BANK OF ISRAEL
Office of the Spokesperson and Economic Information

February 7, 2011

Report to the public on the Bank of Israel's discussions prior to setting the interest rate for February 2011

The discussions took place on January 23 and 24, 2011

General

Before the Governor makes the monthly interest rate decision,[1] discussions are held at two levels—the first in a broad forum, and the second in a narrower one.

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

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

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

1. Developments on the real side

General assessment

Indicators published in the last month (in the period from the decision on the January interest rate on December 27, 2010 till the current decision on January 24, 2011), showed that activity continued to increase in most sectors of the economy. The macroeconomic picture that emerges is that uses of resources, both domestic and

[1] When the Monetary Committee is appointed, in accordance with the new Bank of Israel Law, interest rate decisions will be made by the Committee.

imported, are growing at a rapid rate. GDP is changing consistently with these developments, with increases in capital utilization and labor productivity. Data from the Bank of Israel's Companies Survey and the latest Central Bureau of Statistics (CBS) estimates indicate that the expansionary trend is expected to continue in the first quarter of 2011, and the convergence towards the closure of the output gap is also continuing. The recent spread of demands for wage increases in the public sector and reports of companies in most sectors reported in the Companies Survey of difficulty in recruiting skilled staff show that the labor market is heating up.

The National Accounts

In the middle of January the CBS published its updated estimates of the National Accounts for the third quarter of 2010, showing an increase of 4.4 percent in GDP and of 5.1 percent in business sector product (annual rates, seasonally adjusted). The increase in GDP reflects marked increases in public consumption (8.3 percent compared with the second quarter) and in fixed investment (16.1 percent). In contrast, goods and services exports and private consumption remained basically unchanged. Initial estimates of GDP for the whole of 2010 are for a growth rate of 4.5 percent.

Companies’ reports to the Bank of Israel Companies Survey for the fourth quarter show that economic activity continued to expand at a pace similar to that since the beginning of the year. The increase in business sector activity encompassed all the principal industries, and it is expected to continue in the first quarter of 2011. The rise in the Consumer Confidence Index and the high level of the Purchasing Managers Index also point to an expansion of activity. The Bank of Israel Research Department index based on Google searches shows acceleration in domestic demand towards the end of 2010, and the probability of a slowdown remains below 50 percent.

The composite state-of-the-economy index

The composite state-of-the-economy indices indicate that economic growth continued, and in the last two months of 2010 at an even faster pace. The December index rose by a buoyant 0.7 percent, and the indices for the previous four months were revised upwards. The rise of the index in December was the outcome of increases in all its components, in particular in the index of service exports and imports indices. In the whole of 2010 the composite index rose by 4.2 percent, following a decline of 2.6 percent in 2009.

The labor market

The labor market continued to provide positive data indicating continued improvement in that area. The CBS survey of vacancies showed a fall of 2.1 percent in December compared with November. The average real wage per employee post increased by 3.3 percent in October compared with September, and the nominal wage by 3.7 percent (both seasonally adjusted), and in May–October compared with the same months in 2009 they increased by 1.4 percent and 3.8 percent respectively. It should be noted that the wage agreements signed recently in the public sector, and those due to be signed during the year, are likely to constitute another factor tending to increase wages. Preliminary data on health tax revenue in December, following the increase in November, point to a continued increase in total wage payments.

Foreign trade

In December manufactured exports increased by one percent compared with their November level, and goods exports accelerated (with a 3.1 percent increase). Goods imports increased by 5 percent, following their decline of 4.5 percent in November. The preliminary positive Triple Trade Index[2] for December shows that the rate of growth of world trade increased, after remaining steady for several months.

2. Budget data

The domestic deficit (excluding credit) in 2010 was NIS 30.2 billion, 3.7 percent of GDP. The December deficit alone was NIS 13 billion, about 1.7 percent of GDP. The large deficit in that month was due to an exceptional level of expenditure, exceeding the usual seasonal increase. Total tax revenues in 2010 were NIS 195.4 billion; after accounting for the effects of legislative changes and nonrecurring receipts this represents a real increase of 7.5 percent from the level in 2009.

