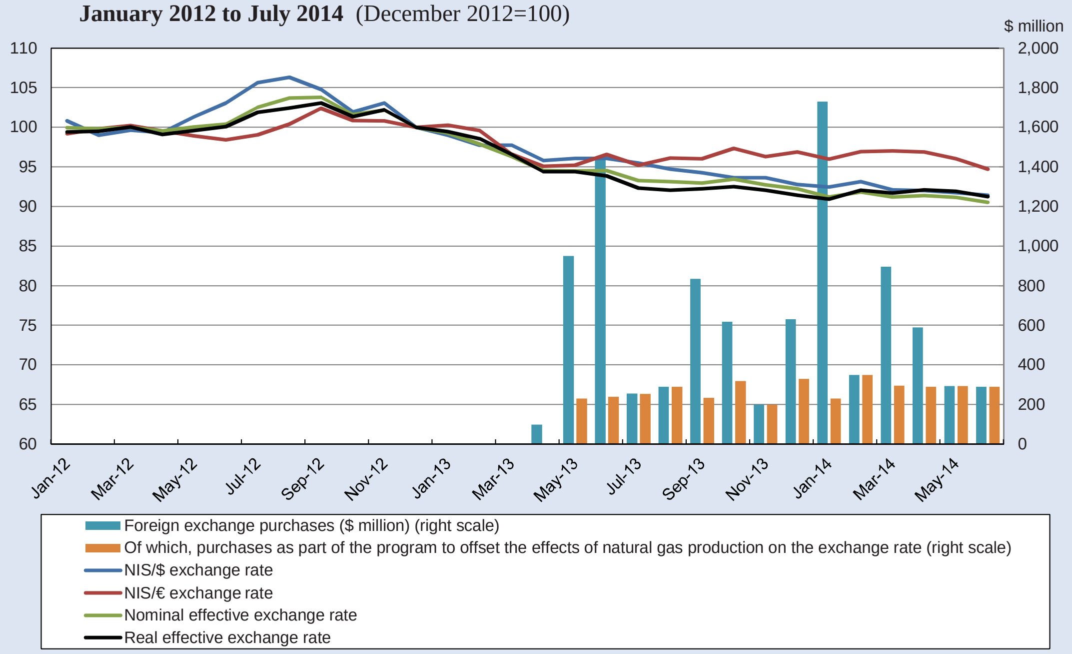
SOURCE: Based on Central Bureau of Statistics.

surveyed period, estimates by the Research Department of the Bank of Israel indicated that in order to be under the ceiling, steps will have to be taken in order to increase revenues, i.e., raising tax rates or cancellation of exemptions and expansion of the tax base, and/or steps to reduce expenditure to below the expenditure ceiling.[4] In addition, the government will have to cut back some of the expenditure programs it has approved in order to avoid exceeding the expenditure ceiling determined by the fiscal rule.

e. The exchange rate

Appreciation pressure continued during the surveyed period and the Bank of Israel purchased foreign exchange in order to moderate the fluctuations in the exchange rate. For the first half of 2014 overall, the real exchange rate remained stable while there was a slight appreciation of the nominal exchange rate. The shekel appreciated by 1.9 percent in terms of the nominal effective exchange rate during the surveyed period. It appreciated by 1.5 percent against the dollar and by 2.2 percent against the euro (the average for June 2014 relative to the average for December 2013). These rates are evidence that the rate of appreciation of the shekel moderated relative to the trend since the end of 2012 (Figure 18). The real exchange rate was relatively stable during the period and overall it appreciated by 0.2 percent.

Figure 18
Foreign exchange purchases by the Bank of Israel and selected exchange rates, January 2012 to July 2014 (December 2012=100)



SOURCE: Bank of Israel.

4 An in-depth discussion of the 2015 budget and trends until the end of the decade appear in Recent Economic Developments, no. 137, October 2013 to March 2014.

During the surveyed period, the Bank of Israel continued to purchase foreign currency. Part of the purchases was meant to offset the effect of natural gas production on the current account[5] and part was meant to moderate the sharp fluctuations in the shekel's exchange rate. During the surveyed period, in February, May, and June purchases were conducted only according to the offset plan. During the other months, particularly in January, there were pressures for an appreciation that led to the purchase of additional foreign currency (Figure 18). It should be mentioned that the pressure for an appreciation that appeared in January occurred against the background of a drop in long-term yields in the US, which occurred despite the fact that the Fed began reducing the scope of quantitative easing. Nonetheless, the shekel is one of the only currencies that strengthened against the dollar during this period. The main factor behind the strengthening of the shekel was the fundamental and persistent surplus in the balance of payments, i.e., the surpluses in the current account and the continuation of foreign direct investment. An additional factor is the hedging activity against currency risk that originates in the foreign currency asset portfolio held by institutional investors, although this is not a long-term fundamental factor.

Figure 19a
Cumulative rates of change in CPI components, the past 12 months

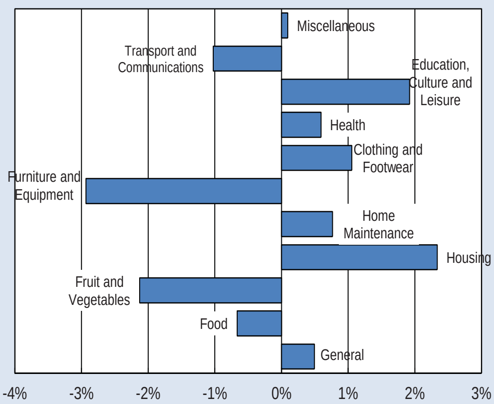
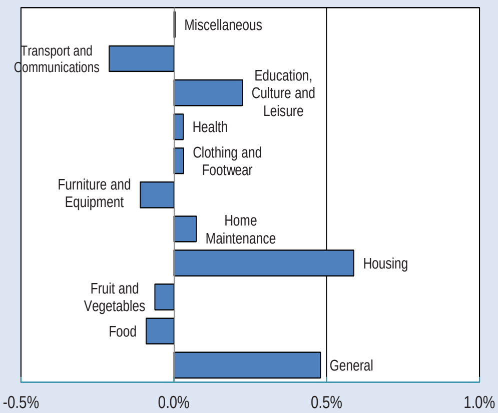


Figure 19b
Contribution of CPI components to changes in the CPI, the past 12 months



SOURCE: Based on Central Bureau of Statistics.

f. Inflation

The inflation rate declined during this period, led by the prices of tradable goods,[6] against the background of the appreciation in the exchange rate and the low level of inflation abroad. The CPI remained unchanged during the first half of 2014 and on a seasonally adjusted basis declined by 0.2 percent. During the preceding 12 months, the CPI increased by only 0.5 percent, which is below the lower bound of the inflation target range (i.e., 1.0 percent). The decline in the rate of increase in the CPI during the last six months encompassed both tradable and nontradable goods. The low rate of CPI inflation is the result of tradable goods, against the background of the appreciation in the exchange rate and the low level of inflation abroad, particularly in the advanced economies. Essentially, during the past four years, the rate of increase in the prices of tradable goods has

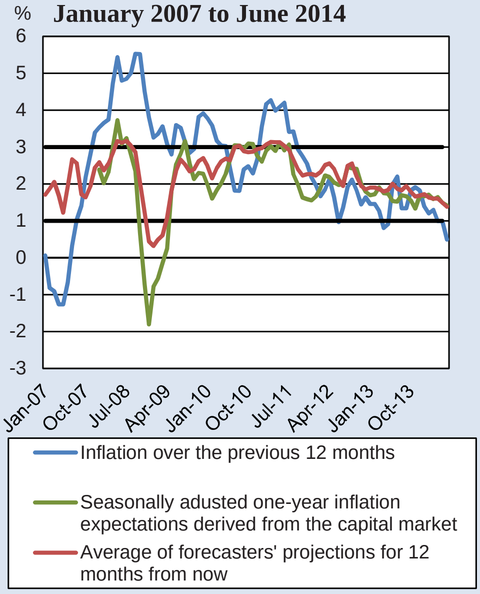
[5] In October 2013, the Bank of Israel announced its intention to purchase $3.5 billion during 2015 as part of the plan to offset the effect of natural gas production on the exchange rate.

[6] The breakdown of the CPI according to tradable and nontradable components is based on Ben Basset, A. (1989) "Price indexes of tradable and nontradable goods", Bank of Israel, Research Department, Discussion Paper 89.11 (Hebrew). An alternative calculation of the two components yields similar results; see Orfaig, D. "Transmission mechanisms from the exchange rate to the CPI: Perspective on the tradable component of the CPI", forthcoming.

been lower than that of nontradable goods and this is the result of the long-term real appreciation the economy is undergoing. During the 12 months ending in June 2014, the prices of tradable goods in the CPI declined by 1.2 percent, while the prices of nontradable goods increased by 1.4 percent. It should be noted that the housing component of the CPI (i.e., rent) constitutes the dominant component of the nontradables index; however, even when this component is omitted a similar picture is obtained, since the prices of nontradable goods excluding housing rose by 0.8 percent during the past 12 months.

The decline in the rate of increase in the CPI was accompanied by a decrease in 1-year inflation expectations, which are within the target range but have moved toward its lower bound. Long-term expectations are in the center of the target range. During the surveyed period, inflation expectations derived from various sources were characterized by a downward trend, and by the end of the period they were located somewhat above the lower bound of the inflation target range (Figure 20). On average, the expectations of inflation in the capital market for the next 12 months were 1.4 percent in June (net of seasonal effects on the CPI); expectations derived from the bank interest rates were 1.1 percent and private forecasters' projections were 1.4 percent. It should be noted that apart from the decrease in June, the annual rate of increase in the CPI has fluctuated within the lower part of the target range (1 to 2 percent) during the past two years (Figure 20). However, until mid-2013, expectations of inflation from the various sources were located in the upper part of the inflation target range, while during the surveyed period they approached the lower bound. These developments, in addition to the more moderate actual rate of increase in prices, reflect a decline in the inflation environment. Nonetheless, forward expectations for the medium term (two to five years) are anchored in the vicinity of the center of the target range and longer-term expectations are somewhat above it at 2.5 percent.

