



Bank of Israel

MONETARY POLICY REPORT

January-June 2013

39

August 2013

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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 a year. The report includes a survey of developments in the areas of price stability and 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.

The Monetary Policy Report is prepared by economists in the Research Department, within the guidelines of the Bank of Israel Monetary Committee, the forum in which monetary policy decisions are reached. The report for the first half of 2013 is based on data that were published up to July 29, 2013, the date of the decision on the interest rate for August 2013.

SUMMARY

- **Monetary and macroprudential policy:** During the first half of 2013, the Monetary Committee lowered the interest rate by 0.75 percentage points to 1.25 percent for July. In view of the continued appreciation in the shekel exchange rate, the Committee decided in April to intervene in the foreign exchange market, and it decided in mid-May, in addition to lowering the interest rate, to implement a foreign exchange purchasing program in order to offset the effect of local natural gas production on the exchange rate. These measures were intended to strengthen the economy's ability to deal with the possible ramifications of the deepening slowdown in the global economy, and to moderate the pressure for appreciation that derived from accommodative monetary policy worldwide and from the expected improvement in the balance of payments as a result of the production of local natural gas. All this was against the background of the continued moderation in the inflation environment and the continued moderate growth in the economy, taking into account the risks implicit in the rapid increase of home prices and the measures adopted by the Supervisor of Banks to reduce them. The interest rate for August was left unchanged at 1.25 percent.
- **Inflation and inflation expectations:** The Consumer Price Index increased during the reviewed period by 1.3 percent, and increased by 1.1 percent on a seasonally adjusted basis. Actual inflation (over the previous 12 months) continued to decline, and fell below the lower bound of the price stability target range in April, but again increased to the center of the target range in June. Forecasters' projections and 12-month inflation expectations as derived from the capital markets ranged slightly below the center of the target range throughout the reviewed period.
- **Domestic real economic activity:** During the first quarter of 2013, GDP grew by 2.9 percent, similar to its average pace of growth in 2012, with a slowdown in growth of business sector product alongside an expansion of exports and of private consumption and a worsening decline in investments. In the labor market, the decline in the unemployment rate was halted, with a slowdown in expansion of employment and a decline in real wages.
- **The global economic environment:** The situation in Europe continued to be a main risk to global growth, and in recent months, there was an added risk of a deepening slowdown in the emerging markets. During the reviewed period, the contraction in activity in Europe continued, and the slowdown spread into Germany and France as well. In the US, the recovery continued with a decline in the unemployment rate and an improvement in the housing market. The slowdown in the major emerging markets continued, and in recent months, there have been increasing signs of the slowdown deepening. The worsening slowdown in the global economy was reflected in the continued stagnation in global trade. In response to the worsening of the real economic situation worldwide, the leading central banks continued to adopt accommodative monetary policies, which was expressed in a continuation—and even an increase—of quantitative easing programs and interest rate reductions. Against the background of the improvement in macroeconomic conditions in the US, the Federal Reserve announced in June that it would reduce quantitative easing should the improvement continue.
- **The exchange rate:** During the reviewed period, the shekel strengthened by about 5.5 percent against the effective exchange rate, against the background of accommodative monetary policy worldwide and the growing expectations of appreciation due to the expected improvement in the balance of payments as a result of the production of local natural gas. Following the measures adopted by the Bank of Israel in May, the shekel weakened sharply in a short period of time, but it strengthened again in June.
- **The financial markets:** During the reviewed period, domestic stock prices increased by about 2 percent. The development of stock prices was not uniform during the reviewed period: they increased in January to May and again declined in June against the background of the sharp declines recorded in global stock

markets. Yields on government bonds increased in June following yield increases worldwide, which took place against the background of the expected reduction in quantitative easing in the US. Credit to the business sector remained stable, with a decline in the volume of bank credit and an increase in non-bank credit. In contrast, credit to households increased, with the increase taking place almost exclusively in housing credit. The spreads in the corporate bond market continued to decline, and reflected, inter alia, a decline in the risk estimation of companies in the economy.

- **Fiscal policy:** Until the budget plan was approved by the government, there was uncertainty regarding how the new government would deal with the need to bring the budget in line with the deficit and expenditure limits, and there was concern that exceeding the government deficit would negatively impact the credibility of policy. At the beginning of May, the government approved the budget plan for 2013 and 2014. If the budget approved by the Knesset maintains the aggregates as approved by the government, the deficit is expected to be 4.65 percent of GDP in 2013 and 3 percent of GDP in 2014.
- **The housing market:** During January and February, the upward trend in home prices continued in parallel with the slowdown in building starts and the increase in the number of transactions and the volume of mortgages. In March and April, there was a slight decline in home prices, but it is still too early to assess whether there has been a turnaround in the housing market. In view of the accelerated growth in housing credit that has taken place in recent years, with its concomitant increase in risk, the Supervisor of Banks published a directive in February to increase capital buffers and the provisions required in respect of the risks inherent in the housing credit portfolio.
- **The forecast:** Based on the staff forecast which was published at the end of June 2013, the Research Department projects that the rate of inflation during the next four quarters will be near the center of the price stability target range, and the Bank of Israel interest rate is expected to remain at its current level. The growth forecast for 2013 remained unchanged at 3.8 percent of GDP, with the main growth factors being the expected growth in public consumption and savings in expenditures on imported energy products due to the production of local natural gas. In contrast, a slowdown is expected in exports, private consumption, and investments. The forecast for 2014 was revised downward to 3.2 percent of GDP, mainly due to the restraining effects of the budget plan and the downward revision of the global forecast.

1. THE BACKGROUND AND INFLATION

The factors considered in the monetary policy decisions

The Bank of Israel Law, 5770–2010, defines the Bank's objectives as: maintaining price stability—defined as an inflation rate within a range of 1–3 percent—as its central goal; supporting the stability and orderly operation of the financial system; and supporting the 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 consistently monitors economic developments in the domestic and global environments, as well as their effects on the policy objectives, and sets the interest rate that is appropriate to achieving those objectives.

