Bank of Israel

Report to the public of the discussions in the Bank of Israel prior to the setting of the interest rate for June 2006

The broad-forum discussion took place in the Bank of Israel on 24 May 2006, and the narrow-forum discussions on 24 and 28 May 2006

General

The process by which the Governor makes the monthly interest rate decision consists of discussions at two levels—the first in a broad forum, and subsequent discussions in a narrower forum. In the broad forum the relevant background economic conditions are presented; these include real and monetary-financial developments in Israel's economy, and developments in the global economy. Participants in this discussion include the Governor, the directors of the various economic departments in the Bank (the Research Department, the Monetary Department, the Foreign Currency Department, and the Foreign Exchange Activity Department), and economists from the different departments who prepare and present the material for discussion.

In the narrow forum, the department heads present their recommendations regarding the interest rate decision, and following a discussion of the possible courses of action, the Governor makes his decision.

A. THE STATE OF THE ECONOMY

1. Developments on the real side

General

The latest data indicate continued rapid growth in the economy, at a rate faster than in 2005 and faster than initially forecast for 2006. Thus, in 2006 the economy may be on an accelerated growth trend compared with last year. This assessment, based on National Accounts figures, is also backed by the monthly data provided by the index of manufacturing production, the index of trade and services revenue, the sales of the retail chain stores, sales via credit cards, tourist bed nights, the number of employee posts, and data on exports. The sharp rise in tax revenues is also consistent with a rapid increase in economic activity.

National Accounts data

National Accounts data received in May show that in the first quarter of the year GDP rose at a rate of 6.6 percent, and business-sector product at a rate of 10.6 percent (all rates herein are annual rates). Domestic public consumption contracted at a rate of 2.5 percent in the first quarter, while public civilian expenditure remained unchanged. Exports rose by 9.4 percent (excluding diamonds, ships, and airplanes). Private consumption (excluding durables) rose by 9.0 percent. The increase in private consumption is an indication of rapid growth, while the 16 percent rise in consumption of durables shows that the public is feeling greater economic security and is confident that steady growth will continue. Fixed investment increased by 16 percent, reflecting a sharp rise in investment in imported machinery and equipment, while investment in buildings and in domestically produced machinery and equipment actually fell. Civilian imports excluding diamonds, ships and airplanes rose by only a modest 2.7 percent.

Indicators of economic activity

Trend data from the monthly indicators also continue to show that economic growth has continued and become more firmly established.

The manufacturing production index rose at an annual rate of 8 percent in the first quarter. The rise was due mainly to expanded production in the high-tech industries. The index of sales of the retail chain stores continued rising in April at a similar rate to those in February and March (1.0 percent and 0.9 percent respectively).[1] The March index of trade and services revenue showed a continuation of the upward trend, although the rise was more moderate.

Arrivals of tourists by air increased relatively slowly in March, as they did in February, after rising faster in the months November to January. The number of tourist bed nights continued its substantial rise.[2]

Trend data of goods exports in April shows a rise, and in April the data for the previous months were also adjusted sharply upwards.

The composite state-of-the-economy index rose by 0.7 percent in April, due mainly to the increases in the index of manufacturing production, in services exports and in goods imports.

Labor market data

The Labour Force Survey for the first quarter of 2006 (which was published on 24 May, after the discussion in the broad forum had taken place) indicated a further decline in unemployment, to 8.7 percent of the civilian labor force (compared with 8.8 percent in the previous quarter), but with a reduction in the labor force participation rate from 55.6 percent to 55.4 percent. The rate of employment dropped slightly, to 50.6 percent of the working-age population, after rising since the beginning of 2005. The number of employees increased by 6,800 in the first quarter of 2006, and the number of unemployed persons went down by 3,300. In the business sector the number of employees rose by 1.4 percent (about 25,000) from the previous quarter, whereas the number of employees in the public services declined by 3.1 percent (about 23,000).

In the twelve months to February 2006 (calculated as the average of three months to February 2006 compared with the three months to February 2005). the average nominal wage per employee post in the business sector rose by 5.4 percent, and in the public sector by 1.5 percent In the business sector the rise in the twelve months to

[1] The trend data reported in the previous month have been updated. In the previous report the index was quoted as rising by only 0.4 percent in January–March; the update revised this figure sharply upwards.