Figure 20
Inflation and forecasts,
January 2007 to June 2014

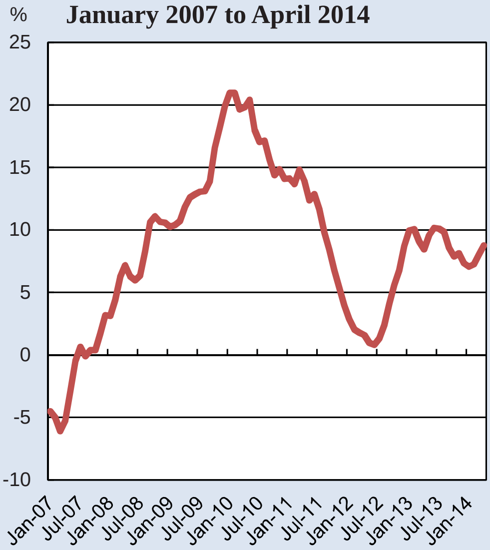


SOURCE: Based on Central Bureau of Statistics.

g. The housing market

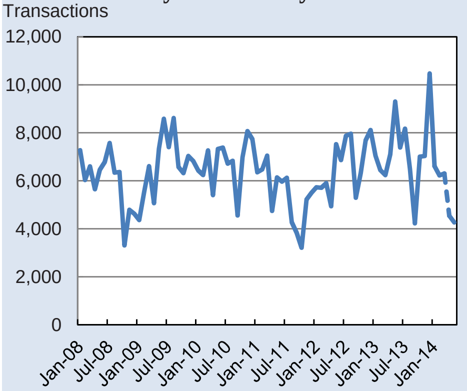
Home prices continue to increase at a rapid rate, despite a decline in the number of transactions. At the same time, the rate of increase in rents has moderated. Since the end of 2012, home prices have increased at an annual rate of 7 to 10 percent (Figure 21). The annual rate of increase until April-May this year (the most recent months for which figures are available) stands at 8.8 percent. At the same time, there has been a significant drop in the number of housing transactions during the first half of the

Figure 21
Rate of increase in home prices in the past 12 months,
January 2007 to April 2014



SOURCE: Based on Central Bureau of Statistics.

Figure 22
Number of home transactions[a], January 2008 to May 2014



[a] The number of transactions for homes of 1.5–5 rooms, according to the real estate price register. Including only transactions made on the market between seller and buyer, excluding gifts, inheritances and so forth. Due to the partialness of the reporting, data for the last four months (dotted line) are inflated in line with historical reporting rates.

SOURCE: Bank of Israel.

year, after reaching a record level at the end of the previous year (Figure 22). The number of housing transactions is a result of the meeting of supply and demand and therefore there is no way of determining the source of the change, i.e., whether it is shocks to demand or shocks to supply, without further information. Nonetheless, there is a not-insignificant positive correlation between the number of transactions and changes in home prices and therefore it can be concluded that the change in the number of transactions is usually evidence of changes on the demand side. Therefore, it can be assumed that the recent drop in the number of transactions is due to a drop in demand. In parallel to these developments, the rate of increase in rents according to new contracts has slowed during the last two years and during the 12 months ending in June it stood at 2.5 percent.

It is reasonable to assume that the plans to reduce VAT to zero for eligible home buyers and to encourage construction at a maximum target price are contributing to the reduced demand for housing in the short term but that they will increase demand in the future. In March of this year, the government announced for the first time that it is formulating a plan to reduce VAT to zero on the purchase of a first apartment for eligible families, and during the second half of 2013 a plan became known to encourage home construction at a maximum target price for homes—that is, a maximum price for homes in specific areas. The announcement of the plans, and in particular that of zero VAT, created an incentive for potentially eligible buyers to delay their purchase of a home and it can be assumed that part of the drop in the number of transactions observed starting in March is the result. However, it should be noted that the drop in the number of transactions started already in January. The postponement of purchases reduces short-term demand and therefore can be expected to weaken the forces working to increase prices; however, it is reasonable to assume that when the plan goes into effect, the pent-up demand will be released and demand will increase.

MONETARY POLICY

Policy and targets

During the first half of 2014, the Monetary Committee reduced the interest rate by 0.25 percentage points and the purchase of foreign currency continued. During the first half of 2014, the Committee reduced the interest rate, for March, by 0.25 percentage points, to 0.75 percent. This represented a continuation of the downward trend in the interest rate, which began in October 2011, and which is intended to maintain the rate of inflation within the target range and to support economic activity. Several factors influenced the interest rate decisions during the surveyed period and most of them supported the reduction of the interest rate. These included: the inflation environment, real economic activity and appreciation pressure. The global environment supported leaving the interest rate at its low level and the housing market provided support for a higher interest rate environment, although the reduced risk characteristics of new mortgages (as a result of the steps taken by the Supervisor of Banks) provide interest rate policy with some room to maneuver. In addition, the economy's performance during the surveyed period was characterized by a higher than usual degree of uncertainty and this was reflected in the contradictory indicators and significant revisions of past data, which made it difficult to determine an appropriate interest rate policy in real time. At the same time, the purchase of foreign exchange continued during the surveyed period; although part of the purchases were intended to offset the influence of natural gas production on the current account, most of it was intended to moderate the sharp fluctuations in the exchange rate during the surveyed period.

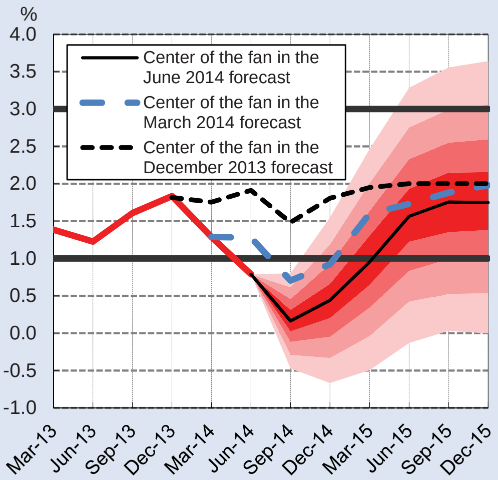
With respect to the second half of 2014, the interest rate for July was left unchanged while for August it was reduced by 0.25 percentage points, to 0.5 percent. The decision to reduce the interest rate for August was based on the low level of inflation, continued appreciation of the shekel, and the continuing weakness in real activity, both in Israel and abroad.[7]

Despite the risks inherent in a low interest rate environment, Committee members assessed that from a financial point of view, there is no major imbalance developing. One of the main risks to financial stability in a low interest rate environment involves the stimulation of demand for credit and a fear that borrowers will not be able to repay debt when interest rates rise again. In the view of the members of the Committee, the main financial risk originates from the housing market, and steps taken by the Supervisor of Banks in recent years are keeping that risk low. The effectiveness of these measures can be seen in the reduced risk characteristics of mortgages. On the other hand, the demand for business credit has not expanded and in general there is no observable financial imbalance in this area.[8]

[7] An analysis of policy for July and August will appear in the Monetary Policy Report for the second half of 2014.

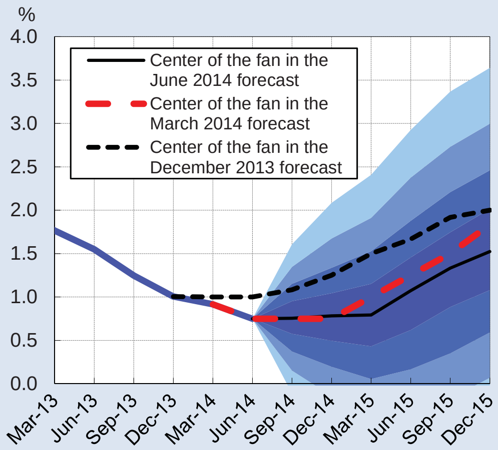
[8] A survey of financial stability appears in the Financial Stability Report of the Bank of Israel, June 2014 (Hebrew).

Figure 23
Actual inflation, and fan chart of expected inflation in the past four quarters, Research Department Staff Forecast from June 2014[a]



[a] The full fan chart covers 66 percent of the distribution of inflation expectations. Each shade represents 8.25 percent.
SOURCE: Bank of Israel.

Figure 24
The actual Bank of Israel interest rate and fan chart of expected interest rate, Research Department Staff Forecast from June 2014[a]



[a] The full fan chart covers 66 percent of the distribution of the expected interest rate. Each shade represents 8.25 percent.
SOURCE: Bank of Israel.

Background conditions and their influence on interest rate policy

The inflation rate has declined toward the lower bound of the inflation target range and this provided support for lowering the interest rate. Inflation during the preceding 12 months has been on a downward trend, from 1.8 percent in December 2013 to 1.0 percent in May. In June, it had already dropped to 0.5 percent, which is below the lower bound of the inflation target range. Inflation expectations and the forecasts from the various sources have been below the midpoint of the target range during the first four months of the year, but they have remained relatively stable. Toward the end of the first half of the year, expectations fell to below the lower bound of the target range, against the background of the April index, among other things. The change in the CPI for April (an increace of only 0.1 percent) surprised to the downside, compared with the average of forecasts at 0.6 percent, even though in April there is a positive seasonal effect on prices. This inflation rate is the lowest for April during the past decade. These developments are evidence that inflation has declined to the vicinity of the lower bound of the target range and therefore provided support for reducing the interest rate.

At the beginning of the surveyed period, the indicators of real economic activity signaled that the economy is continuing to grow at a moderate rate and that there is the possibility of recovery, although a later revision of the figures painted a less optimistic picture. Until the interest rate decision for May, the indicators of real economic activity pointed to a moderate though stable rate of growth and signs of a moderate recovery;

Table 2
Forecasts of inflation and the interest rate for the coming year[a]
(percent)

	Bank of Israel Research Department[b]	Capital market[c]	Private forecasters[d]
Inflation (range of forecasts)	1.6	1.4	1.3 (1.00-1.50)
Interest rate (range of forecasts)	1.00	0.7	0.9 (0.50-1.25)

[a] The Research Department staff forecasts refer to data 4 quarters ahead. Other projections refer to data 12 months ahead..
[b] Forecast from June 24, 2014.
[c] Expectations of seasonally adjusted inflation. Interest rate forecasts are based on
[d] Projections received after the July publication..
SOURCE: Bank of Israel.

in addition, National Accounts data for the fourth quarter were revised upward. Similarly, the updated forecasts of the Research Department, from December 2013 and from March 2014 projected that the economy would continue to grow at about 3 percent in 2014 and 2015. However, the discussions of the Committee raised doubts as to the ability of the economy to continue improving without an acceleration of global growth. At the same time, there were mixed indicators in the labor market. Thus, the Labor Force Survey showed that the unemployment rate for the main working ages had fallen to 4.9 percent, with an increase in the employment and participation rates. On the other hand, there was weakness in the real wage and in the number of vacancies in the business sector. Furthermore, the main growth in the number of salaried positions was concentrated in the public services while the business sector was essentially unchanged. Overall, this situation did not provide support for reducing the interest rate. Nonetheless, National Accounts data for the first quarter of the year, which were released prior to the decision on the interest rate for June, were surprisingly weak. The main surprise was the 0.4 percent growth rate in the business sector and the decline in current private consumption at a rate of -1.6 percent. In addition, there was a downward revision of growth for the last quarter of 2013. These figures were not consistent with the earlier indicators, i.e., consumer goods imports, trade and service industries revenue, industrial production and consumer confidence indices, which painted a more optimistic picture. Although the National Accounts figures for the first quarter were, as expected, revised upward prior to the discussions of the interest rate for July, there was doubt as to the signs of recovery that appeared at the beginning of the surveyed period and an assessment that real economic activity did not justify reducing the interest rate.