Monetary policy is formulated under conditions of uncertainty, regarding both the state of the economy in the present as well as future risks. Policy has to be determined through assessing future risks, since policy steps affect the economy with a lag. During the first half of 2013 (the period reviewed in this report), the uncertainty regarding domestic and global real economic developments and the risk assessment were reflected in the fact that Monetary Committee members formulated different positions on the preferred timing and pace of interest rate reductions.

There were six main issues in the background of the Committee's decisions during the period reviewed: **(1) Moderation of the inflation environment**, as reflected in the low Consumer Price Index and in the decline in inflation expectations; **(2) the worsening slowdown in the global real economy and its ramifications for domestic activity**, and particularly for exports; **(3) continued moderate growth in the economy** with a slowdown in business sector activity alongside growth in exports and private consumption and a worsening decline in investments; **(4) the appreciation of the shekel** against the background of accommodative monetary policy worldwide and increased expectations of appreciation due to the expected improvement in the balance of payments as a result of the production of local natural gas; **(5) uncertainty regarding how the new government will deal with the need to bring the budget in line with debt and expenditure limits** during the period that preceded the government's approval of the budget. Following the government's approval of the budget in May, the concern over a negative impact on the credibility of fiscal policy

declined; and **(6) the risks implicit in the continued increase of home prices** in parallel with the slowdown in building starts and the increase in the number of transactions and in mortgage volume.

In light of developments in all of these areas, the Monetary Committee reduced the interest rate by 0.25 percentage points for January, May and June reaching a level of 1.25 percent for July. In addition to the decision to lower the interest rate in May, which was made outside the regularly scheduled framework, the Committee decided to implement a foreign exchange purchasing program in order to offset the effect of natural gas production on the exchange rate. In view of the accelerated growth of housing credit in recent years, with the accompanying increase in risk, the Supervisor of Banks published a directive in February to increase the capital buffer and the provisions required in respect of the risks inherent in the housing credit portfolio. The interest rate for August was left unchanged at 1.25 percent.

The following are the main developments which were considered in the policy decisions of the Bank of Israel's Monetary Committee:

a. The global environment

As a small and open economy, Israel is greatly affected by developments in the global environment. These developments impact directly on domestic activity, Israel's exports, and domestic price levels, domestic and capital markets.

(1) Real activity, prices and policy

The debt crisis in Europe continued to be key risk to global growth. In the past few months there has been an additional risk of a deepening slowdown in emerging markets. During the reviewed period, the contraction in economic activity in Europe continued, and even spread into Germany and France—the leading economies in the eurozone (Figure 1). The risks of stress events in the eurozone became much lower during the reviewed period, but restraining fiscal policy and the low supply of bank credit continued to weigh down the level of activity. The recovery in activity in the US continued, with the housing and vehicle markets balancing the weakness that was created following the cuts in the government budget and the tax increases. After a slowdown in activity in Japan in 2012, first quarter data indicate accelerated growth, which was mainly influenced by an increase in private consumption, which is a main component of GDP. The slowdown in major emerging markets

Figure 1
Rate of Growth in Selected Countries,
2012:Q1–2013:Q1
 (annualized rates of change)

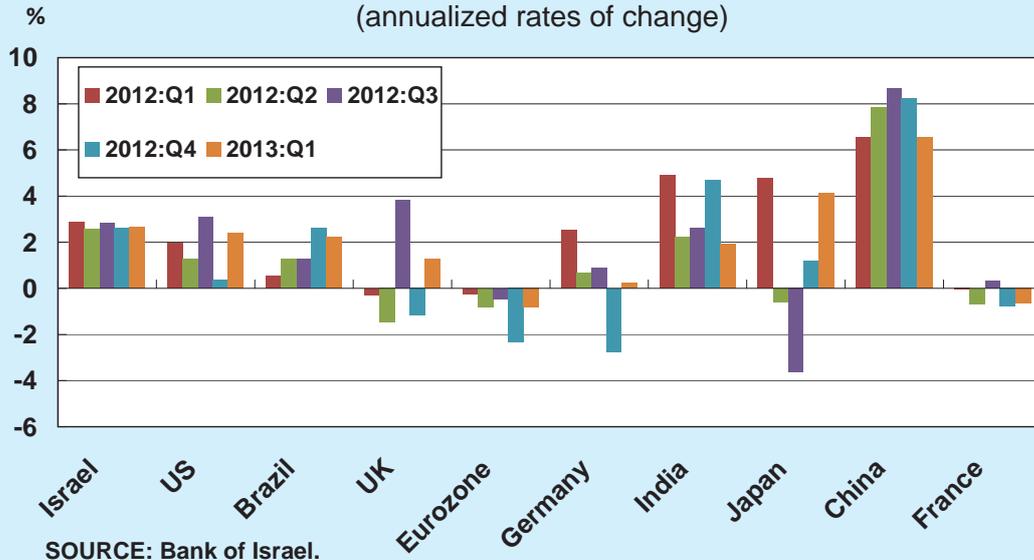


Figure 2
IMF forecast of growth rates and inflation for advanced and developing countries, 2013 and 2014