[2] According to the trend data published 26 March 2006, the number of tourist bed nights declined in August–October 2005, but the latest update revised this to a continued rise.

February 2006 (calculated as above) was particularly notable in three industries: in banking, insurance and financial institutions (26 percent), electricity and water (9 percent), and business services (7.9 percent). Over the same period the average nominal wage in the business sector excluding the banking and insurance and business services industries rose by about 2 percent.

Data relating to the end of 2005 show a continued fall in unit labor costs, the result of a steep increase in labor productivity.

The survey of business-sector employers carried out by the Ministry of Industry, Trade and Labor indicates a rise in the degree of difficulty in filling vacancies in many industries, and a lengthening of the average time that vacancies remain unfilled.

2. Budget data

In January–April there was a cumulative budget surplus of NIS 7.7 billion. This reflects an acceleration in tax revenues combined with a low level of expenditure. The assessments made by the Bank of Israel are that the budget deficit in 2006 will be between zero and one percent of GDP.

Under the assumption that the state’s income from the sale of Iscar, totaling NIS 4.5 billion, will be received in the course of 2006, total government revenue is likely to exceed the budget forecast significantly.

Direct-tax revenues in January–April (adjusted for legislative amendments and non-recurring income) rose by 15 percent in real terms from their level in January–April 2005.

3. Economic developments, nominal

Inflation
The April CPI went up by 0.9 percent, within the range of economists' forecasts, and in line with the seasonal path consistent with the inflation target. Since the beginning of the year the CPI has risen by 1.5 percent, faster than the target defined as price stability. The rate of inflation during the last twelve months was 3.8 percent, considerably higher than the upper limit of the target range. Energy prices and the prices of fruit and vegetables significantly boosted the rise in the CPI during the last year, and the index excluding these items rose by 3.1 percent in that period.

Expectations and forecasts of inflation and the Bank of Israel interest rate
Inflation expectations for the next twelve months derived from the capital market have remained basically unchanged during the last few months. In May they stood at the midpoint of the target range—2 percent. The stability of these expectations is particularly notable in light of the higher-than-expected economic growth rate and against the background of the changes in the NIS exchange rate.

The average of one-year inflation expectations published by economic forecasters declined by 0.3 of a percentage point following the publication of the April CPI. The current average is 1.8 percent, with a relatively wide range of between 1.2 percent and 2.3 percent.

Inflation expectations for longer terms declined slightly during the last few months, and are within the target range: expectations for 2–3 years forward are 2.2 percent, and for 7–10 years, 2.6 percent. These measures incorporate an inflation-risk premium which rises with the length of the terms of the bonds, and they therefore have an upward bias.

Inflation expectations and forecasts depend also on assessments regarding the interest rate. About half of the forecasters expected the interest rate for June to rise, and the other half expected no change in the rate. The average of the forecasters' expectations is a rise of 0.6 of a percentage point in the Bank of Israel policy rate in the course of the next twelve months.[3] The estimate derived from the *makam*[4] curve for the next year is of a more moderate rise in the interest rate, i.e., 0.4 of a percentage point.

The policy-rate differential between Israel and abroad
The interest rate differential between the Bank of Israel rate and the Federal Reserve rate narrowed with the raising of the Fed rate, and is currently 0.25 of a percentage point.

Expected real interest rate
The expected short-term real interest rate has been on a rising trend since February 2006. The rise in real interest in the last few months is mainly due to the increase in the Bank of Israel interest rate.

The makam market and the bond market
The yield on 12-month *makam* rose to 5.8 percent in May, from 5.7 percent in April. In the government bonds market there was no significant change in price; the yield on 5-year CPI-indexed *Galil* bonds was 3.7 percent in May, the same as in April. The yield on 5-year unindexed *Shahar* bonds declined from 6.2 percent in April to 6.0 percent in May.

The yield gap between Israel and abroad
The nominal and real long-term yield gaps between Israeli and US bonds have declined in the last few months due to the rise in yields in the US, and the nominal gap narrowed from 160 basis points to an unprecedented low of 130 basis points.

The money supply
In April the annual rate of increase of the money supply reached its lowest level for eight months (17.9 percent), but is still high relative to the GDP growth rate *plus* the rate of inflation.