The surveyed period was characterized by a higher than normal degree of uncertainty with regard to the economy's performance. Monetary policy always operates under conditions of uncertainty—not just with respect to future economic developments but also present and past ones—due to the partial and temporary nature of the data. However, it appears that the surveyed period was characterized by a greater than usual degree of uncertainty, which was reflected in the contradictory indicators and the major revisions of previous data, primarily those applying to the first quarter of the year (Table 3).

The exchange rate was relatively stable although the cumulative appreciation since 2013 affected exports and raised concern about further appreciation. This supported a measured reduction of the interest rate and the continuation of foreign

Table 3
National Accounts - data available at the time of decisions on the interest rate

Decision on rate for:		January	February	March	April	May	June	July
GDP	2013:Q3	2.2	2	2.1	1.8	1.8	1.9	2
	2013:Q4			2.3	2.7	3.2	2.9	3.2
	2014:Q1						2.1	2.7
Business sector product	2013:Q3	2.1	1.7	1.6	1.3	1.3	1	1.2
	2013:Q4			1.6	2.1	2.7	2.1	2.5
	2014:Q1						0.4	1.5
Current private consumption	2013:Q3	4.2	4.2	3.7	4	3.7	3.2	3.3
	2013:Q4			3.6	3.6	3.4	1.5	2
	2014:Q1						-1.6	-0.4
Fixed capital formation	2013:Q3	16.9	18.4	16.8	14	13.5	12.3	12.3
	2013:Q4			4.5	9	8.8	4.1	4.1
	2014:Q1						-14.4	-14.3
Exports excluding diamonds and startups	2013:Q3	-22.6	-19.9	-21.6	-22.5	-22.6	-22.2	-21.0
	2013:Q4			61	52.1	61.9	61	56.6
	2014:Q1						-4.4	11
Civilian imports excluding ships and planes	2013:Q3	11.4	11.4	10.2	7.5	7.1	7.5	7.7
	2013:Q4			3.3	1.6	0.3	-0.4	0.4
	2014:Q1						2.6	5.7

SOURCE: Based on Central Bureau of Statistics.

currency purchases by the Bank of Israel. There was a slight appreciation of the nominal exchange rate in the first half of 2014, though it was in parallel with the reduction in the domestic interest rate by the Bank of Israel and its continued purchases of foreign currency. During the surveyed period, the Bank of Israel purchased about $4.15 billion, of which about $1.75 billion was part of the program to offset the effect of natural gas production on the current account. Within the surveyed period, foreign currency was purchased as part of the offset plan in February, May and June. In the rest of the months, and in particular January, there was appreciation pressure which led to additional purchases. It should be mentioned that in January, there was a minor appreciation of the shekel against the dollar even though the dollar had strengthened worldwide and it is reasonable to assume that in the absence of the foreign exchange purchases, the extent of the appreciation would have been much greater. At the same time, services exports continued to expand and the weakness in exports focused on the low technology industries, in which Israel has no clear comparative advantage. The relative stability of the exchange rate against the background of the continued purchases of foreign currency—together with the mixed picture of exports, according to the breakdown by industry—supported a small reduction in the interest rate.

The situation of the global economy provided support for a low domestic interest rate but did not call for an additional reduction. During the surveyed period, there were signs of a recovery in the advanced economies, led by the US, although following the decision for the interest rate in June the National Accounts figures for the US were revised downward. Europe advanced from negative to positive, though moderate, growth, primarily due to the German economy. Emerging economies had stronger performances but their rates of growth slowed and projections of global growth forecast an improvement in economic activity, even though they were later revised downward. Monetary policy in the US gradually retreated from the quantitative easing program, while the interest rate in Europe was maintained at 0.25 percent until May and then reduced somewhat to 0.15 percent in June, with an interest rate of -0.1 percent on surplus reserves of the commercial banks. The reduction of the interest rate in Europe occurred after the markets had expected quantitative easing. The low level of interest rates worldwide provided support for a low interest rate in Israel; however, considering the relative stability in the interest rate gap and the signs of recovery in the advanced economies, the global environment did not call for an additional reduction of the domestic interest rate.

Home prices continued to increase and to constitute a major consideration against reducing the interest rate; however, the reduction in the risk characteristics of new mortgages, as a result of the measures introduced by the Supervisor of Banks, provides monetary policy with some room to maneuver and strengthens the stability of the banking system. Home prices continued to rise and the rate of increase has ranged between 7 and 10 percent for over a year. During the 12 months ending in April, housing prices increased by 8.8 percent. Building completions continued to increase but building starts moderated, although they are still at an elevated level. Members of the Committee noted that the discussion by the government of policy measures in the housing market is expected to result in a temporary drop in demand. New mortgage volume stabilized at an elevated level, while their risk levels were reduced as a result of the various directives issued by the Supervisor of Banks in recent years. In particular, there has been a drop in loan to value ratios and the payment to income ratio. The increase in home prices does not provide support for maintaining a low interest rate; however, the steps taken by the Supervisor of Banks have reduced the risk to households and to the banking system of default on housing loans. This provides the interest rate policy with greater room to maneuver in achieving its other goals, i.e., an inflation rate that is consistent with the inflation target and the support of economic activity.

Economic conditions at the background of the decisions on the interest rate—first half of 2014

Decisions for month:	January	February	March
Date of decision	Dec. 23, 2013	Jan. 27, 2014	Feb. 24, 2014
Decision	No change	No change	-0.25 percentage point
Interest rate	1 percent	1 percent	0.75 percent
Voting distribution	Unanimous	Unanimous	Reduce by 25 basis points: 4 No change: 1
Inflation environment	Within target range, slightly below midpoint.	Within target range, slightly below midpoint.	Decline in actual inflation to 1.4% over preceding 12 months. Jan. CPI surprised to downside, inflation expectations revised downward. Relative stability in inflation expectations from capital market.
Real economic activity	Growth rate stable and signs of recovery are seen. Strong labor market data derived mainly from public services industries.	Growth rate remains moderate and stable. C'tee members noted that despite low unemployment rate, other data—including real wages, virtual standstill in number of employee posts in business sector and vacancies in business sector—indicate labor market weakness,	National Accounts data for 4th quarter of 2013 indicate moderate growth rate, mainly in business sector. Labor market weakness continues, despite low unemployment rate.
Exchange rate	Slight appreciation of shekel. C'tee members assessed that it is too early to tell how tapering in the US will affect exchange rate.	Moderation in rate of appreciation, *inter alia* due to interest rate reduction and forex purchases, but there are still appreciation pressures.	Depreciation in shekel exchange rate against most major currencies, while $ and € weakened. C'tee members said that the cumulative appreciation still acts as a moderating factor on the tradable sector, and the slow world trade growth highlights how important the exchange rate is to exports.
Housing market	In Sept.-Oct., the home price index declined by 0.1% and previous index readings were revised downward, though the annual growth rate is high, 8.6%. C'tee members noted that the moderation in the rate of price increases, the stabilization of mortgage volume and the increase in supply serve as positive indicators, though there are risks and it is too early to conclude that there has been a turnaround.	Stability in the annual rate of price increases, at 8%. C'tee members noted that the housing market state is a factor against reducing the interest rate. The rate of home price increases and mortgage volume remain high, but stability can be seen in them and there is continued improvement in risk characteristics of new mortgages.	Sharp 1.5% increase in home prices in Nov.-Dec., and stability in annual rate of increase, at 8.1%. Sharp rise in number of housing purchases in December. The state of the housing market was a central claim against reducing the interest rate, and in C'ttee discussions concern was raised over the long term impact that a low interest rate can have on demand for homes.
Global environment	Recovery in advanced economies, primarily US. Fed began tapering quantitative easing.	Appears that advanced economies recovery continues, led by US. Global growth forecast revised upward, world trade projections revised downward. Despite improvement in US economy and Fed tapering, assessments were that the fed funds rate will remain low for an extended time. Assessment for Europe was that further monetary easing needed. C'tee noted that these developments will likely impact future interest rate decisions in Israel.	US recovery process continues, while growth in Europe is fragile and not uniform. C'tee members felt that the recovery process is expected to be slow and developing market interest rates will be low for a lengthy time.
Research Dept. staff forecast	2014 GDP: 3.3% 2014 Inflation: 1.8% 2015 GDP: 3.2% 2015 Inflation: 2.0%		

Economic conditions at the background of the decisions on the interest rate—first half of 2014