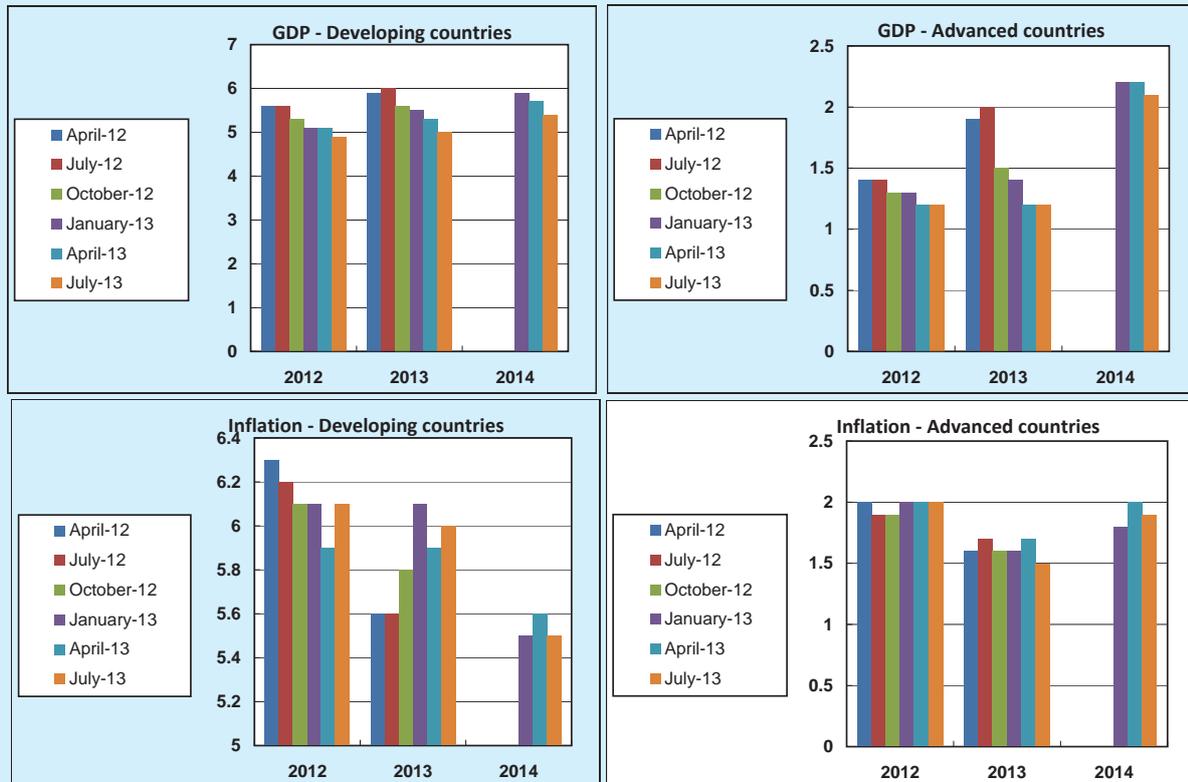


Figure 3
Price Indices of Base Metals, Food and Energy, January 2007 to July 2013

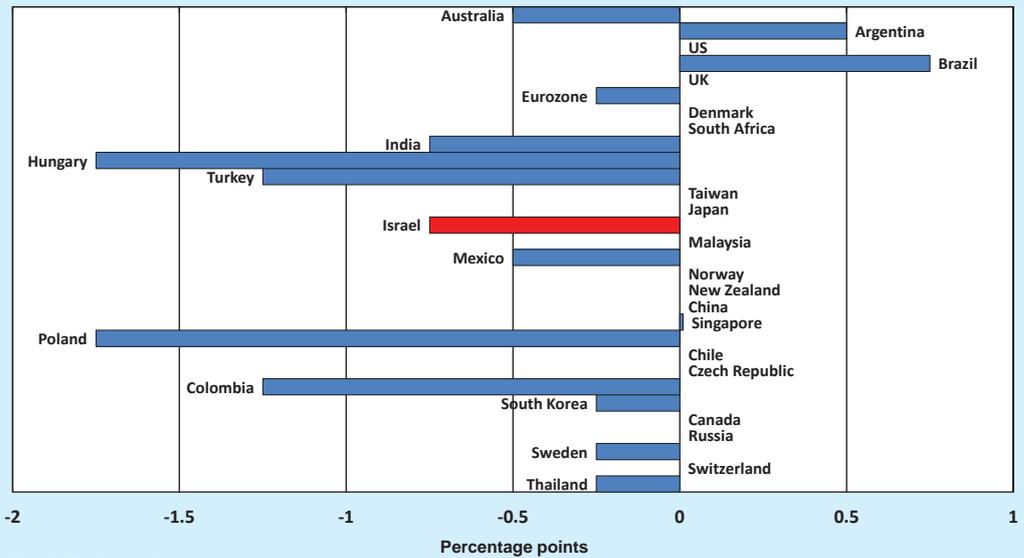


SOURCE: Bloomberg.

continues, and in recent months there have been increasing signs of the slowdown deepening. In consideration of these developments, the International Monetary Fund lowered its 2013 growth forecast for the emerging markets and most of the major economies (Figure 2).

Against the background of the global slowdown and forecasts for continued deterioration, the inflation environment worldwide moderated. Global food, commodity and energy prices declined during the period, and their low level indicated weakness in global demand (Figure 3). In response to the deterioration in the real situation and the decline in the inflation environment, expansionary monetary policy continued worldwide, reflected in a continuation—and even an increase—in quantitative easing programs and interest rate reductions (Figure 4) (See box).

Figure 4
Changes in Central Bank Interest Rates July 2012 to July 2013



SOURCE: Bank of Israel.

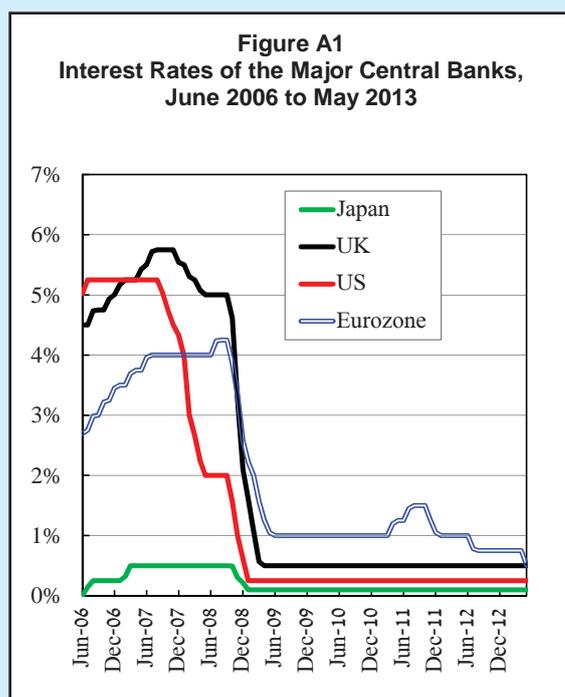
Box 1: Monetary Policy and Foreign Exchange Rates Worldwide

Since the financial crisis worsened in 2008, there has been a slowdown in economic activity worldwide, and the major advanced economies even entered a recession in part of the period. The slowdown has been noticeable in lower growth rates than in the past, and in a decline in the rate of expansion of global trade. In response to the slowdown, central banks around the world, led by the US Federal Reserve, adopted significant accommodative monetary policies, of a scope not seen prior to the crisis: They lowered the interest rates to near zero and adopted quantitative easing policies (asset purchases, including government bonds), that led to a marked expansion of their balance sheets (Figure 1).