3. Developments on the nominal side

Inflation

The December CPI rose by 0.4 percent, the top of the range of forecasters' inflation predictions. Inflation in 2010 was 2.7 percent, within the range of the price stability target. Excluding the housing component, the CPI increased by 1.9 percent in 2010.

The increase in the index in December was due mainly to the clothing and footwear component, which rose by 9.8 percent (a seasonal increase), communications (2.5 percent), and fresh fruit (which rose by 1 percent). The fresh vegetables and culture and entertainment items were the main components showing a decline.

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

[2] This index measures the total foreign trade of the US, Germany and Japan, and provides an early indicator of world trade.

The average of forecasters' inflation expectations for the next twelve monthly CPIs increased slightly to 3 percent, the upper limit of the target inflation range. One-year-forward inflation expectations calculated from the capital market also started increasing at the end of December, and their average in January this year was 3.2 percent, above the upper limit of the inflation target range. The forecasters expect, on average, that in the three months January to March 2010 the CPI will rise by a total of between –0.3 percent and +0.2 percent. Inflation measured over the previous twelve months is expected to be above the upper limit of the target inflation range for most of 2011, and to return to within the range towards the end of the year.

The average of the forecasters' predictions is that the interest rate in a year's time will be 3.3 percent. Most forecasters expect the Bank of Israel to increase the interest rate for February 2011.

The makam and bond markets

Yields on local currency government bonds increased slightly along the entire curve in the period between last month’s interest rate decision and the current one. The yield on indexed government bonds declined, against the background of the renewed rise in inflation expectations and in line with the worldwide trend, due inter alia to the increase in world commodity prices and the fact that the Bank of Israel did not increase the interest rate last month. The yield curve of unindexed government bonds showed increases in yields of about 5–10 basis points (b.p.) for different terms. The yield on unindexed government bonds showed a sharp decline of up to 35 b.p. and the curve steepened. This was due to the increase in inflation expectations and was in line with the global trend. The *makam* yield curve became steeper, and the yields did not change uniformly—yields up to three months declined by up to 20 b.p., and yields to the other terms increased by up to 10 b.p. This occurred against the background of renewed activity by foreign investors, an increase in daily turnover, and a steep drop in short yields.

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

Following the no-change interest rate decision for January and prior to the current interest rate decision, the Bank of Israel interest rate was 1.75–2.0 percentage points higher than the US federal funds rate and 1 percentage point higher than the ECB rate. In December and January the yield gap between ten-year unindexed Israeli and US government bonds widened to 143 b.p., compared with 128 b.p. in the previous month, due mainly to a sharper increase in yields in Israel.

The expected real interest rate

The Bank of Israel interest rate—*deflated* by the twelve-months-forward inflation expectations derived from the capital markets—averaged *minus* 1.1 percent in January (to the date of the current discussions), a decrease of 0.2 percentage points from the December level, due to a similar increase in inflation expectations.

The monetary aggregates

The M1 monetary aggregate (cash held by the public and demand deposits) increased by 2.3 percent in December, and the M2 aggregate (M1 *plus* unindexed deposits of up to one year) increased by 1.9 percent. In the whole of 2010 the M1 aggregate increased by 4.1 percent, and M2 by 3.3 percent, significantly slower rates of expansion than in the years prior to the latest global crisis.

The credit markets

The total balance of business sector credit increased by 0.9 percent in November, to NIS 755 billion; half of the increase derived from the depreciation of the shekel against the dollar. From January to November 2010 this credit grew by 2.5 percent. The balance of credit to households increased by 9.4 percent in January–November 2010. The balance of housing loans in November 2010 was 10 percent higher than that at the end of 2009. Of the total housing credit advanced in December, 47 percent was unindexed at floating interest rates, compared with the monthly average of 50.4 percent in the whole of 2010.