April	May	June	July
Mar. 24, 2014	Apr.28, 2014	May 26, 2014	June 23, 2013
No change	No change	No change	No change
0.75 percent	0.75 percent	0.75 percent	0.75 percent
Unanimous	No change: 5 Increase by 25 basis points: 1	Unanimous	No change: 5 Reduce by 25 basis points: 1
Further decline in inflation, to 1.2%. Moderate decline in inflation expectations. C'tee noted the recent decline in inflation derives mainly from tradable goods prices.	Actual inflation at 1.3%. Inflation expectations continue decline. With that, C'tee noted that prices of nontradable products increased by 2.6% over the past 12 months, and net of housing rose 2.2%, near target midpoint.	Further decline in inflation, to 1.0%. April CPI surprised to the downside. C'tee members felt that most CPI components being low supported the assessment that it reflects a decline in the level of inflation. Forecasts and expectations at 1.3–1.5%.	Actual inflation at 1.0%.Slight increase in inflation expectations. C'tee members agreed that the moderation in inflation derives *inter alia* from weakness in global economy and shekel appreciation, and most felt that it also derives from domestic demand weakness, particularly private consumption.
Indications of stable growth at moderate rate continue. Estimate of business sector product growth for 4th quarter of 2013 revised upward. Also, a trend of recovery in high tech exports is apparent.	Upward revision of growth rate estimate continues, and there was a slight recovery in activity, but doubts arose about the extent to which improvement in economy could become entrenched without accelerated global growth. It was noted that the low unemployment rate derives *inter alia* from long term structural processes so that it is difficult to assess, based on that, how close the economy is to full employment.	National Accounts data for 1st quarter are low, and data for 4th quarter of 2013 were revised downward. It was noted that the weak data, especially contraction of current consumption, are not consistent with most current indicators for the 1st quarter.	National Accounts data for 1st quarter revised upward, but still signal domestic demand weakness, especially private consumption. C'tee members noted that National Accounts data are in line with monthly indicators, which also point to moderate growth in the 1st quarter. As for 2nd quarter, most indicators do not signal further moderation.
Appreciation of 1% in nominal effective exchange rate terms since previous interest rate decision. However after C'tee reduced interest rate in previous month it felt there was no room for additional change. It was also noted that Fed actions are expected to reduce the effective yield gap with the US and thus ease appreciation pressure on the shekel.	Slight shekel appreciation. The C'tee claimed that the low level of the interest rate contributes to moderation in appreciation trend.	Slight shekel depreciation. It was noted that since the beginning of the year the shekel has been relatively stable, while over the course of 2013 there was a large appreciation.	Appreciation of 1.4% in terms of nominal effective exchange rate since previous interest rate decision. It was noted that the yield spread between Israel and advanced economies is tiny, and the appreciation does not derive from short term capital flows. C'tee members said that the appreciation was related to a current account surplus, to the large volume of direct investment in the economy, and hedging by institutional investors of investments abroad, and the fact that the macroeconomic situation is stable relative to other advanced economies.
Increase of 0.1% in home price index in Dec.-Jan.; downward revision of previous index readings; increase of 6.3% over past 12 months. C'tee members assessed that the government's discussion on housing market policy steps will lead to a decline in activity in coming months. C'tee also referred to possible fiscal effects of those steps.	Continued price increases, annual rate is 6.4%. Number of transactions declines in Feb. Rate of building starts declines, though their level remains relatively high. It was noted that at this stage it is hard to assess, based on the data, what the effect of government steps will be when implemented.	Continued price increases, annual rate is 7.1%. Despite the decision to reduce VAT to 0% for eligible buyers, no slowdown seen in rate of mortgages taken out. Rate of building starts declines, even though their level remains high, and increase in building completions continues. Continued improvement in risk characteristics of new mortgages.	Continued price increases, annual rate is 8.3%, rate of mortgages taken out remains high, though decline is apparent in number of transactions. Agreed that data only partially reflect the waiting for government steps in housing market to go into effect. Risk characteristics of new mortgages stabilized at lower level than in the past.
Downward revision of US 4th quarter growth, monthly data mixed, as weather was harsh. Nonetheless, assessment was that US recovery continues and Fed will continue to reduce quantitative easing. ECB revised Europe growth forecast upward, but deflation concern remains.	Advanced economies continue to recover, led by US. IMF reduced global growth forecast slightly, due to moderation in developing market growth. Weak US activity in beginning of year ascribed to severe weather then. US fed funds rate expected to be raised in 2nd half of 2015, subject to continued recovery. Moderate recovery seen in Europe, inflation declined to 0.5%. Further monetary easing in Europe expected.	Assessments of slowing global growth in 2014 and 2015 strengthened. US and Europe 1st quarter data disappointed. European growth depends mainly on Germany. Fed continues tapering, as expected. ECB announces readiness to take further accommodative action.	World Bank reduced its 2014 global growth and world trade forecasts. US 1st quarter growth data revised downward. ECB took accommodative monetary steps and US continued tapering of quantitative easing.
2014 GDP: 3.1% 2014 Inflation: 0.9% 2015 GDP: 3.0% 2015 Inflation: 2.0%			2014 GDP: 2.9% 2014 Inflation: 0.4% 2015 GDP: 3.0% 2015 Inflation: 1.8%

Appendix

Appendix Table 1

The domestic assets markets

(rates of change)

	January 2014	February 2014	March 2014	April 2014	May 2014	June 2014
Yields to maturity (monthly average, percent)						
3-month *makam*	1.0	0.9	0.7	0.7	0.7	0.7
1-year *makam*	0.9	0.9	0.7	0.7	0.6	0.6
Unindexed 5-year notes	2.4	2.3	2.1	2.1	1.9	1.8
Unindexed 20-year bonds	5.2	5.1	4.8	4.8	4.5	4.2
CPI-indexed 1-year notes	-0.8	-0.9	-1.0	-0.7	-0.8	-0.8
CPI-indexed 5-year notes	0.1	0.0	-0.2	-0.1	-0.2	-0.1
CPI-indexed 10-year bonds	1.6	1.5	1.3	1.3	1.1	0.9
Yield spread between government bonds and private bonds rated AA-AAA[a] (percentage points)	1.0	1.0	0.9	1.0	1.0	1.1
Yield spread between government bonds and unrated private bonds excluding real estate[a] (percentage points)	3.8	3.7	4.2	4.3	4.0	4.1
Stock market (percentage change during the month)						
General share price index	1.1	4.9	2.8	-2.4	0.6	0.3
Tel Aviv 25 Index	-2.2	3.9	3.8	-1.7	1.1	-0.4
Foreign currency market (percentage change during the month)						
NIS/$	0.8	-0.1	-0.3	-0.6	0.3	-1.1
NIS/€	-0.9	1.3	0.3	-0.2	-1.5	-0.7
Nominal effective exchange rate	-0.7	0.6	0.1	-0.2	-0.2	-0.8
Risk measures derived from the trade in NIS/$ options on the Tel Aviv Stock Exchange (monthly averages, percent)						
Implied volatility	8.6	8.5	8.2	8.3	7.6	7.5
Probability of depreciation greater than 5%	2.0	2.0	1.8	1.3	1.2	1.3
Probability of appreciation greater than 5%	0.7	0.7	0.6	0.4	0.9	1.3

[a] The calculation changed for CPI-indexed bonds, excluding convertible bonds, with a yield of up to 60 percent and a duration of beyond 6 months. The spreads between each series of corproate bonds and the “Galil” with the equivalent duration.

SOURCE: Bank of Israel.

Appendix Table 2
The inflation environment and interest rates

(monthly averages)

	January 2014	February 2014	March 2014	April 2014	May 2014	June 2014
Inflation environment (percent)						
Monthly change in CPI	-0.6	-0.2	0.3	0.1	0.1	0.3
Forecasters' opredictions of monthly CPI (average of forecasts prior to publication of CPI)	-0.2	-0.2	0.2	0.6	0.2	0.2
12-month change in CPI	1.4	1.2	1.3	1.0	1.0	0.5
One-year inflation expectations derived from the capital market	1.7	1.8	1.7	1.4	1.4	1.5
Forecasters' one-year inflation predictions	1.7	1.6	1.6	1.6	1.5	1.4
Inflation expectations for various terms[a]						
Short term (second and third years forward)	2.4	2.4	2.4	2.3	1.9	1.6
Medium term (fourth to sixth years forward	2.3	2.4	2.3	2.4	2.3	2.3
Long term (seventh to tenth years forward)	2.3	2.2	2.2	2.2	2.2	2.4
Interest rates and interest rate differentials						
Bank of Israel interest rate	1.00	1.00	0.75	0.75	0.75	0.75
Derived real interest rate	-0.76	-0.9	-1.0	-0.7	-0.8	-0.8
Short-term interest rate differential between Israel and the US	0.75	0.75	0.50	0.50	0.50	0.50
Short-term interest rate differential between Israel and the eurozone	0.75	0.75	0.50	0.50	0.50	0.59
Forecasters' predictions of change in the Bank of Israel interest rate for next month (average forecst, prior to the decision)	-0.1	-0.1	-0.1	0.0	0.0	-0.1
Forecasters' predictions of the interest rate a year hence	1.1	1.1	0.9	0.9	0.9	0.8
Long-term (10-year) nominal interest rate differential between Israel and the US	1.1	1.1	0.9	0.9	0.7	0.5
Long-term (10-year) real interest rate differential between Israel and the US	1.0	0.9	0.7	0.7	0.7	0.5

[a] Inflation expectations are measured by the difference between yields on local currency unindexed and indexed bonds. These expectations include an element of risk premium, which rises with the length of the term to which the expectations relate.
SOURCE: Based on Central Bureau of Statistics data and private forecasters' reports.

APPENDIX: MINUTES OF THE INTEREST RATE DISCUSSIONS

Following is a summary of the discussions held by the Monetary Committee and the considerations taken into account in their decisions during the first half of 2014.

THE INTEREST RATE DECISION FOR JANUARY 2014

Main points of discussion

The 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 January 2014, it was decided to leave the interest rate unchanged at 1 percent. The decision was unanimous.

The discussion focused on the following main issues: (1) inflation; (2) the level of economic activity; (3) the global economy; (4) the housing market; and, (5) the exchange rate.

Actual inflation over the past 12 months, and inflation expectations for the next year provided from various sources, are within and slightly below the center of the target range. The Committee members noted that the greater than expected decline in the Consumer Price Index for November followed a surprise to the upside in the previous month, and that the inflation environment remains within the target range, and the level of the interest rate is consistent with it.

The Committee members discussed data on economic activity, and particularly foreign trade data. They noted that recent data indicate a certain acceleration in growth and in exports. In the labor market, there was prominent growth in employment in recent months, stemming from an increase in employee posts in the public sector, while there is a standstill in the business sector. Therefore, in order to maintain a high level of employment, an increase in the number of positions in the business sector will be necessary, mainly in view of the expectation that there will be only a moderate increase in public consumption in 2014. In this context, the Committee members noted that budget performance in 2013 and planning for 2014 are consistent with maintaining fiscal targets.

The Committee's discussion on global developments focused on the announcement by the Federal Reserve that it would begin tapering of quantitative easing. The Committee members agreed that this step signals the entrenchment of improvement in the American economy. In addition, the Committee members noted the Fed's declaration of its continuing commitment to a low federal funds rate for a considerable period of time. The apparent improvement in the state of the American economy and upward revisions in global trade projections by foreign financial institutions are expected to support the continued recovery of exports. The picture in the eurozone remains mixed. The likelihood that the economy will begin a sustainable recovery in the near future seems low, but it seems that as of now, the risk of a further crisis has lessened.

The Committee members discussed the housing market data, and agreed that the moderation in the rate of home price increases in recent months, in the new mortgages granted and in the number of transactions, as well as the supply of new homes, which continues to expand as reflected in data on building starts and completions, are all positive indications. The Committee members said that even so, the risks in the housing market still exist, and it is still early to discern a turnaround in the trend from the new data. In addition, the Committee members noted that the increase in the average interest rate on new mortgages (despite the concurrent decline in the Bank of Israel interest rate) and the decline in the risk level of new mortgages issued are evidence of the effectiveness of the macroprudential policy adopted by the Banking Supervision Department.