The weakness of economic activity in the large advanced economies, alongside near-zero interest rates and quantitative easing, create pressure for real appreciation in markets that are not at the heart of the crisis. Some of the pressure for appreciation derives from the relative weakness of the large economies, and some derives from capital flows due to interest rate gaps. In response, monetary policy makers in economies that are not at the heart of the crisis use a variety of tools that impact on the exchange rate: interest rate reductions, foreign exchange purchases, and various regulatory interventions.¹ These measures moderate the pressure for appreciation, and the pressure is therefore not fully reflected in actual fluctuations of the exchange rates of these countries.

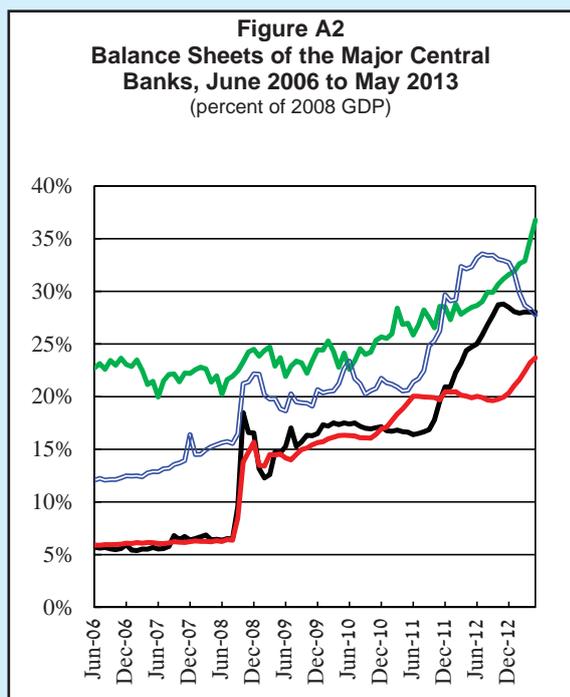
Figure 2 presents the developments of the real effective exchange rate of a number of countries compared to four of the largest advanced economies—the US, Europe, Japan and the UK²—and the change in foreign currency reserves of the various countries as a percentage of GDP. The figure shows that from about 2008–9, all of the countries increased their foreign currency reserves, apparently in response to pressure for appreciation of the local currency. This step was taken in parallel with lowering the interest rate—against the background of the slowdown in economic activity, mainly in the advanced countries—which also moderates the pressure for appreciation (Table 1).

In this context, it is worth noting that some countries, particularly developing economies, were dealing with pressure for appreciation even before the outbreak of the crisis. For instance, Brazil, South Korea, Malaysia, and the Philippines increased their foreign currency reserves even before the crisis, but despite the foreign exchange purchases, their real exchange rates appreciated (Figure 2). In contrast, other countries, particularly advanced economies such as Denmark, Sweden, Switzerland



1 For instance, Brazil imposed a liquidity requirement on foreign exchange short sell transactions and raised tax rates on short-term capital inflows. Indonesia required central bank bond purchasers to hold them for a minimal time frame. (In July 2010, they were required to hold them for a month, and in May 2011, the period was extended to 6 months.). In Israel, a liquidity requirement was imposed against foreign residents' transactions in foreign exchange derivatives, and their exemption on capital gains from short-term state loans was cancelled.

2 The exchange rate is against the International Monetary Fund's Special Drawing Rights (SDR). The SDR is the weighted effective exchange rate of the dollar (41.9%), the euro (37.4%), the Yen (9.4%) and the pound (11.3%). The weights are updated every five years. The current weights are expected to remain in place until December 2015.



and Israel, changed their foreign exchange policies as a result of the crisis (Figure 2). Prominent among these is Switzerland which, in response to the large inflow of financial capital, declared a minimum exchange rate of 1.2 Swiss francs to the euro in September 2011. Since then, the central bank of Switzerland has been making foreign exchange purchases in order to protect this rate. In parallel, the bank lowered its interest rate to near zero (Table 1A).

In regard to the large advanced economies, the Central Bank of Japan declared a program to double its pace of bond purchases in April, with the aim of doubling the Japanese monetary base within two years, against the background of years of disinflation and economic weakness in the country. The start of the plan's implementation was marked on the Bank of Japan's balance sheet (Figure 1B). Immediately after the declaration, the pace of depreciation of the yen accelerated against the major currencies, further to its

weakness of the preceding months. In view of this, the expansion of purchases renewed the discussion of the possibility of a "war of currencies".

A "war of currencies" is a situation where each country tries to improve its competitiveness in international markets by weakening its local currency. When the other variables are fixed, depreciation of the local currency makes the countries products cheaper in terms of foreign currency, thereby enabling local manufacturers to increase their market share on global markets. However, since the depreciation of one currency means the appreciation of another, a situation where all currencies depreciate is not possible. Therefore, a war of currencies may end in a situation where there is no significant change in the exchange rates or in the countries' competitive advantage.

Figure 2 shows that the small economies are trying to protect themselves against the effects of appreciation of their currencies compared to the major currencies. As stated, the advanced economies have only been doing so since the outbreak of the global crisis, while the developing economies were under pressure for appreciation even before then. However, monetary expansion in the large advanced economies derives mainly from internal considerations, and not necessarily from considerations of global competitiveness. It seems that this is also the situation regarding the most recent monetary expansion in Japan, at least according to official publications by the central bank, which claim that the measure is intended to lead to inflation of 2 percent per year. In any case, the most recent announcements by the Federal Reserve regarding the retreat from quantitative easing in the US reduce the concern of a war of currencies among the large advanced economies.