The econometric models[5]

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[3] The average of the range of forecasts.
[4] As derived from the term structure in the *makam* market (*makam*— short-term bills issued by the Bank of Israel for purposes of monetary management).
[5] The Bank of Israel uses results of various scenarios derived from econometric models. Due to the nature of the models, including the fact that their results naturally depend on certain assumptions about

Alternative scenarios examined using econometric models measured the dampening effect on inflation of the strengthening of the NIS, while the narrowing of the output gap (stronger demand and a lower rate of unemployment) acted in the opposite direction, and together with the rise in dollar prices of imports, constituted elements of inflationary pressure. The Research Department model showed that inflation for the previous twelve months is expected to come back within the target range with the publication of the June or July CPI. Using models together with judgmental adjustments, several scenarios were examined to assess the effect of various factors. For example, in the Monetary Department model, according to one of the simulations in which the Bank of Israel key interest rate rises to 5.5 percent in the second half of the year and the exchange rate moves around the level of NIS 4.5 to the dollar until the end of the year, inflation in 2006 will be 2.4 percent.

4. Capital flows, the foreign currency market and the share market

Capital flows

In April the inflow of long-term capital from nonresidents persisted, mostly in the form of direct investments, which totaled $ 0.5 billion. The outflow of capital by Israelis also continued in April, albeit in smaller amounts than in the previous months. The announcement of the sale of Iscar in May contributed to the positive atmosphere and to the strengthening of the NIS.

The foreign currency market

From the last policy-rate discussion on 24 April 2006 until 24 May the NIS strengthened by 0.9 percent against the dollar, weakened by 0.7 percent against the currency basket, and weakened by 3.3 percent against the euro. In the course of the period since the last monetary update, the financial markets continue to exhibit signs of strength, supported by mainly domestic factors. The strengthening of the NIS was partly the effect of the global weakening of the dollar for most of the period. The strength of the NIS was supported mainly by positive domestic events, headed by the purchase of Iscar at the beginning of May, in the wake of which the NIS gained one percent. In addition, Moody’s raising of Israel’s rating outlook to “positive” and the publication of the figures on Israel’s growth in the first quarter, which exceeded expectations, contributed to the continuation of the trend.

The resilience of Israel’s financial markets was particularly notable in the light of the weakness in other emerging markets. From the second week in May, the currencies of most developing economies weakened significantly, with concurrent sharp declines in their share markets. At that time Israel’s financial markets remained relatively stable, and the NIS behaved similarly to the currencies of the advanced economies. The NIS remained stable, yields on Israel’s capital markets hardly changed, and the TASE indices also stayed level.

The share market

The share market showed greater uncertainty than in the previous months, although the markets remained stable. On 28 May the Tel Aviv 100 index was back to its level of 24 April (the date of the last monetary update).

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relevant variables, these scenarios are taken as just one among several inputs in the discussions on the interest rate.

5. Israel's financial risk, the risk premium, and foreign investment houses' surveys

Credit rating agency Moody's raised Israel's foreign-currency and local-currency credit rating outlook from "stable" to "positive." In its statement, it noted that Israel, and particularly its decision makers, had demonstrated remarkable resilience in meeting the challenges facing it in recent years. Moody's also noted the impressive growth and continuing fall in the debt/GDP ratio. Following the upgrade, Moody's also raised the credit rating for Israel's five largest banks' long-term foreign-currency deposits from "stable" to "positive."

Israel's risk premium, as measured by the CDS spread, contracted this month to 30 basis points, similar to the contraction in risk premium among some of the emerging markets. However in Turkey, Brazil and South Africa, the CDS spreads expanded.

The foreign investment houses all noted the strength of the Israeli economy, even in surveys published before the publication of the latest growth figures for the economy. According to the reviews by foreign investment houses, the possible deterioration in the geopolitical scene constitutes a risk that could weaken the NIS, though the positive macroeconomic situation and the expected continued global weakening of the dollar support a further strengthening of the NIS against the dollar.

6. Developments in the global economy

General

Growth in the global economy, both in the developed and developing economies, remained strong and is expected to reach 4.9 percent in 2006 and a similar rate in 2007. The US, Japan and the euro zone are all growing at a rate close to potential, following a long period in which Europe and Japan were trailing behind. Inflation in most economies is at a low level and is even expected to fall slightly during 2006 and 2007. However energy and commodity prices together with the narrowing output gap in developed countries pose a danger of inflationary pressures.