The Committee members also discussed developments in the effective exchange rate, and agreed that it is still early to estimate what the over-all effect of the tapering process will be on the exchange rate of the shekel.

Following the discussion, the five members of the Monetary Committee voted on the Bank of Israel interest rate for January 2014. All of the Committee members supported leaving the interest rate unchanged at 1 percent.

In its announcement of the decision, the Bank emphasized that the decision to leave the interest rate for January unchanged at 1 percent is consistent with the Bank of Israel's monetary policy, which is intended to entrench the inflation rate within the price stability target of 1–3 percent a year over the next twelve months, and to support growth while maintaining financial stability. The path of the interest rate in the future depends on developments in the inflation environment, growth in Israel and in the global economy, the monetary policies of major central banks, and developments in the exchange rate of the shekel.

The inflation environment is within the target range, slightly below its midpoint. The CPI reading for November surprised to the downside, and there was a moderate increase in expectations, from various sources, for inflation over the year ahead, though they all remain slightly below the midpoint of the inflation target.

Data that became available this month indicate that the growth rate of the economy is stable, and there are even signs of some recovery in activity, including exports. Given the forecasts for recovery in the global economy and in global trade, the Research Department forecast indicates a moderate increase in the rate of growth (excluding the effect of natural gas production) next year. The unemployment rate remains low, though conflicting trends in the labor market—an increase in employment in public services and a decline in business sector employment—continue.

- After depreciating in the days before the previous monetary discussion, the shekel has strengthened since then by 1.1 percent against the nominal effective exchange rate. From a longer term perspective, after marked appreciation in the first half of the year, there has not been a trend of change in the effective exchange rate in recent months.
- The Federal Reserve announced the beginning of the process of tapering its quantitative easing, and at the same time reiterated its commitment to a low federal funds rate for a considerable period, which resulted in a moderate effect on bond yields. Against the background of low inflation and a slow recovery, monetary policy in major economies remained highly accommodative.
- Recent data from the housing market indicate a moderation in the rate of price increases, in the number of transactions, and in mortgages granted, alongside a decline in risk characteristics of mortgages and indications of increased supply. With that, a change in trend in the housing market cannot yet be indicated.

The Bank of Israel will continue to monitor developments in the Israeli and global economies and in financial markets, particularly in view of the continuing 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 published on December 23, 2013.

Participants in the narrow-forum discussion:

Members of the Monetary Committee

Dr. Karnit Flug, Governor of the Bank and Chairperson

Prof. Alex Cukierman

Prof. Reuben Gronau

Prof. Rafi Melnick

Prof. Nathan Sussman, Director of the Research Department

Other participants in the narrow-forum discussion:

Mr. Andrew Abir, Director of the Market Operations Department

Mr. Eddy Azoulay, Chief of Staff to the Governor

Mr. Itamar Caspi, Economist in the Research Department

Ms. Esti Schwartz, Secretary of the Monetary Committee

Mr. Yoav Soffer, Acting Spokesperson of the Bank of Israel

THE INTEREST RATE DECISION FOR FEBRUARY 2014

Main points of discussion

The 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 February 2014, it was decided to leave the interest rate unchanged at 1 percent. The decision was unanimous.

The discussion focused on the following main issues: (1) inflation; (2) the level of economic activity and the labor market; (3) the global economy and global monetary policy; (4) the exchange rate; and (5) the housing market.

Actual inflation over the past 12 months, and inflation expectations for the next year provided from various sources, are within and slightly below the midpoint of the target range. Therefore, the inflation environment does not require a change in policy.

The Committee members discussed the state of economic activity, and particularly the question of how this is reflected in labor market data. They noted that the growth rate, and particularly the per capita growth rate, is moderate. The Committee members remarked that despite the fact that the data indicate a low unemployment rate, other data indicate weakness in the labor market—the moderate rate of increase in real wages, the standstill in the number of employee posts in the business sector, the decline in the rate of job vacancies in the business sector, and the moderation in the growth rate of health tax receipts. In addition, some of the Committee members argued that, without recovery of demand abroad, it will be hard for the economy to grow at a more rapid pace.

In the Committee's estimation, the transmission from monetary policy to economic activity during this period is operating mainly through the exchange rate and its effect on foreign trade and alternatives to imports, and to a lesser extent through the real interest rate—and through it on investments, other than in the construction industry.

The recovery in the other advanced economies, mainly the US, is continuing. This development is consistent with the fact that the World Bank and the International Monetary Fund made upward revisions to the global growth forecast for the next two years. In contrast, their projections for world trade growth, and particularly the forecast for imports by advanced economies, which is an important channel for the global economy's effect on the domestic economy, were revised downward. The Committee members noted that notwithstanding the improvement in the US economy and the start of the tapering of quantitative easing in the US, assessments are that the Federal Reserve will maintain the federal funds rate at its low level for an extended period, and that the same holds true in the UK. In regard to Europe, the assessment is that further monetary accommodation may be necessary, and the conditions for the beginning of tapering are not yet in place. These developments may have an impact on the Monetary Committee's future decisions.

The Committee members also discussed developments in the effective exchange rate. While the rate of appreciation of the shekel has declined in recent months, inter alia due to the interest rate reductions and the Bank of Israel's direct intervention in the foreign exchange market, there are still appreciation pressures. Since the previous interest rate decision, the dollar strengthened around the world, mainly against emerging market currencies, some of which depreciated sharply. However, the shekel is among the few currencies to have strengthened against the dollar during this period.

In addition to these issues, the Committee members noted the housing market as a consideration against lowering the interest rate. The pace of increases in home prices and the volume of mortgages remain high, even though there is some stability in them and the improvement in the risk characteristics of new mortgages continues.

Following the discussion, the five members of the Monetary Committee voted on the Bank of Israel interest rate for February 2014. All of the Committee members supported leaving the interest rate unchanged at 1 percent.

In its announcement of the decision, the Bank emphasized that the decision to leave the interest rate for February unchanged at 1 percent is consistent with the Bank of Israel's monetary policy, which is intended to entrench the inflation rate within the price stability target of 1–3 percent a year over the next twelve months, and to support growth while maintaining financial stability. The path of the interest rate in the future depends on developments in the inflation environment, growth in Israel and in the global economy, the monetary policies of major central banks, and developments in the exchange rate of the shekel.

The following are the main considerations underlying the decision:

- The inflation rate in 2013 was 1.8 percent. Inflation expectations for one year ahead, from various sources, are all slightly below the midpoint of the inflation target.

- Data which became available this month indicate continued growth of the economy at a moderate rate, with some improvement in the fourth quarter of 2013 compared with the preceding quarter. The picture in the fourth quarter regarding exports is better than it was in the third quarter, but there was some moderation again in December. Over the longer term there has essentially been a standstill in exports, against the background of moderate growth of world trade and the appreciation of the shekel. The unemployment rate continued to decline and is at a low level, though various indicators, such as job vacancies and health tax receipts, indicate some labor market weakness.

- Since the last monetary policy discussion, the shekel appreciated by 1 percent against the dollar, while the dollar strengthened against most major currencies worldwide. In terms of the nominal effective exchange rate, the shekel appreciated by 1.5 percent.
- After two years during which all the revisions to their forecasts were downward, the World Bank and the IMF this month revised their global growth projections upward. With that, the revision was moderate and projected world trade growth was revised downward. Major central banks continue to express their commitment to leaving monetary interest rates at a low level for an extended period of time. Despite the beginning of Federal Reserve tapering of bond purchases in the US, long-term yields declined this month.
- After data in the previous month had indicated some moderation, there was an increase this month in home prices and in mortgages granted. The number of transactions and the share of investors in those transactions also began to increase again. Against the background of the Supervisor of Banks directives regarding housing credit, the trend of decline continues in new mortgages' risk characteristics, such as the average loan to value ratio, the payment to income ratio, and the share of mortgages granted at variable rate interest.

The Bank of Israel will continue to monitor developments in the Israeli and global economies and in financial markets, particularly in view of the continuing 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 published on January 27, 2014.

Participants in the narrow-forum discussion:

Members of the Monetary Committee

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THE INTEREST RATE DECISION FOR MARCH 2014

Main points of discussion

The 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 March 2014, it was decided to reduce the interest rate by 0.25 percentage points, to 0.75 percent. Four Committee members supported this decision, and one member voted to keep the interest rate unchanged.

The discussion focused on the following main issues: (1) inflation; (2) economic activity and the labor market; (3) the global economy and monetary policy worldwide; (4) the exchange rate and exports; and (5) the housing market.

Actual inflation over the past 12 months, and inflation expectations for the next year provided from various sources, are below the midpoint of the target range. Most Committee members felt that there has been some decline in the inflation environment, based on the lower than expected January CPI and forecasters' projections that were revised downward following the CPI reading. Most Committee members claimed that these developments support a change in policy that will return the inflation environment to the middle of the target. In contrast, one member claimed that the low CPI reading does not indicate a decline in the level of the inflation environment, since most of the surprise in the CPI derived from components that do not necessarily indicate weakness in demand.

In their discussion on the state of economic activity, most Committee members agreed the GDP growth rate, primarily growth of business sector product, is moderate, and that there is an expectation this trend will continue. In the view of most Committee members, the low growth rate, together with the CPI developments noted above, is consistent with an environment of moderate demand. Similarly, most Committee members felt that although the unemployment rate remains low, other data continue to signal labor market weakness. The assessment of labor market weakness is supported, in their view, by the virtual standstill in real wages, the increase in the number of jobseekers, and data on employee posts, which indicate that the recent increase in employment derives mostly from an increase in employee posts in the public sector. In contrast, in the business sector there is notable weakness in employment, seen in the low level of job vacancies and the standstill in the number of employee posts. Most Committee members felt that in order to maintain a high level of employment in the future, there will need to be an increase in business sector employee posts, especially in light of the expectation that in 2014–15 the public sector's contribution to growth will decline. In contrast, one Committee member claimed that labor market data indicate stability and that they represent primarily the slowdown in activity, especially in exports, that occurred in the third quarter of 2013, which led to accommodative monetary policy; in addition, he noted, the unemployment rate is low, and the employment rate is high. The Committee member also noted that current indicators are positive, and in the past three months, there has been an increase in bank credit to the business sector, following a long period of contraction.