Table A1: Growth, inflation and the central bank interest rate in small open economies

(percentage points, 2005-2012)

		2005	2006	2007	2008	2009	2010	2011	2012
Israel	Growth ^(a)	4.9	5.8	5.9	4.1	1.1	5.0	4.6	3.2
	Inflation ^(b)	2.4	-0.1	3.4	3.8	3.9	2.7	2.2	1.6
	Depreciation ^(c)	-1.4	-1.8	-3.2	-6.9	-0.4	-8.6	6.0	-0.1
	Interest rate ^(d)	3.7	5.1	3.9	3.7	0.8	1.6	2.9	2.3
Brazil	Growth ^(a)	3.2	4.0	6.1	5.2	-0.3	7.5	2.7	0.9
	Inflation ^(b)	5.7	3.1	4.4	5.9	4.3	5.9	6.5	5.8
	Depreciation ^(c)	-24.4	-1.9	-14.4	23.5	-26.1	-9.1	4.6	8.8
	Interest rate ^(d)	19.1	15.1	12.0	12.5	9.9	10.0	11.8	8.5
Denmark	Growth ^(a)	2.4	3.4	1.6	-0.8	-5.7	1.6	1.1	-0.5
	Inflation ^(b)	2.2	1.8	2.3	2.4	1.4	2.8	2.5	2.0
	Depreciation ^(c)	5.3	-4.9	-4.5	3.6	-4.7	6.6	1.0	0.4
	Interest rate ^(d)	2.0	2.8	3.9	4.1	1.5	0.8	1.0	0.3
Indonesia	Growth ^(a)	5.7	5.5	6.3	6.0	4.6	6.2	6.5	6.2
	Inflation ^(b)	17.1	6.6	5.8	11.1	2.8	7.0	3.8	4.3
	Depreciation ^(c)	-13.7	-7.0	5.1	5.5	-13.5	-11.9	0.3	3.4
	Interest rate ^(d)	9.1	11.8	8.6	8.7	7.1	6.5	6.6	5.8
South Korea	Growth ^(a)	4.0	5.2	5.1	2.3	0.3	6.3	3.6	2.0
	Inflation ^(b)	2.6	2.1	3.6	4.1	2.8	3.0	4.2	1.4
	Depreciation ^(c)	-9.8	-4.7	4.7	37.6	-12.4	-5.7	-0.5	-6.3
	Interest rate ^(d)	2.0	2.5	3.0	3.0	1.3	1.3	1.5	1.4
Malaysia	Growth ^(a)	5.3	5.6	6.3	4.8	-1.5	7.2	5.1	5.6
	Inflation ^(b)	3.2	3.1	2.4	4.4	1.1	2.1	3.0	1.2
	Depreciation ^(c)	-8.3	-1.8	-1.3	-0.5	0.6	-11.4	1.6	-3.3
	Interest rate ^(d)	2.8	3.4	3.5	3.5	2.0	2.5	2.9	3.0
Philippines	Growth ^(a)	4.8	5.2	6.6	4.2	1.1	7.6	3.9	6.6
	Inflation ^(b)	5.9	4.1	3.6	7.8	4.4	3.6	4.2	2.9
	Depreciation ^(c)	-14.3	-4.6	-12.2	4.1	-2.3	-9.7	-1.4	-7.4
	Interest rate ^(d)	6.6	5.4	3.7	4.8	3.9	3.9	4.4	3.9
South Africa	Growth ^(a)	5.3	5.6	5.5	3.6	-1.5	3.1	3.5	2.5
	Inflation ^(b)	3.6	5.8	9.0	10.1	6.3	3.5	6.1	5.7
	Depreciation ^(c)	1.9	12.9	-4.4	29.7	-25.5	-12.7	16.6	1.4
	Interest rate ^(d)	7.1	7.7	9.7	11.6	8.2	6.3	5.5	5.3
Sweden	Growth ^(a)	3.2	4.3	3.3	-0.6	-5.0	6.6	3.7	0.8
	Inflation ^(b)	0.9	1.6	3.4	0.9	0.6	2.3	2.3	-0.1
	Depreciation ^(c)	12.0	-9.0	-1.4	19.7	-6.7	-7.1	1.0	-2.2
	Interest rate ^(d)	1.8	2.0	3.3	4.0	1.3	0.5	1.7	1.5
Switzerland	Growth ^(a)	2.7	3.8	3.8	2.2	-1.9	3.0	1.9	1.0
	Inflation ^(b)	1.0	0.6	2.0	0.7	0.3	0.5	-0.7	-0.4
	Depreciation ^(c)	7.0	-1.2	-0.6	-2.5	-5.1	-7.4	0.0	0.8
	Interest rate ^(d)	1.3	2.0	2.9	2.9	0.8	0.8	0.5	0.3

(a) Annual GDP compared to previous year.

(b) CPI change over the year.

(c) Change in the real effective exchange rate relative to SDR over the year.