Since the second week in May there has been a rise in investors' global risk aversion: positions regarded as risky began to be closed and volatility has increased. Relatively sharp falls were seen in bond and currency markets in the emerging economies, as well as a drop in commodity prices and stock indices in both the developed and emerging markets.

US

The initial figures for 2006 first-quarter GDP data published this month attested to an acceleration in growth in the US to an annual rate of 4.8 percent, in line with expectations. The strong growth rate is supported principally by a sharp rise in private consumption and in business-sector investment. Since the release of the initial Q1

GDP data, additional statistics for the quarter have been published that exceeded expectations. In light of this, economists believe that the Q1 GDP figure will be revised upward significantly to reach a growth level of around 5.8 percent.

As expected, the Fed raised its interest rate in May by 25 basis points to 5 percent. While the Fed left an opening for future interest rate rises, it changed the wording of its statement, saying that the extent and timing of any such increases will depend on inflation and growth forecasts as derived from macroeconomic data. The Fed's reference to the lagged economic effects of increases in interest rates and high energy prices also suggests that a rise in the interest rate at the next meeting at the end of June is not a foregone conclusion. Fed-rate futures contracts factor in a 25-basis-points rise in the meeting of the Open Market Committee of the Federal Reserve convened for June 29, with a probability of around 40 percent. However, most investment houses expect the interest rate to remain at 5 percent.

Europe

The rate of growth in the first quarter of 2006 increased, and stood at a quarterly 0.6 percent, in line with expectations. The ECB expects growth in Europe to rebound and broaden in the first half of 2006, while local demand, which has been weak until now, should improve gradually. In addition, the strong global economy will continue to provide support to the export sector and corporate investment is expected to remain high given the favorable financing conditions.

The investment houses expect average growth of 2.3 percent in the second quarter, similar to growth in the first quarter. They also expect average growth of 2.2 percent for the year 2006.

Inflation rose in April to an annual rate of 2.4 percent. The ECB expects inflation to remain above 2 percent in the short-term, though there is a risk of inflation overstepping this forecast due to developments in oil prices and the expected rise in indirect taxes in Europe. The investment houses on average expect inflation to fall below 2 percent only in the third quarter of 2006.

As anticipated, the ECB left the interest rate unchanged this month at 2.5 percent. The investment houses have on average factored in a rise in interest to 3 percent by the end of 2006, while the futures market has factored in a higher interest rate of 3.25 percent. The recent strengthening of the euro raises a question mark over how tight a monetary policy the ECB will follow.

Japan

GDP figures for the first quarter of 2006 attest to a slowing of growth for the Japanese economy to an annual rate of 1.9 percent.

Despite the relatively weak growth, other recent economic data attest to a continued broad economic revival. On average, investment houses predict a rise in the growth rate to 3.1 percent in the second quarter of 2006, and growth of 3.1 percent for the year as a whole.

The core inflation rate for March rose 0.5 percent in annual terms, the same as the rate in February. Investment houses expect inflation in Japan to remain positive throughout 2006. They further expect that the central bank will raise interest rates as early as the beginning of the second half of the year. The markets have now factored in a rise of 0.38 percentage points in the third quarter.

Emerging markets
After a long period of rising stock markets in the emerging economies, together with falling bond yields and strengthening currency rates, a change in trend began in the second week of May, in the form of a rise in global risk aversion among investors. In light of this, positions regarded as risky began to be closed and volatility has increased. Relatively sharp falls were seen in the bond, stock and currency markets in emerging economies, as well as in stocks and commodities in the rest of the world. Emerging markets' currencies weakened significantly. At the same time, the bond yield spread between the US and the emerging markets widened by more than 20 basis points, as measured by the EMBI+. Commodity prices, led by metals and energy, fell by around 7 percent. Although the markets have been calm in the past few days with the fall in share prices moderating, it is not clear if the rise in risk aversion will continue or if it is only temporary.

B. NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR JUNE 2006

The discussions this month took place against the background of the high rate of inflation in the past 12 months—above the upper limit of the target range—and the rapid rise in prices this year. The participants were of the opinion, on the basis of detailed monthly inflation forecasts, that there was a high probability that 12-month rolling inflation would return to within the target range within the next few months. The timing of the return, however, would depend on the behavior of the exchange rate, which has a nearly immediate effect on prices. They note that inflation expectations derived from the capital market and forecasters were that in the next 12 months inflation would be about 2 percent, and that capital market data and interest rate forecasts imply that to achieve this the Bank of Israel would be required to raise the interest rate by about 50 basis points.