In their discussion on the global economy, Monetary Committee members agreed that the recovery process in the US seems entrenched, while in Europe, in contrast, the moderate recovery continues but is fragile and uneven. Most Committee members feel that these recovery processes are expected to be slow, lasting for several years, and that this will impact on Israeli exports. Committee members pointed to the relatively weak US economic data published recently, though it was agreed that it is too early to determine if this is a change in trend or a temporary, weather-related, slowdown. Committee members said that there is no change in assessments that the Federal Reserve will leave the federal funds rate at a low level for an extended period of time, and that the Bank of England will also leave the interest rate low for a lengthy time. Regarding the eurozone, it is assessed that it is likely that additional accommodative monetary policy will be required, especially in light of the low level of inflation, and concerns of deflation. In this context, Committee members discussed the extent of the effect that inflation worldwide has on Israel's inflation rate.

Participants discussed the Bank of Israel's direct intervention in the foreign exchange market last month, and agreed that the action contributed to the weakening of the shekel in terms of the effective exchange rate, and especially against the dollar. With that, they agreed that the cumulative appreciation recently is still a moderating factor on activity in the tradable sector. In contrast, one member claimed that for the first time in several months the foreign exchange market is signaling stability. Most Committee members agreed that if an additional appreciation occurs, it would be liable to undermine the recent trend of improvement in Israel's exports. Committee members noted that the importance of the exchange rate to Israeli exports is particularly notable in view of the slow growth in world trade volumes, growth which is not expected, according to most assessments, to increase markedly in the coming years.

In contrast, as the main consideration against reducing the interest rate, developments in the prices of assets, primarily homes, and their potential impact on financial stability, were discussed. In the discussion, concern was raised of the long term effect that a low interest rate can have on demand for homes. Committee members said that home prices continue to increase at a rapid pace and mortgage volume remains high. In this regard, Committee members noted that the measures adopted by the Supervisor of Banks were effective—they reduced the risk characteristics of new mortgages. In addition, Committee members discussed the positive developments which have occurred recently on the supply side of homes—the number of building completions increased markedly and there is a large stock of homes available for sale.

In conclusion, most Committee members agreed that reducing the interest rate by one-quarter of one percentage point is a necessary step in light of the decline in the inflation environment, the slowdown in GDP growth, the weakness in the labor market, the cumulative appreciation in the effective exchange rate, and the concern of an additional slowdown in the global economy. They emphasized that this step is required despite the risks, which moderated, in continued home price appreciation, as seen in the reduction of the risk characteristics of new mortgages. In a dissenting view, one Committee member supported keeping the interest rate unchanged, in light of the stability in the exchange rate in the past month, positive current indicators in both the domestic and global economies, the low unemployment rate, and the risk in continued home price increases.

Following the discussion, the five members of the Monetary Committee voted on the Bank of Israel interest rate for March 2014. Four Committee members supported reducing the interest to 0.75 percent, and one Committee member advocated leaving the interest rate unchanged.

In its announcement of the decision, the Bank emphasized that the decision to reduce the interest rate for March by 0.25 percentage points is consistent with the Bank of Israel's monetary policy, which is intended to entrench the inflation rate within the price stability target of 1–3 percent a year over the next twelve months, and to support growth while maintaining financial stability. The path of the interest rate in the future depends on developments in the inflation environment, growth in Israel and in the global economy, the monetary policies of major central banks, and developments in the exchange rate of the shekel.

The following are the main considerations underlying the decision:

- The CPI for the month of January surprised to the downside, and the inflation rate over the preceding 12 months is 1.4 percent—in the lower portion of the target range. After the CPI reading was published, private forecasters reduced their projections for the next 12 CPI readings, and inflation expectations for one year ahead, from various sources, are all below the midpoint of the inflation target.

- According to the initial estimate for the fourth quarter of 2013, GDP increased by 2.3 percent and business sector product increased by only 1.6 percent. The positive turnaround in export data in the fourth quarter is based mainly on pharmaceuticals exports which are generally volatile, and exports by labor-intensive industries are still in a virtual standstill. Various indicators of activity in January pointed to some recovery, but consumer confidence indices continued to signal pessimism, and data continued to indicate a lack of growth in employment and wages in the business sector.
- In the past month, the shekel depreciated by 1 percent in terms of the nominal effective exchange rate; since the beginning of 2013, there has been a cumulative appreciation of 7.3 percent.
- After two quarters of rapid growth, recent US economic data were disappointing, though it is too early to determine if it is a temporary slowdown or a turning point downward. In Europe, slow growth continues, and there are growing concerns of deflation. The Federal Reserve's tapering process in its asset purchase program is expected to continue, and the accommodative monetary policy in other major economies is expected to continue for an extended period of time.
- Home prices increased by 8.1 percent in the past year, and the increase in the number of transactions and the high volume of mortgages being granted continue. There is a continued trend of improvement in the risk characteristics of new mortgages.

The Bank of Israel will continue to monitor developments in the Israeli and global economies and in financial markets, particularly in view of the continuing 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 published on February 24, 2014.

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Mr. Yoav Soffer, Acting Spokesperson of the Bank of Israel

THE INTEREST RATE DECISION FOR APRIL 2014

Main points of discussion

The 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 April 2014, it was decided to leave the interest rate unchanged, at 0.75 percent. The decision was unanimous.

The discussion focused on the following main issues: (1) inflation; (2) economic activity; (3) the labor market; (4) the global economy and monetary policy worldwide; and (5) the housing market.

During the discussion on the issue of inflation, the Committee members related to the fact that the inflation environment is low, below the midpoint of the target range, and they made the assessment that it mainly reflects moderate global activity and the accompanying low level of inflation, while reflecting domestic demand factors to a lesser extent. This assessment was based on the fact that the prices of tradable goods included in the CPI—which constitute about one-third of the CPI and are affected by global prices and by the exchange rate—declined by 1 percent in the past 12 months, while the prices of non-tradable goods, which reflect domestic activity, increased by 2.3 percent.

While the annual inflation rate over the past 12 months is expected, according to the projections of some forecasters, to be below the lower bound of the inflation target for a few months in 2014, it is expected to return to within the range toward the beginning of 2015. With that, expectations of inflation for the next 12 months are above the lower bound of the inflation target—around 1.4 to 1.6 percent. The stability of inflation expectations for the intermediate and long terms supports the assessment that the decline in the pace of inflation is considered temporary.

The Committee members discussed the picture of real economic activity and the extent to which changes can be identified in it as a result of the new data that became available since the decision last month. An analysis of the up-to-date data indicates that in the last quarter of 2013 and the beginning of 2014, there was some recovery in activity, mainly in exports, and particularly in the high technology industries, against the background of the improvement in global trade. With that, according to some of the indicators, the recovery in activity is still at a moderate pace. According to the updated staff forecast, GDP in 2014 is expected to grow by 3.1 percent, with a moderate increase in the unemployment rate.

The discussion also dealt in particular with the picture that emerges from the labor market: The Committee members assessed that the labor market is not significantly far from full employment, but there is still the potential for expansion. This is noticeable from the moderate pace at which real wages increased in the past year. The decline in the unemployment rate during the past year is explained in part by the growth of employment in the public services, and in part by the decline in structural unemployment.

Another main issue that came up for discussion is developments in the global economy, the changes in monetary policy in the US, and their effects on the necessary policy in Israel. It was noted that the Federal Reserve announced that it would continue tapering the quantitative easing program by another $10 billion, to a monthly volume of $55 billion, and that the Federal Open Market Committee (FOMC) forecasts were updated to include a slightly more rapid interest rate path than what was presented in its previous interest rate decisions. This path is expected to reduce the interest rate gap between Israel and the US, thereby reducing the pressure for appreciation derived from it. The Committee members assessed that, in total, these developments signal a positive direction for the US economy, although the improvement in the US and in other countries is still fragile, and that the future interest rate path in Israel will be affected by developments in the global economy, and particularly by the global interest rate path derived from it.

In its discussions, the Committee also related to the housing market policy measures discussed by the government. The Committee members believed that in the near future, there may be a temporary slowdown in activity in the market for homes due to buyers' preference to wait until the picture becomes clearer. In addition, the Committee related to the possible fiscal implications of such measures, and emphasized the importance of maintaining the deficit framework.

The Committee members expressed the position that the current interest rate environment is consistent with economic conditions from the standpoint of inflation and real economic activity, and that it is consistent with the low level of interest rates that is prevalent in the major advanced economies. In relation to the financial activity environment, some of the Committee members noted that, against the background of the fact that low short- and long-term interest rates are prevalent worldwide, the prices of various financial assets—shares and bonds—increased. With that, it was noted that this phenomenon has not been accompanied by expansion of credit to the business sector.

It was also noted since the previous interest rate decision, the shekel has appreciated by 1 percent in terms of the effective exchange rate. However, following the reduction of the interest rate last month, the Committee believed that there is no room for a further change in the interest rate.

In summation, all of the Committee members agreed that the current level of the interest rate is consistent with the current economic activity and inflation environments and the interest rate levels that are typical of the advanced economies, and that no significant risks of an imbalance in the financial markets can be discerned. The Committee members also agreed that there is no place to change the interest rate after it was reduced the previous month.

Following the discussion, the six members of the Monetary Committee voted on the Bank of Israel interest rate for April 2014. All of the Committee members supported leaving the interest rate unchanged at 0.75 percent.

In its announcement of the decision, the Bank emphasized that the decision to keep the interest rate for April 2014 unchanged at 0.75 percent, after it was reduced last month, is consistent with the Bank of Israel's monetary policy, which is intended to entrench the inflation rate within the price stability target of 1–3 percent a year over the next twelve months, and to support growth while maintaining financial stability. The path of the interest rate in the future depends on developments in the inflation environment, growth in Israel and in the global economy, the monetary policies of major central banks, and developments in the exchange rate of the shekel.

The following are the main considerations underlying the decision:

- The CPI for the month of February declined by 0.2 percent. The inflation environment is within the bottom portion of the target range, and it is likely that over the next several months, inflation over the preceding 12 months will decline temporarily to below the target range, though it is expected to return to within the target toward the beginning of 2015. Inflation expectations for one year ahead are within the target range, below the midpoint of the inflation target.

- Data which became available this month continue to indicate moderate economic growth, and some recovery in the growth rate is seen in the first quarter of 2014. In particular, a recovery in private consumption is apparent, as well as some increase in exports, which is focused on high tech and business services industries. Other manufacturing exports remain at a virtual standstill. Labor Force Survey data indicate elevated employment and low unemployment, derived from structural factors as well; the increase in the number of employee posts in the business sector remains moderate.