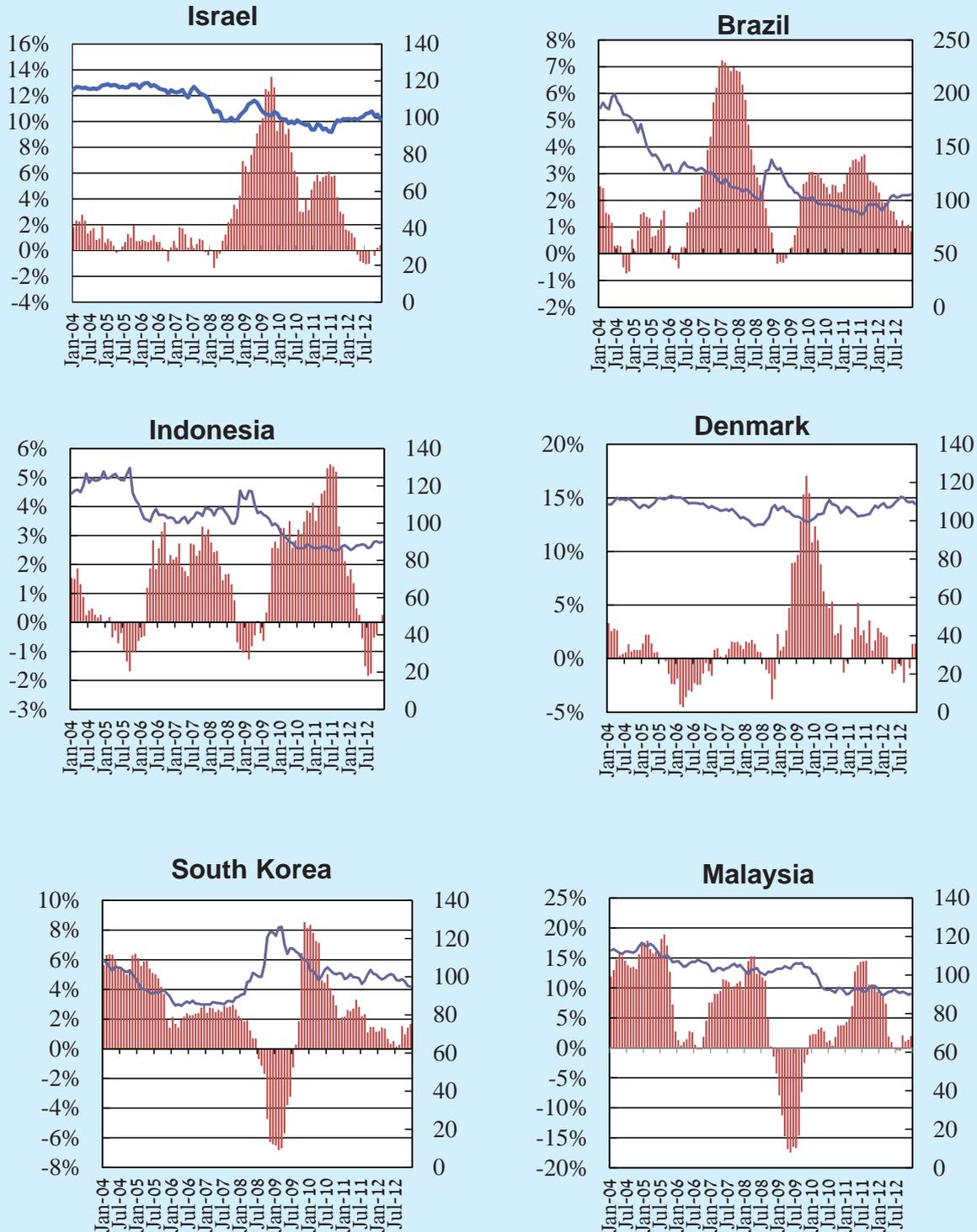
(d) Yearly average.

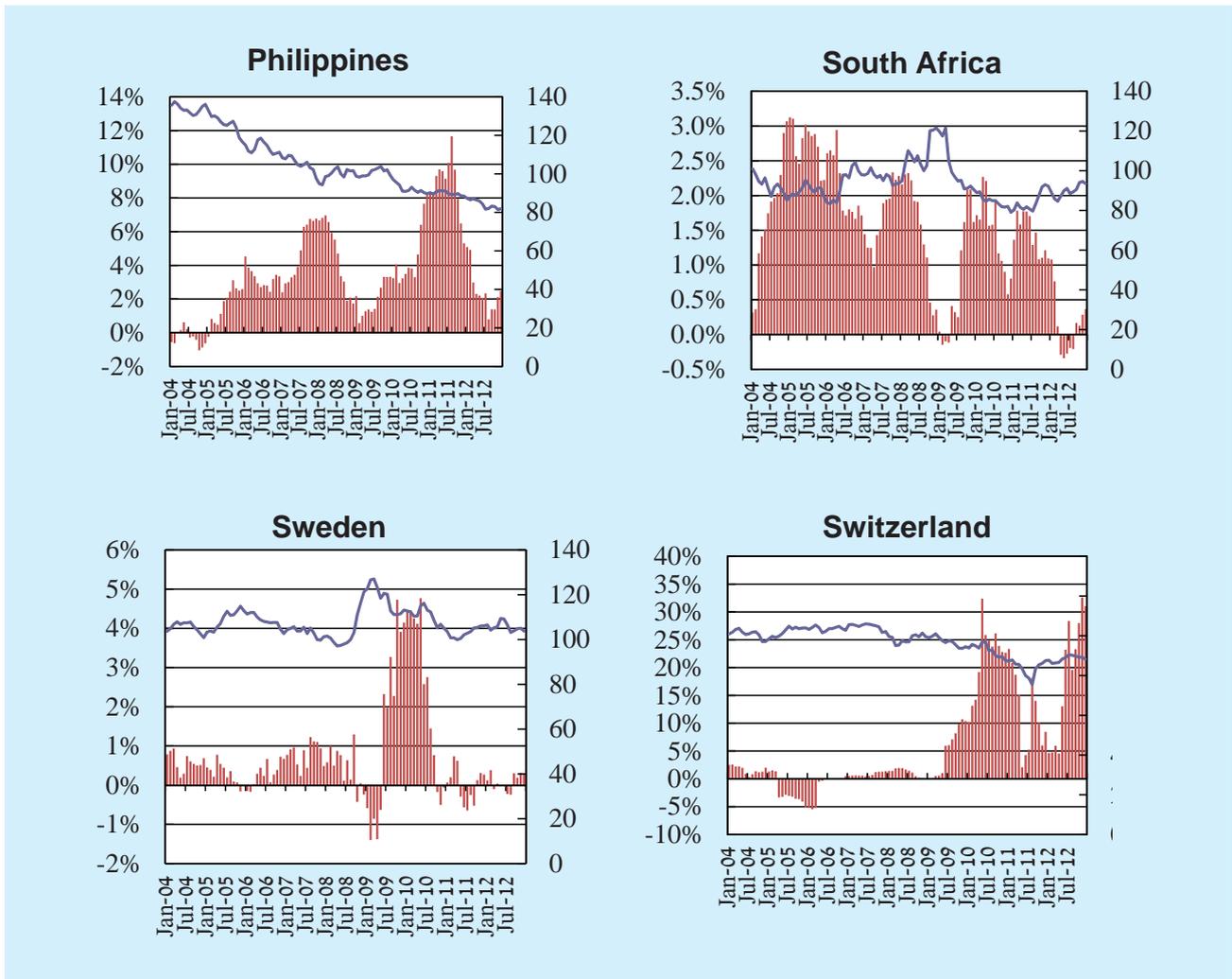
SOURCE: International Monetary Fund, International Financial Statistics.

