Bank of Israel

Report to the public of the Bank of Israel's discussions prior to setting the interest rate for May 2008

The discussions took place on 27 and 28 April 2008

General

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

In the broad-forum discussion, the relevant background economic conditions are presented, including real and monetary 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 economic departments of the Bank (the Research, Monetary, Foreign Currency, and Foreign Exchange Activity departments) 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 economic departments 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

In 2008:Q1 the first indications of a slowdown in the rate of growth became visible. The Bank of Israel growth forecast for 2008 is 3.2 percent.

The Companies Survey

The Companies Survey for 2008:Q1 shows that in that period the rate of increase of business sector activity started slowing compared to its rate in the previous quarter. This occurred in most industries, with the notable exceptions of the hotel and retail commerce industries in which activity expanded.

Companies participating in the survey reported that the drop in demand made it difficult for them to increase activity in the first quarter compared to the previous one. In contrast, the production capacity constraint affected companies less than in the previous quarters.

The composite state-of-the-economy index

The composite state-of-the-economy index rose by 0.5 percent in March. The rise of the index in the first quarter, which averaged about 0.4 percent per month, is consistent with the continued expansion of economic activity. The rise in the index in March was due mainly to the increase in services exports and goods imports and exports. The index of manufacturing production moderated the increase in the index this month.

The index for February was left unchanged, but that for January was amended downwards, from 0.4 percent to 0.2 percent.

The labor market

The number of employee posts in the economy rose between November 2007 and January 2008 by 4.7 percent relative to the same period a year earlier.

Over the same period the nominal wage per employee post increased by 2.9 percent in the business sector and by 5.4 percent in the public sector.

Foreign trade and the balance of payments

Goods exports (excluding diamonds) expanded in 2008:Q1 by about 19.7 percent relative to 2007:Q1 (in dollar terms, seasonally adjusted, annual rate). In March these exports rose by 6.4 percent from their February level (in dollar terms, seasonally adjusted).

The import of goods (excluding ships, aircraft and diamonds) grew by 24.6 percent in 2008:Q1 (in dollar terms, seasonally adjusted, annual rate) relative to 2007:Q1. In March these imports rose by 4.5 percent from their February level (in dollar terms, seasonally adjusted, monthly rate).

2. Budget data

In the first quarter of 2008 the government's had an overall surplus, excluding credit, higher than the seasonal path consistent with the 1.6 percent of GDP target deficit for the year.

3. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) rose by 0.3 percent in March 2008, above the assessments of private forecasters (which had ranged from no change to a decline of 0.4 percent), and close to the seasonal path consistent with the midpoint of the target inflation range. The surprise in the March index compared with the forecasts was essentially due to the housing component, which rose by 0.4 percent against expectations of a 1.5 percent decline, and which continues to express the weakening of the link between changes in the NIS/$ exchange rate and housing prices. The main other components of the index that increased were food (which rose by 1.6 percent), and transport and communications (0.5 percent), against the background of the rises in world prices of food and energy. In the last twelve months the CPI has risen by 3.7 percent, above the inflation target, and despite the strengthening of the shekel against the dollar by about 13 percent during that period. The CPI excluding the energy and food components, which constitutes 79 percent of the overall index, rose by 1.8 percent in the past twelve months

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

The expectations of inflation for the next 12 months, as derived from the capital market (break-even inflation), rose in April, after the publication of the March CPI, to about 3 percent. The local forecasters predict, on average, that inflation during the next 12 months will be about 3 percent (compared to their forecasts of 2.7 percent last month).

On average, local forecasters expect that the cumulative rise in the CPI for the months April to June 2008 will be 1.6 percent.

Local forecasters estimate, on average, that the interest rate for May will be left unchanged, and that the Bank of Israel interest rate at the end of 2008 will be about 3.5 percent and in twelve months will be 3.7 percent.

At the time of the decision on the interest rate for May, the slope of the *makam* yield curve reflected the financial market's expectations of a rise of about 0.75 percentage points in the Bank of Israel interest rate in the next twelve months.

The makam and bond markets

The interest rate on CPI-indexed 5-year bonds rose a little on average from 2.3 percent in March to 2.4 percent in April. The nominal yield on unindexed 5-year government bonds rose during the last month by about 0.1 percentage points and its average level during April was about 5.1 percent. The nominal yield on one-year *makam* fell by about 0.2 percentage points in April from its March level, to an average level of 3.6 percent.

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

Prior to this interest rate decision, the Bank of Israel interest rate was one percentage point higher than the US federal funds rate and 0.75 percentage points lower than the ECB rate.

The spread between unindexed shekel yields and 10-year US bond yields declined during the last month from 210 basis points on 24 March to 197 basis points on 24 April.

The expected real interest rate

The expected real rate of interest (the Bank of Israel interest rate *minus* inflation expectations) for one year forward was about 0.8 percent on average in April, a decline of about 0.3 percentage points from the March level.

The money supply

The annual rate of increase of the (M1) money supply in March (measured over the previous twelve months) was about 13 percent.