The discussion focused on an analysis of the conflicting forces expected to affect prices in the future: on the one hand, the inflationary impact of the closing of the output gap; on the other, the strengthening of the NIS, that reduces inflationary pressures.

The participants in the discussion analyzed the inflationary forces that stem from the closure of the output gap, particularly given the latest National Accounts data which point to faster-than-expected growth. The Research Department noted that it was in the process of revising its growth forecast for 2006, and that the revised forecast would likely be about 5 percent for GDP, with a 6.5 percent rise in business-sector product. Participants were concerned both about the direct impact of the declining output gap on prices, and by its indirect effect operating through wage pressures.

In the discussion, it was noted that with labor productivity rising faster than wage costs, unit labor costs continue to fall. However in certain industries, particularly those that rely on skilled workers, the shortage of such workers has increased and nominal wages have risen relatively fast.

In addition to demand pressures pushing up prices in the economy, there are indicators that point to a rise in the dollar-price of imports, including in the energy sector.

In light of the importance of changes in the exchange rate on inflation, much of the discussion was devoted to an analysis of the effect of the appreciation of the NIS that has already taken place on the price indices in the coming months, and to the expected developments of the foreign currency market. In the background there is a possibility of a moderate rise in the Fed interest rate.

Participants expressed the opinion that the strengthening of the NIS from March to mid-May was the major factor acting to curb inflationary pressures in the short term. The NIS strengthened against the dollar by a cumulative 5 percent in the past month and a half, an appreciation that wiped out the depreciation of the currency in the second half of 2005 and the beginning of 2006. Developments in the foreign currency market have been influenced by global forces, particularly the global weakening of the dollar, but also by the positive assessments of the state of the economy and of the economic policies pursued by the government. Some of the participants believed that net capital flows were strengthening, supporting a stabilization of the exchange rate or even a further appreciation of the NIS, principally due to the positive evaluation of the Israeli economy by private financial institutions abroad. Other participants raised several possible scenarios, such as continued instability of the financial markets in the emerging economies, which could weaken the NIS in the foreign exchange market.

The government budget continues to be a restraining factor on aggregate demand and the participants believed that the budget will remain relatively restrained for this year.

In weighing up the various factors and influences on inflation, some of the participants in the discussion stressed that the recent strengthening of the NIS had the stronger effect, and would restrain inflationary pressures in the near future. Others emphasized that it was inadvisable to place too much weight on the recent strengthening of the NIS against the dollar, as the exchange rate can change rapidly in reaction to factors that affect the foreign currency market, and that these changes in the exchange rate very quickly affect the rate of inflation. In this analysis of the opposing forces that affect inflation, the econometric models supported the assessments that the moderating effect of the appreciation of the NIS was stronger and faster than the upward pressure on prices caused by the narrowing of the output gap.

In summary, the departmental directors participating in the discussion were of the opinion that the strengthening of the NIS against the dollar from March to mid-May would exert a stronger effect in restraining inflationary pressures in the near future than the inflationary effects of the narrowing output gap. In addition, they observed that recent increase in the Bank of Israel's interest rate, and the resulting rise in short-term real interest, will continue to moderate demand to some extent, as the effect of the rise in interest has not yet been expressed in full.

Despite the different weights afforded to conflicting forces acting on inflation, in assessing the whole range of considerations relevant to the interest rate decision all the department directors who participated in the discussion recommended that the interest rate for June be left unchanged. The Governor decided not to change the interest rate, which would remain for June at the level of 5.25 percent.

The decision was made and published on May 28, 2006.

Those present at the discussion:
Prof. Stanley Fischer, Governor of the Bank of Israel
Dr. Edward Offenbacher, Director of the Monetary Department
Barry Topf, Director of the Foreign Currency Department
Balfour Ozer, Director of the Foreign Exchange Activity Department
Dr. Karnit Flug, Director of the Research Department
Ohad Bar-Efrat, Head of International Affairs and Advisor to the Governor
Gaby Fiszman, Chief of Staff to the Governor
Amnon Jacoby, Advisor to the Governor
Sarit Giladi-Dor, Spokesperson and Media Advisor
Rimona Leibowitz, Deputy Spokesperson