Figure A3

The real effective exchange rate compared to the SDR and the change in foreign currency reserves over the past 12 months as a percent of GDP, small and open economies, 2004–2012

(Real exchange rate in August 2008=100)





Advanced economies

Eurozone

During the reviewed period, the slowdown in real activity in Europe deepened, affecting even the leading economies in the eurozone. During the first quarter of 2013, GDP in the eurozone contracted by 1 percent, while growing by just 0.2 percent in Germany and recording negative growth in France, which officially entered a recession. The slowdown in Europe was reflected in negative macroeconomic data, which indicated that the unemployment rate increased and continues to rise, demand is declining and industrial production is contracting. In view of the accumulation of negative macro data, the European Central Bank (ECB) reduced its interest rate in May to a low of 0.5 percent, while revising its 2013 growth forecast downward.

The main factors in the slowdown in the level of activity in the eurozone are fiscal restraint measures taken with the aim

of reducing the volume of debt, and the low supply of bank credit. While the stability of the banking system improved during the reviewed period, the improvement derived mainly from a reduction in the volume of credit to the business sector, particularly for small and medium-sized businesses, and from an increase in the purchase of government bonds.

The uncertainty regarding the stability of the eurozone increased again with the emergence of the crisis in the banking system in Cyprus. However, the European Stability Mechanism's response to the crisis helped return calm to the financial markets. In general, the risk of stress events in the eurozone declined markedly during the reviewed period, which was reflected in narrower CDS spreads on government bonds in heavily indebted countries.

United States

During the reviewed period, the recovery in real activity continued in the US, where the housing and vehicle markets balanced the weakness created due to the cuts in the government budget and the tax increases. Even though growth in the first quarter of 2013 was lower than forecast, most of the macro data indicated an improvement in activity. Prominent among these were employment, housing, and credit data and the moderation of the fiscal deficit. Unemployment rates continued to decline, and the amount of new employee posts stabilized at a high level. In the credit market, there were signs of easing in the terms of credit to businesses alongside an increase in demand for credit. Against the background of the cuts in government expenditure and tax receipts that were higher than forecast, the Congressional Budget Office revised the deficit forecast for 2013 downward from 5.3 percent to just 4 percent. The recovery in the American economy and expansionary monetary policy had a positive effect on the performance of the large corporations, and most of them presented higher than forecast profits in the first quarter.

The recovery in the US economy is supported by the Federal Reserve's accommodative monetary policy. At the end of 2012, the Federal Reserve announced the purchase of long-term government bonds totaling \$45 billion per month, and opened activity in the mortgage-backed securities (MBS) market. The Federal Reserve also announced that the low interest rate would remain as long as the unemployment rate remains above 6.5 percent and expected inflation does not exceed 2.5 percent.

Against the background of the decline in the unemployment rate, the improvement in macro data and the moderation of the deficit, the Federal Reserve announced in June that it would

reduce quantitative easing in the future, provided that the improvement in macroeconomic conditions continues.

Japan

Following the stagnation in activity in 2012, the government adopted an expansionary monetary and fiscal policy during the reviewed period, intended to support activity. GDP data for the first quarter surprised to the upside with growth of 4.1 percent. The improvement in activity derived mainly from an increase in private consumption, which was affected by expansionary monetary policy. In contrast, goods exports contracted and industrial production expanded at a lower-than-expected rate.

Since price deflation continued in 2012, and against the background of the need to support financial sector activity and stability and to strive toward a path of sustainable growth, the government decided in January to raise the inflation target from 1 percent to 2 percent and to implement a further accommodative program. At the beginning of April, Japan announced a doubling of the pace of the bond purchasing program—to a volume of 7.5 trillion yen per month. Following the increase in quantitative easing, investors in Japan increased their holdings of foreign bonds at the expense of local bonds, thereby contributing to an acceleration of the depreciation of the yen and an increase in long-term yields.

Emerging economies

Growth rates in major emerging markets in the first quarter continued to be below the trend, particularly in China, and signs of a deepening slowdown have increased in recent months. Following the acceleration of the growth rate in China in 2012, macroeconomic data for the first quarter indicated a slowdown in the economy. The growth rate in the first quarter was just 7.7 percent, against the background of a slowdown in private consumption, which was affected by a decline in household income. In order to prevent an appreciation of the local currency, the government announced new regulations intended to reduce the flow of foreign currency into China. Concerns of a financial crisis in China increased in recent months against the background of reports of liquidity problems in the banking system that led to a spike in inter-bank interest rates.

India's economy continued to stagnate, with growth in the last fiscal year reaching the lowest point in a decade. The slowdown in Brazil continued and growth during the first quarter was lower than forecast. The central bank of Brazil continued its

tight monetary policy against the background of high inflation and continued weakening of the local currency. In view of these developments, the International Monetary Fund lowered its growth forecast for 2013 for the major emerging markets.

(2) Global Financial Markets

During the reviewed period, the level of risk inherent in the global financial markets declined, particularly in debt-laden countries. This was mainly against the background of the assistance program to heavily indebted countries, increasing fiscal discipline and calming declarations regarding the commitment to keep the eurozone intact. Evidence of the decline in the risk level can be found in the fact that the CDS spreads (Figure 5)—which reflect the long-term risk level—continued to narrow, and in the fact that the VIX in most countries stabilized at the lowest levels since the outbreak of the crisis in 2008. In Japan, however, this index increased sharply since the beginning of the year against the background of the risks implicit in the expansionary fiscal policy (Figure 6). The decline in risk levels was also expressed in the fact that, in most of the reviewed period, the decline in yields on 10-year government bonds continued in debt-laden countries (Figure 7). At the beginning of June, against the background of increasing estimations that quantitative easing in the US would be reduced, the trend in the bond markets reversed and yields increased in most countries.