The housing market

House prices—which are presented in the CBS survey of house prices and which are not included in the CPI—increased in October–November at a rate of 1.4 percent a month, following their increase of 0.4 percent in September–October. In 2010 house prices increased by a steep 17.3 percent. The ratio of house prices to rentals and to the wage per employee post also increased.

The housing price index, which is based mainly on renewed rental contracts and which is included in the CPI, rose by 0.3 percent in December, after remaining unchanged in November. The housing price index increased by 4.9 percent in 2010 as a whole.

The Research Department assessment (staff forecast)

The Bank of Israel staff forecast is that inflation in 2011 will be 2.6 percent, with a gradual increase in the interest rate to about 3.3 percent in the last quarter of the year.

The main reason for expectations that inflation will be in the upper part of the target range are: the price of housing (rentals), which is expected to continue rising rapidly, an increase in aggregate demand, and increases in energy and commodity prices. Factors acting in the opposite direction are the low level of inflation in the advanced economies, and the appreciation of the shekel, which act to slow the rate of price increases.

The main risks to real economic activity and inflation in Israel derive from developments abroad and in the housing market. Substantial capital inflows into Israel, should they occur, with the pressures towards appreciation that they cause, would have a moderating effect on growth, inflation, and the pace of interest rate increases.

4. The foreign currency market and the share market

The foreign-currency market

From the previous monetary policy discussion held on December 26, 2010 until January 21, 2011, the shekel depreciated by 2.8 percent in terms of the nominal effective exchange rate.[3] The measures relating to the foreign currency market announced by the Bank of Israel in the third week of January weakened the shekel, and in the period December 26 to January 21 it depreciated by 0.7 percent against the dollar. Against the euro the shekel depreciated by 5 percent, in line with the changes in the major currencies.

The capital market

Between the monetary policy discussions of December 26 and January 21, the Tel Aviv 25 index rose by 2.3 percent, and the volume of trade on the stock exchange increased. In this period stock markets around the world showed a mixed trend. The implied volatility of Maof (Tel Aviv 25) options dropped considerably in December and January to 17–18 percent, from a level of more than 20 percent in the preceding months. In the corporate bond market the Tel-Bond 20 index rose by 2 percent, and the Tel-Bond 40 index by 2.2 percent. New issues of corporate bonds totaled NIS 4.9 billion in December, about 45 percent higher than the average monthly flotation in 2010. Most issues were in banking (totaling NIS 2.6 billion) and in trade and services (NIS 1.2 billion). Seventy-one percent of the issues were graded AA. In the first quarter of 2011 repayments of NIS 6.9 billion are expected, of which about one-third is expected to be in the real estate industry.

[3] Calculated as the trade-weighted average shekel exchange rate against 28 currencies (representing 38 of Israel's trading partners). The weight of the dollar in the effective exchange rate is about 25 percent, and that of the euro, about 33 percent.

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

Israel's risk premium, as measured by the five-year credit default swap (CDS) spread, decreased slightly to 115 b.p.

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

The most recent macroeconomic data relating to the global economy, and in particular to the US and China, indicate that the recovery from the crisis is becoming firmer. Nevertheless, high rates of unemployment and low rates of growth in the advanced economies continue to temper the general optimism. Concerns related to the European debt crisis eased slightly in light of several successful bond issues by some of the PIIGS countries (Portugal, Ireland, Italy, Greece and Spain). The need to borrow on a large scale in some of those countries in the coming year and the uncertainty in the European markets are expected to keep the situation in Europe the focus of attention in the global economy in the near future. Inflation in the US remained low, while in the eurozone inflation exceeded the target this month. In light of that development the expected timing of an increase in the interest rate in Europe was brought forward a little. Inflationary pressures continue to mount in the emerging market economies, deriving from the steep increases in commodity prices in general, and food prices in particular. Those increases give rise to concern over possible contractionary measures that could hold back global growth.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR FEBRUARY 2011

In the narrow-forum discussion, four members of management make recommendations to the Governor regarding the appropriate rate of interest for the economy. In the current discussions on the interest rate for February, all the participating members of management recommended that the Governor increase the interest rate by 0.25 of a percentage point, to 2.25 percent.