The econometric models[1]

Various scenarios were examined using the Bank of Israel's econometric models. However, in recent months they have yielded contradictory results, thus making it difficult to rely on their outputs. According to the Research Department's quarterly model, in a scenario in which prices abroad rise by 2 percent a year, the unemployment rate stays steady from 2008:Q3 at 7.6 percent, the exchange rate stabilizes at NIS 3.51 to the dollar, and the Bank of Israel interest rate rises to 4.75 percent by the end of 2008, the rate of inflation in 2008 will be about 2.7 percent.

According to the Monetary Department's quarterly model, in a scenario in which the derived Bank of Israel interest rate rises from an average of 3.3 percent in the second quarter of 2008 to an average level of 3.6 percent in the last quarter, with an average exchange rate of about NIS 3.53 to the dollar in the last quarter, inflation will reach 3.1 percent in 2008. According to this scenario, the interest rate reduces to 3.2 percent in the second quarter of 2009, and inflation in 2009 is 1.5 percent.

The results of the models are particularly sensitive to changes in the exchange rate.

4. The foreign currency market and the share market

The foreign-currency market

During the month since the previous interest rate discussions, the shekel strengthened against the dollar, from about NIS 3.52 to the dollar on 24 March to NIS 3.45 on 24 April, i.e., an appreciation of about 2 percent. During the same period the shekel remained steady against the euro, at NIS 5.44 to the euro on both 24 March and 24 April.

Since 24 March the Bank of Israel has been implementing its plan to increase the foreign exchange reserves by $10 billion in the next two years by purchasing about $25 million a day on the market.

The share market

From the previous interest rate decision on 24 March until 24 April the Tel Aviv 25 share price index rose by about 6.9 percent but since the beginning of the year it has fallen by about 10 percent, against the background of the sharp declines in share markets around the world.

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

Israel's risk premium, as measured by the five-year CDS spread, dropped this month from about 90 basis points to about 60 basis points. CDS spreads for most emerging economies declined at similar rates.

On 17 April Moody's upgraded Israel's local currency and foreign currency government bonds from A2 to A1.

[1] The Bank of Israel uses econometric models to test various scenarios. Due to their nature, including the fact that their results naturally depend on certain assumptions about relevant variables, the scenarios should be viewed as one input among several in the discussions on the interest rate.

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

In April the IMF published its prediction of slower world growth in 2008, 3.7 percent, and in 2009, 3.8 percent, compared with a rate of 4.9 percent in 2007.

During the past month the world's financial markets were somewhat calmer, with a reduction in risk premia, but it is too soon to assume that the financial crisis has reached a turning point.

World prices of food, commodities and energy continued rising last month, and the risks of global inflation increased.

At the time of these Bank of Israel's interest rate discussions for the month of May, prices of futures contracts reflected expectations of an additional 0.25 percentage point reduction in the Fed interest rate at its next meeting, on 30 April, without further reductions thereafter. The Bank of England was also expected to cut its interest rate. The ECB and the Bank of Japan were not expected to cut their interest rates before the end of 2008.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR MAY 2008

The participants in the discussion analyzed the rapid rise of energy and food prices around the world in the last few months, and its effect on inflation in Israel. They noted that the continued rise in these prices constituted an inflationary pressure in many economies. In Israel, too, the deviation from the inflation target over the previous twelve months was the outcome of the rises in energy and food prices. The point was made that the increases in food prices till now was higher than had been expected, and would apparently continue to contribute to inflation.

Although inflation in the last three months was consistent with the inflation target of 1–3 percent a year, the March index was higher than expected. This, together with the increases in food and energy prices, pushed inflation expectations and forecasts for the next twelve months up to about 3 percent, the upper limit of the target.

Participants also discussed the possibility of a weakening of the shekel during the year. The Bank of Israel's assessment is that the current account of the balance of payments will change from a $5 billion surplus in 2007 to a smaller one in 2008, or even to a small deficit. This fact, together with the Bank's purchases of foreign currency (in the context of the program it announced of raising the foreign exchange reserves by about $10 billion in the next two years) could weaken the shekel, and counter the trend of the strengthening of the shekel evident in the last few months. If the shekel does weaken, the exchange rate will no longer offset the forces exerting inflationary pressure, as it did in the 2007 and the first quarter of 2008.

The point was made that acting in the opposite direction to the inflationary forces were several factors tending to reduce those pressures, reflected by the assessments that the slowdown in growth in the US and the reduced expansion of demand in Europe and the rest of the world are expected to continue into 2009. The global slowdown is expected to affect Israel's rate of growth and through it, inflation, and it may also have an effect on the rise in world commodity prices.

The rate of growth in Israel is expected to slow to 3.2 percent in 2008, higher than in most of the advanced economies but slower than the rate in Israel in the last four years. Responses from companies participating in the Bank of Israel Companies Survey for 2008:Q1 are consistent with predictions of a slowdown in growth.

In light of the expected slowdown in world growth, further interest rate cuts are expected in the advanced economies, although the extent of the cuts moderated in the last month.

Taking account of these conflicting forces affecting inflation, all members of the executive recommended no change in the interest rate for May, and the Governor decided to leave the rate unchanged for May, at 3.25 percent.