- In the past month, the shekel appreciated by 1 percent in terms of the nominal effective exchange rate; since the beginning of 2013, there has been a cumulative appreciation of 8.2 percent.

- There is a renewed trend of growth in world trade, and the global economy is expected to continue to grow moderately. Mixed data were reported in the US this month, primarily against the background of severe weather, but the tapering process continues and the interest rate path projected by FOMC members rose, reflecting an expectation for continued recovery. In Europe, the growth forecast was revised slightly upward. Weakness remains apparent in emerging markets.

- The pace of appreciation in home prices moderated this month, and over the past year they have increased by 6.3 percent. There is a continued high volume of mortgages taken out. With that, the improvement in risk characteristics of the new mortgages continues. The housing market policy steps being considered are likely to lead to volatility in volumes of activity and in prices in the market in coming months.

The Bank of Israel will continue to monitor developments in the Israeli and global economies and in financial markets, particularly in view of the continuing 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 published on March 24, 2014.

Participants in the narrow-forum discussion:

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THE INTEREST RATE DECISION FOR MAY 2014

Main points of discussion

The 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 May 2014, it was decided to keep the interest rate unchanged, at 0.75 percent. Five members of the committee voted for this decision, and one voted to increase the interest rate by 0.25 percentage points.

The discussion focused on the following main issues: (1) inflation; (2) economic activity and the labor market; (3) the global economy and monetary policy worldwide; (4) the housing market; and (5) the fiscal situation.

During the discussion on the issue of inflation, Committee members agreed that the level of inflation and inflation expectations are in line with the monetary policy targets. The forces acting for inflation to be lower than the midpoint of the target range are moderate global activity and the low inflation that is accompanying it. Prices of nontradable goods increased by 2.6 percent in the past 12 months. Excluding the Housing Prices Index, which is influenced to a greater extent by forces unique to that market, they increased by 2.2 percent—around the midpoint of the target range.

In discussing the state of economic activity, the Committee members agreed that the upward revision in GDP and business sector product data, as well as the data that became available in the past month, indicate some improvement in the rate of economic expansion. With that, most Committee members noted that it is too early to evaluate the extent to which this improvement will persist, particularly because it is being led by domestic demand, and not by an acceleration in the rate of global growth and in exports. Most Committee members noted that it is hard to deduce from the low unemployment rate how near the economy is to full employment, since the continued decline in unemployment has derived from, among other things, long-term processes that have acted to bring down structural unemployment. The standstill in real wages supports the assessment that the labor market is not in full employment, despite the high level of employment and the low unemployment rate.

As to the global economy, the Committee members agreed that the trend of recovery in advanced economies is continuing. In the US, the recovery process is becoming entrenched, and the Committee members agreed that the weak data on US economic activity published at the beginning of the year derived from the weather conditions during that period. The Committee members referred to assessments that the tapering process in the US (reducing quantitative easing) would continue at the current pace. The federal funds rate is expected to begin increasing in the second half of 2015, subject to continued recovery. The moderate recovery in Europe is continuing, but it is fragile, and inflation has declined in the past year to a low of 0.5 percent. The assessment is that it is possible that the ECB will decide on further monetary accommodation in order to prevent deflation and a further strengthening of the euro. The International Monetary Fund reduced its global growth forecast slightly due to the moderation of growth in emerging markets.

Committee members agreed that the discussion held by the government regarding policy measures in the housing market may lead to a temporary decline in the volume of activity in the coming months. At this stage, it cannot be concluded from the volume of activity or from the development of prices in the housing market what effect the measures will have when they are implemented.

On the issue of the fiscal situation, it was noted in the discussion that the data on tax revenues are positive and that the government's domestic surplus (excluding net credit) is higher than the seasonal path that is consistent with meeting the deficit target for 2014. The Committee members related to the fact that the fiscal frameworks for 2015 have not yet been formulated, but it can already be said that based on the expected volume of tax revenues and planned expenditure, budgetary adjustments will be required for that year in order to meet the deficit path set out by the government.

In summation, most of the Committee members were of the opinion that the current level of the interest rate is consistent with the current economic activity and inflation environments, and with the accommodative monetary policy in advanced economies, including the continued quantitative easing in the US. They claimed that the current low level of the interest rate has supported activity and contributed to halting the real appreciation, and that the importance of monetary accommodation to growth is particularly large as long as the slow expansion of the volume of world trade continues. Most of the Committee members emphasized that no significant risks of the creation of financial markets imbalance can be discerned, and in this context they mentioned the measures taken by the Supervisor of Banks in the mortgage market, which have acted to reduce the risks inherent in new mortgages. In contrast, one of the Committee members supported increasing the interest rate by 0.25 percentage points, in view of the positive current indicators both in the Israeli economy and in the global economy, the stability of the exchange rate, the financial risks that accompany the low interest rate, particularly in the housing market and the bond market, and the continued tapering of quantitative easing adopted by the Federal Reserve.

Following the discussion, the six members of the Monetary Committee voted on the Bank of Israel interest rate for May 2014. Five of the Committee members supported leaving the interest rate unchanged at 0.75 percent, and one Committee member supported increasing it by 0.25 percentage points.

The decision to keep the interest rate for May 2014 unchanged at 0.75 percent is consistent with the Bank of Israel's monetary policy, which is intended to entrench the inflation rate within the price stability target of 1–3 percent a year over the next twelve months, and to support growth while maintaining financial stability. The path of the interest rate in the future depends on developments in the inflation environment, growth in Israel and in the global economy, the monetary policies of major central banks, and developments in the exchange rate of the shekel.

The following are the main considerations underlying the decision:

- The CPI for the month of March increased by 0.3 percent, and inflation over the preceding 12 months was 1.3 percent. Inflation expectations for one year ahead remain within the target range, below the midpoint of the range.
- Data which became available this month indicate that in the first quarter there was some acceleration in the expansion of the economy, led by domestic demand and services exports, and with a virtual standstill in goods exports. Labor Force Survey data continue to indicate a decline in unemployment and an increase in employment. The number of employee posts of Israelis increased sharply in January, primarily in domestic-market oriented industries, but there are no indications of wage increases, and the growth rate of health tax receipts remains moderate.
- In the past month, the shekel weakened by 0.4 percent in terms of the nominal effective exchange rate, while the effective exchange rate has remained stable for the year to date, and has appreciated by 4.5 percent over the past year.

- This month, the IMF slightly reduced its global growth and world trade volume forecasts, both by 0.1 percent, primarily against the background of a decline in the forecast for economic activity in emerging markets. Positive data were published in the US and Europe this month. In the US, the Fed is expected to only begin increasing the federal funds rate in the second half of 2015, and there are assessments that in Europe, additional accommodative monetary policy measures will be adopted. Emerging market economies remain weak.
- Home prices continued to increase this month, and their annual rate of increase is fluctuating around 6–7 percent. The rate of mortgages taken out remains elevated, while there is stabilization, at a lower level, in the risk characteristics of new mortgages. There is continued uncertainty regarding how the policy measures which were decided upon will affect price levels and activity volume.

The Bank of Israel will continue to monitor developments in the Israeli and global economies and in financial markets, particularly in view of the continuing 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 published on April 28, 2014.

Participants in the narrow-forum discussion:

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THE INTEREST RATE DECISION FOR JUNE 2014

Main points of discussion

The 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 June 2014, it was decided to keep the interest rate unchanged, at 0.75 percent. The six members of the committee voted in favor of this decision.

The discussion this month focused on two main issues: inflation and economic activity. This was against the background of the CPI for April being particularly low, as well as the contradiction between National Accounts data and much of the most recent data published, which both indicate moderation in the economy's growth rate, and data from the labor market and consumer confidence indices indicating continued recovery. In addition, Monetary Committee members discussed the state of the housing market, the fiscal situation and global developments.

Regarding inflation, the discussion revolved around the question of to what extent the low April CPI reading points to a decline in the rate of price increases or whether it is just a one-time downward movement which will be corrected over the course of the year. The Committee agreed that the fact that the increases in most components of the CPI were relatively low supports the assessment that the low CPI reflects a decline in the level of inflation. This month, the decline in tradable goods prices (imported inflation) continued, affected by the decline in energy prices, other commodity prices, and the appreciation of the shekel in the past year. Additionally, in recent months a decline has also been observed in the rate of increase of prices of nontradable goods, products that domestic demand influences the prices of more than the prices of tradable goods. The assessment that the decline in prices in the past month will not be corrected in coming months is reflected as well in assessments of most private forecasters, who revised downward their projections of inflation in the current year.

It was noted that in the past, the CPI for April was high relative to CPI readings of other months, and impacted on the annual rate of price increases. The low CPI reading is thus expected to affect, throughout the coming year, the annual rate of price increases, and over the course of the summer months it is expected to (as measured over the preceding 12 months) decline to below the lower bound of the target inflation range. Such a decline is consistent with a flexible inflation targeting regime which allows a temporary deviation from the target range.

Inflation expectations and projections for the year ahead, affected by the low CPI, were revised slightly downward (to 1.3–1.5 percent), though they are still in the area of the midpoint of the inflation target.

In a discussion on the state of economic activity, Committee members agreed that first quarter National Accounts data, especially the figure indicating the decline in current private consumption, are not consistent with most current indicators for the quarter, and in particular with positive labor market data and figures related to the rapid increase in direct tax revenues. With that, the most recent data, including foreign trade, services exports, and industrial production, also point to moderation in the rate of growth, which was reflected as well in the Composite State of the Economy Index which remained unchanged.

In light of the inconsistency in the picture presented by various data, and in view of the fact that the National Accounts data published for the first quarter is a first estimate, which is often revised considerably later on, Committee members emphasized the uncertainty regarding the rate of growth at this time.

As far as the housing market, it was pointed out that despite the decision on zero VAT for eligible buyers on a first home purchase from a contractor, a slowdown in taking out mortgages is not discerned so far. However, there is an apparent slowdown in building starts, though their level remains elevated. The increase in the annual rate of building completions continues, and home prices continued to increase at an annual rate of 7 percent.

Committee members said that in terms of the fiscal situation, based on data so far, it appears that the government will meet its deficit target for this year. It was also noted that meeting the fiscal targets in the 2015 budget will require significant adjustments on the expenditure side and on the revenue side.

In reference to the global economy, Monetary Committee members agreed that assessments strengthened this month of a slowdown in global growth in 2014 and 2015. The US economy grew by only 0.1 percent in the first quarter, compared with the fourth quarter. In Europe, as well, GDP growth in the first quarter, compared with the fourth quarter, was disappointing, at 0.2 percent, deriving primarily from a lack of growth in France and from negative growth in the Netherlands and in Italy, offset by 0.8 percent growth in Germany.