As stated in previous announcements of interest rate decisions, the Bank of Israel is implementing a policy consistent with the process of gradually restoring a more normal interest rate environment—a process aimed at stabilizing inflation within the target range, and supporting further growth of economic activity while maintaining financial stability. The pace of interest rate increases depends on the inflation environment, growth in Israel and globally, the monetary policies of the major central banks, developments in asset prices, and the exchange rates of the shekel. The 25-basis-point increase in the interest rate for February is consistent with that process. At the new rate of interest, monetary policy continuous to be expansionary.

Several issues were discussed, in particular the actual path of inflation and that expected in the future, the development of asset prices, mainly in the housing market, and the effect on the exchange rate of widening the differential between the interest rate in Israel and rates abroad. All the above is in the context of expanding economic activity and more buoyant assessments of the recovery of the global economy.

In the discussion it was noted that the change in forecasters' predictions of inflation and those derived from the capital market indicate the need for an increase in the interest rate. The point was emphasized that forecasters' predictions were currently at the upper limit of the target inflation range, and those derived from the capital market were even higher. It was also noted that the Bank of Israel Research Department forecast shows that inflation in the coming year is expected to be around the midpoint of the target range, with the interest rate on a rising path. Most forecasters expect the Bank to increase the interest rate for February.

Members of the narrow forum agreed that the substantial expansion in economic activity and employment was continuing. The latest published data showed that in the last month (from the previous interest rate decision to the current one) activity increased in most economic sectors. The expansion is expected to continue at a similar pace in the first quarter of 2011 and to boost inflation. It was also noted that the most recent data indicate more positive assessments of the recovery of the global economy from the economic crisis. The participants in the discussion were of the opinion that the totality of the above considerations also supports an increase in the interest rate.

Developments in the housing market were also discussed. House prices increased by 17.3 percent during 2010. This took place against the background of the rapid expansion of housing credit reflecting the effect of the low rate of interest and also the relatively slow adjustment of the supply of houses. The latest figures (relating to October–November) showed a renewed acceleration in prices and that there was a marked increase in the volume of new housing loans (with a significant share at floating interest rates). The outstanding balance of housing loans towards the end of 2010 (in November) was 10 percent higher than that in December 2009. Participants agreed that there was a significant probability that housing prices would continue their rapid rate of increase in the coming year. In light of developments in the housing market, participants discussed the effects of the steps taken so far in the economy to influence housing prices. It was suggested that the Bank of Israel would need to introduce other macroprudential measures if there was no change in the path of prices and in the degree of leverage. With regard to prices of other assets, attention was drawn to the latest developments in share prices, and the need to monitor those prices more closely.

Another issue discussed was the expected effect of the proposed increase in the interest rate on the exchange rate of the shekel. Participants expressed the view that the increase in the interest rate would strengthen the existing pressures for appreciation of the shekel, as it would attract capital inflow, and hence strengthen the shekel. This is in light of the fact that the interest rates of the leading advanced economies remained unchanged. Acting in the opposite direction, however, were the new Bank of Israel directives strengthening the reporting requirement and increasing the liquidity requirement, which were intended to weaken the above forces somewhat and to act to moderate the effect of the widening of the interest rate differential on the appreciation of the shekel. Additionally, the question was discussed whether there was still a need for intervention in the foreign currency market, and if so, what degree of intervention was required. Discussion focused particularly on how much flexibility the exchange rate should be allowed, and the implications of various scenarios on the trade balance and on capital flows. It was agreed that in light of the developments on the real side during 2010, the Bank of Israel's policy announced in August 2009 was still essential and should continue.