The Bank of Israel will continue to monitor economic developments closely, and will stand ready to raise the interest rate as necessary to preserve price stability. Subject to this, the Bank will continue to support the attainment of a range of objectives of macroeconomic policy, in particular the encouragement of employment and growth. In addition, the Bank will continue to support the stability of the financial system.

The decision was made and published on 28 April 2008.

Those participating 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, Director of the Monetary Department
Mr. Barry Topf, Director of the Foreign Currency Department
Mr. Balfour Ozer, Member of the Executive
Dr. Ohad Bar-Efrat, Advisor to the Governor and Head of International Affairs
Mr. Gaby Fiszman, Chief of Staff to the Governor
Dr. Yossi Saadon, Bank of Israel Spokesperson

Appendix: Major Global Economic Developments

U.S.

Last month the IMF published its forecast of US economic would growth—0.5 percent in 2008 and 0.6 percent in 2009, compared with a growth ate of 2.2 percent in 2007.

The labor market, which had shown strength for a long time, weakened considerably again this month, indicating that the crisis in the housing market is continuing to affect other sectors of the economy. Labor market data for March showed a reduction in the number of wage earners for the third month in succession, with a concurrent rise in the number of job hunters. The rate of unemployment rose significantly, by 0.3 percent, to 5.1 percent.

Data on the housing market continue to indicate further deterioration. The very high number of houses available for sale is not likely to fall in the near future, and this in the context of the continued fall in house prices, the tightening of credit terms, and the significant rise in foreclosures on houses.

Although the Purchasing Managers Indices in the manufacturing sector and in the services sector rose slightly in March, they remain below 50, indicating contraction of economic activity.

The slowdown in private consumption has become more severe, and consumer confidence surveys continue to indicate a sharp drop in the confidence of the American consumer to its lowest level since the 1980s. Although data of wholesale sales in March came as a pleasant surprise, showing a slight increase, this reflected a correction to the steep fall in February. The negative momentum in private consumption data is expected to persist, in light of the continuing rise in fuel prices, the weakness in the labor market, the tightening of credit terms, and the impact on the wealth effect of the US consumer resulting from falls in real estate prices and the share market since the crisis started.

The Fed forecasts that inflation will remain high in the coming months, but that it will moderate in 2009, in light of the expected economic slowdown and the fact that households' medium- and long- term inflation expectations have stayed moderate till now.

These expectations and the calm in the financial markets this month reduced expectations of an interest rate cut, and prices of Fed interest rate futures reflect an expected 25 basis point reduction in interest at the next Federal Open Market Committee (FOMC) towards the end of April, with no further reductions following.

Europe

The IMF forecast last month predicts growth in the Euro area of 1.4 percent in 2008 and 1.2 percent in 2009, compared with growth of 2.6 percent in 2007.

The ECB estimates that domestic demand and demand from abroad will continue to support the EU economy, although to a lesser extent that in 2007.

Uncertainty about the growth forecast is unusually high, in light of the crisis in the financial markets that is likely to persist longer and to have a greater effect than originally expected. In addition, the continued rise of food and energy prices together with the strengthening of the euro constitute a downside risk to the resilience of the export sector, private consumption and companies' investments.

Inflation in the euro zone rose in March, and the rise in the CPI during the previous twelve months reached 3.6 percent. The rise in inflation was mainly a reflection of the sharp increases in food and energy prices in the last few months. The European Central Bank (ECB) expects that inflation will remain above its 2 percent target, and that it will decline gradually in the course of 2008.

Japan

The IMF forecast for Japan last month was that growth would be 1.4 percent in 2008 and 1.5 percent in 2009, compared with growth of 2.1 percent in 2007.

Although the export sector is expected to continue to contribute towards economic growth, a significant slowdown in world growth is likely to have a serious impact on Japan's exports. Company profits, although still at a high level, have declined recently, and at the same time the business confidence index has dropped to its lowest level in four years, in light of the strengthening of the yen and the slowdown in the US. As a result, company investment is also expected to fall. Data on manufacturing production also disappointed, showing a reduction for the second month in succession against the background of concern over lower global demand. On the other hand, private consumption is expected to continue improving in light of the further moderate rise in household income.

Inflation data published this month continue to indicate an upward trend. Core inflation (excluding fresh food) was surprisingly high, and in February reached 1 percent, measured over the previous twelve months. This can be ascribed mainly to the rise in prices of energy and imported raw material. As expected, the Bank of Japan left the interest rate unchanged at 0.5 percent. Investment houses and central bank interest rate futures do not indicate expectations of a change in interest in 2008.

The emerging markets

The figures for growth in the emerging markets have remained strong until now in most of the countries. The IMF forecast a growth rate of 6.7 percent in 2008 in the emerging and developing economies, and a rate of 6.6 percent in 2009., down from 7.9 percent in 2007. The Chinese economy is expected to grow by 9.3 percent in 2008, and the Indian economy by 7.9 percent.

In the emerging and developing economies too inflation risks have risen recently and have attracted much attention, due to the problem of poverty that exists in several of those countries and the sharp increase in food prices.