This month the OECD revised its 2014 global growth forecast downward, by 0.2 percent, and revised its 2014 world trade forecast downward by 0.4 percent—this was only due to first quarter weakness, since there was no change in the assessment that the recovery in the world economy continues. In addition, there was a slight upward revision in 2015 projections.

Monetary Committee members noted the relative stability this month of the exchange rate for the year to date, after the major appreciation in 2013.

In conclusion, Committee members were of the opinion that the current level of the interest rate is in line with the economic environment as depicted in most data which became available this month, and with the inflation environment, given the accommodative monetary policy in advanced economies. In their assessment, the low level of the current interest rate supports activity and contributed to halting the real appreciation. Some Committee members noted that the picture of economic activity becoming clearer, in contrast to the especially high uncertainty about it this month, will impact on interest rate decisions in coming months.

Following the discussion, the six members of the Monetary Committee voted on the Bank of Israel interest rate for June 2014. All six of the Committee members supported leaving the interest rate unchanged at 0.75 percent.

The decision to keep the interest rate for June 2014 unchanged at 0.75 percent is consistent with the Bank of Israel's monetary policy, which is intended to entrench the inflation rate within the price stability target of 1–3 percent a year over the next twelve months, and to support growth while maintaining financial stability. The path of the interest rate in the future depends on developments in the inflation environment, growth in Israel and in the global economy, the monetary policies of major central banks, and developments in the exchange rate of the shekel.

The following are the main considerations underlying the decision:

- The CPI increased by only 0.1 percent in April, markedly lower than expectations, and the rate of inflation over the previous 12 months was 1 percent, the lower bound of the target range. This measure of the inflation rate is expected to decline in the coming months, to below the lower bound of the target range, though expectations for 1 year ahead are within the target range.
- Indicators of real economic activity which became available this month point to more moderate growth than assessed in the previous month, though the extent of the moderation is uncertain. The first estimate of first

quarter data signals a slowdown in growth, due to a contraction of private consumption and fixed capital formation, while labor market data continue to indicate growth in employment and reduced unemployment, and there was improvement in indices of consumer confidence and of expectations of activity. Signs of moderation are also seen in Composite State of the Economy Index data, including goods exports.

- In the past month, the shekel weakened by 0.4 percent in terms of the nominal effective exchange rate, while since the beginning of 2014 the effective exchange rate has been stable, and it has appreciated by 4.4 percent over the past year.
- Against the background of disappointing first quarter growth data in the US and in Europe, the OECD reduced its 2014 global growth and world trade projections this month. Emerging market weakness continues to weigh on global growth. The probability of further monetary easing in Europe increased, and expectations remain that in the US, the federal funds rate will begin to be increased in the second half of 2015.
- Home prices continued to increase in February–March, and their annual rate of increase remains around 6–7 percent. The rate of mortgages taken out remains elevated, with continued decline in the risk characteristics of new mortgages. The increase in the number of building completions continues, but some slowdown is apparent in the number of building starts. This month, as well, there is continued uncertainty regarding the effect on housing market price levels and activity volume of the policy measures that the government decided upon.

The Bank of Israel will continue to monitor developments in the Israeli and global economies and in financial markets, particularly in view of the continuing uncertainty in the global economy and regarding economic activity in Israel. 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 published on May 26, 2014.

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

Prof. Alex Cukierman

Prof. Reuben Gronau

Prof. Rafi Melnick

Prof. Nathan Sussman, Director of the Research Department

Other participants in the narrow-forum discussion:

Mr. Andrew Abir, Director of the Market Operations Department

Mr. Eddy Azoulay, Chief of Staff to the Governor

Mr. Yuval Mazar, Economist in the Research Department

Mr. Yoav Soffer, Spokesperson of the Bank of Israel

Mr. Ilan Socianu, Assistant to the Secretary of the Monetary Committee

THE INTEREST RATE DECISION FOR JULY 2014

Main points of discussion

The 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 July 2014, it was decided to keep the interest rate unchanged, at 0.75 percent. Five members of the Committee voted in favor of this decision, and one voted to reduce the interest rate by 0.25 percentage points.

The discussion focused on several main issues: (1) inflation; (2) economic activity; (3) the exchange rate; (4) the corporate bond market, and (5) the housing market.

During the discussion on inflation, Committee members referred to the inflation rate, as measured over the previous 12 months, being expected to decline in the coming months to below the lower bound of the price stability target range. Committee members agreed that the moderation in the rate of price increases in recent months derives from, among other things, the continued weakness in the global economy and the appreciation. Most Committee members were of the opinion that this moderation also derives from weakness in domestic demand, and in particular from moderation in the private consumption growth rate. They expressed the concern that this moderation will lead to a decline in inflation expectations and claimed that under certain conditions it could lead to further moderation in activity. In contrast, some Committee members emphasized the possibility that structural changes contributed to the moderation in the rate of increase of food prices and to the moderation in inflation. At the end of the discussion on inflation, all Committee members expressed their satisfaction with the fact that inflation expectations for longer terms are consistently slightly above the midpoint of the target range, and assessed that the Bank of Israel’s commitment to the price stability target will keep them around there.

In their discussions on economic activity, Committee members agreed that the economy is continuing to grow at a moderate rate. They emphasized the weakness of domestic demand, and in particular the moderation in the growth rate of private consumption, after a long period in which it supported the growth of the economy. Committee members referred to the weakness in demand from abroad and weakness in exports, and noted in this regard the fact that international institutions reduced growth projections for 2014, and the assessment that the global economic recovery would continue to be slow. Committee members felt that the revised National Accounts data are consistent with other indicators of economic activity, indicators that also point to moderate economic growth in the first quarter. They noted that most monthly indicators do not signal additional moderation in the second quarter, and that confidence and expectations indices even improved in the past month.

In a discussion of the effective exchange rate, Committee members referred to the renewed appreciation of the shekel in the past month, after the shekel had been stable since the beginning of the year. It was noted that the interest rate gap between Israel and advanced economies is already very small and the appreciation does not derive from short term capital flows. Committee members agreed that continued appreciation is related to the surplus in the current account, the large volume of direct investment in the economy, institutional investors hedging their investments abroad, and to the macroeconomic situation being stable compared with other advanced economies. Committee members discussed the effect of the appreciation on the moderation of prices and its negative effects on the tradable sector.

Committee members discussed corporate bond spreads being at a low level and that mutual funds specializing in such securities increased their net investment. Committee members claimed that the low interest rate levels in Israel and worldwide increased the attractiveness of this investment vehicle, in a search for yield. They agreed that the risks to financial stability deriving from this market should continue to be monitored.

With regard to the housing market, Committee members discussed the continued increase in prices in March–April and that the rate of increase was even faster than that of previous months, the continued large volume of mortgages taken out, and that, in contrast, there was a slowdown in activity in the industry in the first quarter of the year. It was agreed that the data reflect only partially the period of waiting for planned housing market measures to go into effect. The possibility was raised that the decline in the number of transactions is still not reflected in mortgage data, due to the lag between the date of purchase of new homes and the date of taking out a mortgage, and that the decline would be reflected in the coming months. It was noted that that the risk characteristics of new mortgages stabilized at a lower level than in the past, due to Banking Supervision Department guidelines.

In conclusion, most Committee members were of the opinion that the current level of the interest rate supports the economy's stable rate of growth, and that it is consistent with meeting a flexible inflation target which allows a deviation for some time from the target range—the inflation rate is expected to decline in coming months to below the lower bound of the price stability target, but according to the Research Department staff forecast it is expected to return to the target range within about six months. Most Committee members felt that maintaining the current level of the interest rate is consistent with the need to maintain financial stability in the asset markets, and noted in this regard the steps taken by the Supervisor of Banks in the mortgage market. In contrast, one Committee member supported reducing the interest rate by 0.25 percentage points, in light of the moderation in the growth rate of private consumption, the assessment that inflation will decline in upcoming months to below the lower bound of the price stability target, and in light of the appreciation which occurred in the shekel in recent weeks.

Following the discussion, the six members of the Monetary Committee voted on the Bank of Israel interest rate for July 2014. Five Committee members supported leaving the interest rate unchanged at 0.75 percent, and one member voted in favor of a 0.25 percentage point reduction.

The decision to keep the interest rate for July 2014 unchanged at 0.75 percent is consistent with the Bank of Israel's monetary policy, which is intended to entrench the inflation rate within the price stability target of 1–3 percent a year over the next twelve months, and to support growth while maintaining financial stability. The path of the interest rate in the future depends on developments in the inflation environment, growth in Israel and in the global economy, the monetary policies of major central banks, and developments in the exchange rate of the shekel.

The following are the main considerations underlying the decision:

- The CPI increased by 0.1 percent in May. Inflation measured over the preceding 12 months is at the lower bound of the target range, but is expected to decline below the lower bound in the coming months. With that, 1-year expectations from all sources are within the target range, and expectations for longer terms are around the midpoint of the target.

- The picture of real activity seen in the data and indicators which became available this month points to the economy continuing to grow at a moderate rate, similar to that of the second half of 2013. National Accounts data for the first quarter were revised upward, but there are signs of moderation in the growth of private consumption, and the virtual standstill in goods exports continues against the background of moderation in world trade. The Composite State of the Economy Index increased by 0.2 percent, and most indices of confidence and expectations improved this month.
- In the past month, the shekel strengthened by 1.3 percent against the dollar and by 1.4 percent against the euro. In terms of the nominal effective exchange rate, the shekel strengthened by about 1.4 percent this month, and by about 1.2 percent for the year to date.
- The World Bank reduced its 2014 global growth forecast this month, primarily against the background of first quarter data in the US. The ECB adopted several accommodative monetary measures this month, while in the US the tapering process continues, and in the UK, the Bank of England provided a first indication that it is likely that with the recovery, there will be an increase in the interest rate by the end of 2014.
- Home prices continued to increase in March–April, and their annual rate of increase rose above 8 percent. The rate of new mortgages taken out remained elevated, while risk characteristics of new mortgages remained stable after they declined due to steps taken by the Supervisor of Banks. In the first quarter of the year, there was a slowdown in building starts and completions, as well as in the number of transactions. Notwithstanding a slight increase this month, corporate bond spreads have been at a low level for a long time.

The Bank of Israel will continue to monitor developments in the Israeli and global economies and in financial markets. 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 published on June 23, 2014.

Participants in the narrow-forum discussion:

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