In its announcement of the decision, the Bank of Israel emphasized the following points for increasing the interest rate for February 2011:

- Inflation in the last twelve months was within the target range. Inflation expectations of forecasters for one year ahead are at the upper limit of the target range, and those derived from the capital market are above it. The Bank of Israel Research Department staff forecast, however, is that inflation will be 2.6 percent in 2011. These forecasts are based on expectations that the interest rate will be increased. Inflation measured over the previous twelve months is expected to be above the upper limit of the target inflation range for most of 2011, and to return to within the range towards the end of the year.

- The acceleration in house prices was renewed last month, and in the last twelve months they have risen by 17.3 percent. The volume of new housing loans increased steeply in December. The outstanding balance of housing loans at the end of 2010 was 14.7 percent higher than that at the end of 2009.

- Up-to-date economic indicators and data show that the rapid growth in the first three quarters of 2010 continued in the fourth quarter. Growth was evident in most areas of economic activity, and is expected to continue in the first quarter of 2011. Recently published data indicate that the global economy is continuing along the path of recovery from the economic crisis.

- The decision to increase the interest rate was taken despite the fact that interest rates of the central banks in the major advanced economies are at low levels and are not expected to rise in the near future. Nevertheless, some central banks in economies that are already showing relatively fast rates of growth continued the process of raising their interest rates again last month. Against this background, the amendment issued last week by the Bank of Israel to the liquidity directive contributed to a weakening of the shekel and is also expected to moderate the effect of the increase in the interest rate differentials on the strengthening of the shekel.

The Bank of Israel will use the instruments 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, including keeping a close watch on developments in the assets market, and especially in the housing market.

The decision was made and published on January 24, 2011.

Participants in the narrow-forum discussion:

Prof. Stanley Fischer, Governor of the Bank of Israel
Prof. Zvi Eckstein, Deputy Governor of the Bank of Israel
Dr. Karnit Flug, Director of the Research Department
Dr. Edward Offenbacher, Member of Management and Head of the Monetary and Finance Division, Research Department
Mr. Barry Topf, Director of the Market Operations Department
Mr. David Zaken, Supervisor of Banks
Mr. Eddy Azoulay, Chief of Staff to the Governor
Dr. Yossi Saadon, Advisor to the Governor and Bank of Israel Spokesperson
Mr. Konstantin Konsenko, Economist, Research Department

Appendix: Major Global Economic Developments

The US

US macroeconomic data continue to indicate an improvement in the recovery from the economic crisis.

Last month there was a marked rise in private consumption (which is expected to be supported by further tax relief measures and the considerable strengthening of the share market), in credit to the private and business sector, and in the recovery in the motor vehicle industry (the last two which are expected to support the recruitment of additional workers). In addition, exports grew and the manufacturing and services indices strengthened and are at higher levels than in the previous period. Employment data also seem to indicate an improvement, with a further decline in the number of layoffs, the creation of about 100,000 new jobs, and a drop in the unemployment rate from 9.8 percent to "only" 9.4 percent. The minutes of the Federal Open Market Committee (following the decision to hold the interest rate at the near zero level for an extended period in light of the low level of inflation) show that the Committee members consider that the economic situation in the US is improving. Furthermore, the Fed chairman informed the Senate that private consumption and expenditure by small businesses indicate a sustainable recovery, and he even increased the growth forecast for 2011 to 3–4 percent.

Nevertheless, despite the positive and optimistic macroeconomic market data relating to the US economy, several aspects continue to dampen the optimism and require attention:

- First, the employment situation seems to be worse than the data suggest, and the labor market continues to be a very serious risk factor to growth in the US. Thus, for example, the unemployment rate calculated via the comprehensive (U-6) method (a more comprehensive gauge of labor underutilization) is about 16.7 percent, compared with the 9.4 percent rate actually reported.

- Second, the lack of occupational security and falling house prices related to the extent of foreclosures that reached an unprecedented level in 2010 (and which is expected to continue increasing in 2011) continue to indicate the shaky situation in the housing market.
- The increase in the government deficit and the statement by the Secretary of the Treasury that the government's deficit ceiling, currently $14.3 trillion, is likely to be exceeded as early as the end of March, increase the risks that the quantitative easing program will be cut back later in the year. Without an improvement in the labor market, this development is likely to be expressed by a fall in private consumption in the future.

In addition, despite the World Bank review that stated that the US is the only large economy in which the rate of growth is not expected to decline in 2011 (the expectation is growth of 2.8 percent), and the increase in investment houses' 2011 US growth forecasts from 3.07 percent to 3.30 percent, that remains a low rate of growth for a period of exiting from a crisis. At such a time growth should be significantly faster than the long-term rate, and it is likely to decline in the future due to a fall in the participation rate in the labor market.

Europe

Macroeconomic data on Europe continue to present a mixed picture, with disappointing figures of retail sales and manufacturing (recently also in Germany), but with rises in the Purchasing Managers Index and economic confidence which reveal optimism about future growth. The European debt crisis eased a little following several successful bond issues by some of the PIIGS countries (Portugal, Ireland, Italy, Greece and Spain) (that were supported by the ECB, China and Japan), and some softening of the German opposition to expanding the European Financial Stability Facility (EFSF). However, the need for heavy borrowing in the coming year[4] and the atmosphere of uncertainty prevailing in the European markets are expected to keep the European debt crisis at the center of attention of the global economy in the near future.

In addition, the ECB, which since the outbreak of the crisis has pursued an expansionary monetary policy in light of the low growth rates and high levels of debt, is for the first time caught in a dilemma, as **inflation in December was higher than the target, at 2.2 percent, the highest level since November 2008**. As was the case with growth rates and the deficit/GDP ratio, inflation too differs greatly between the PIIGS countries and the core members of the eurozone (Germany recorded the highest growth since reunification in 1990), a fact that is likely to make it more difficult to pursue a uniform monetary policy in such a heterogeneous group of countries. Although the ECB president decided not to increase the interest rate this month, the

[4] It should be noted that despite the success of Italy, Portugal and Spain in raising a total of some €10 billion, they are supposed to raise another €150 billion during the year.

market interpreted his statement that the interest rate is appropriate to the level of inflation as a hint that he would be prepared to increase the interest rate in the future to tackle inflation, despite the European debt crisis.

The emerging markets

The emerging markets continue to lead the global economy. China reported a 10 percent growth rate in 2010, and its share of world trade continued to increase. Recently, however, it seems that there has been some slowdown, with a decline in exports, in the trade surplus vis-à-vis the US, and in the Purchasing Managers Index, apparently due to the tightening of monetary policy. China is still facing the problem of inflation which mainly affects the poor, with steep rises particularly in food prices and more moderate increases in energy prices. Inflation is thought to have been greatly affected by the weather which ruined crops around the world, so that at least part of its contribution to inflation may be temporary.

In the struggle against rising inflation, the Chinese authorities threatened to impose sanctions on speculators who cause food prices to increase, and the press in China recently reported that it is intended to impose a property tax for the first time. In addition, the banks' reserve ratio was increased by 50 basis points this month (to 18.5 percent for the large banks and to an average of 19.5 percent for all banks), following no fewer than six increases in 2010. All the above steps were aimed at avoiding further increases in the interest rate, that would widen the differential vis-à-vis the emerging market economies, thereby increasing the inflow of capital from there and threatening the stability of the market by creating bubbles in asset prices. The World Bank survey states that the main risks to the emerging markets are the fluctuations in the financial markets, the ongoing inflow of capital from the advanced economies, and the sharp increase in food prices.

The capital markets

Stock markets around the world reacted to the positive macroeconomic data from the US and the high level of liquidity for the successful bond issues in Europe with price increases, with the MSCI world index rising by 2.7 percent since the previous monetary survey, and the EMCI index of the emerging markets by 3 percent. Bond markets were volatile during the period since the previous interest rate discussions, but over the period as a whole there were only small changes. The EMBI spread also remained unchanged.