Despite the slowdown in global real activity, the stock market indices in the advanced economies increased markedly in the period from January to May, and even set record highs in the US and Japan (Figure 8). The rise in share prices was mainly influenced by the decline in risk assessments against the background of the calm that was prevalent surrounding the debt crisis in Europe, and from the increase in liquidity levels in the markets due to the quantitative easing programs. In June, against the background of increasing estimations that the quantitative easing in the US would be reduced and would lead to a decline in liquidity levels in the markets, the trend reversed and share prices declined markedly in most stock markets in the world.

b. Real economic developments in Israel

In order to formulate appropriate monetary policy, it is necessary to understand the state of real economic activity—both because the level of activity and changes in it have an impact on prices, and because the policy is intended to support growth and employment, among other things. However, an assessment of the state of the real economy is complicated, since such an assessment is based

Figure 5
CDS Spreads of Israel and Selected Countries
January 2011 to July 2013
 (daily data)

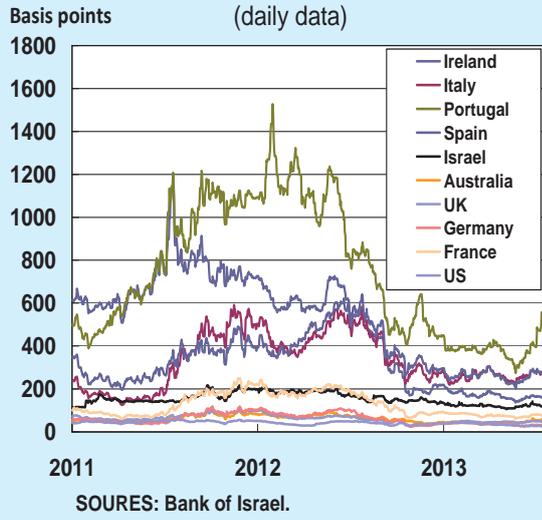


Figure 6
Implied Volatility in Prices of Options on Stock Market Indices (VIX) January 2009 to July 2013
 (Monthly averages)

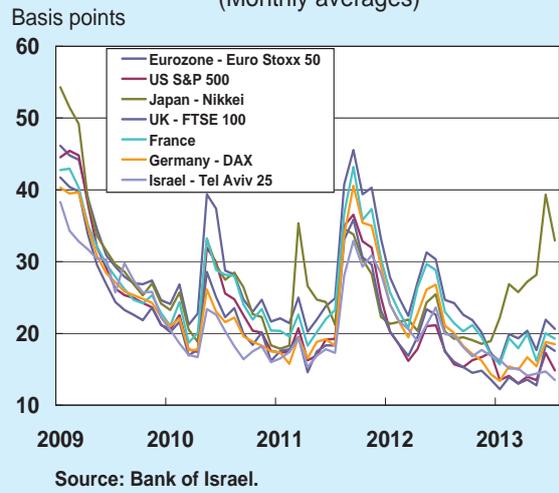


Figure 7
Ten-Year Yields to Maturity for Unindexed Government Bonds, Israel and Selected Countries, daily frequency, January 2008 to July 2013

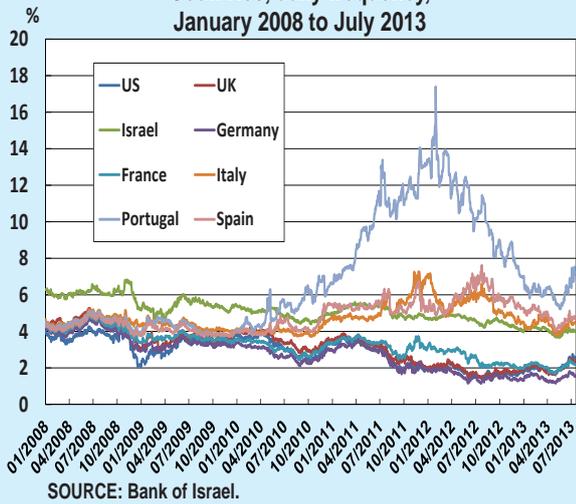
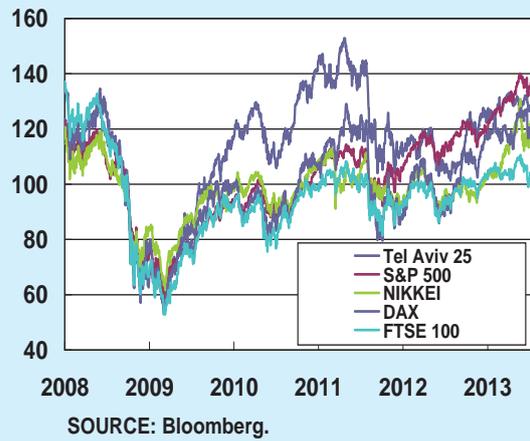


Figure 8
Global Share Indices (in dollar terms), January 2008 to July 2013
 (September 15, 2008=100)



for the most part on quarterly National Accounts data, as well as on a wide range of monthly indicators of the level of activity, which are published with a lag and revised retroactively. In addition, the monthly indicators, which are published earlier than National Accounts data, do not always present a uniform view.

National Accounts data for the first quarter indicated continued moderate GDP growth, with a slowdown in the growth of business product, alongside an expansion in exports and in private consumption and a worsening decline in investments. In the first quarter, GDP grew by an annual rate of 2.9 percent, similar to its average rate of growth during 2012 (Figure 9 and Table 1). In contrast, business sector product grew at a more moderate pace than in the previous year.

Exports (excluding start-ups and diamonds) grew during the first quarter by 4.3 percent, following sharp declines in the second half of 2012. Fixed capital formation declined sharply by about 20 percent, continuing the declines recorded in the last two quarters. It is worth noting that some of the decline came from the end of large one-time investments made in previous years.

It is important to emphasize that National Accounts data for the first quarter were revised twice since their first publication in May. As such, the picture supplied to the Monetary Committee changed during the reviewed period. For instance, in the last revision, which was published in July, the growth rates of GDP, business sector product and exports were revised upward (See Table 1).

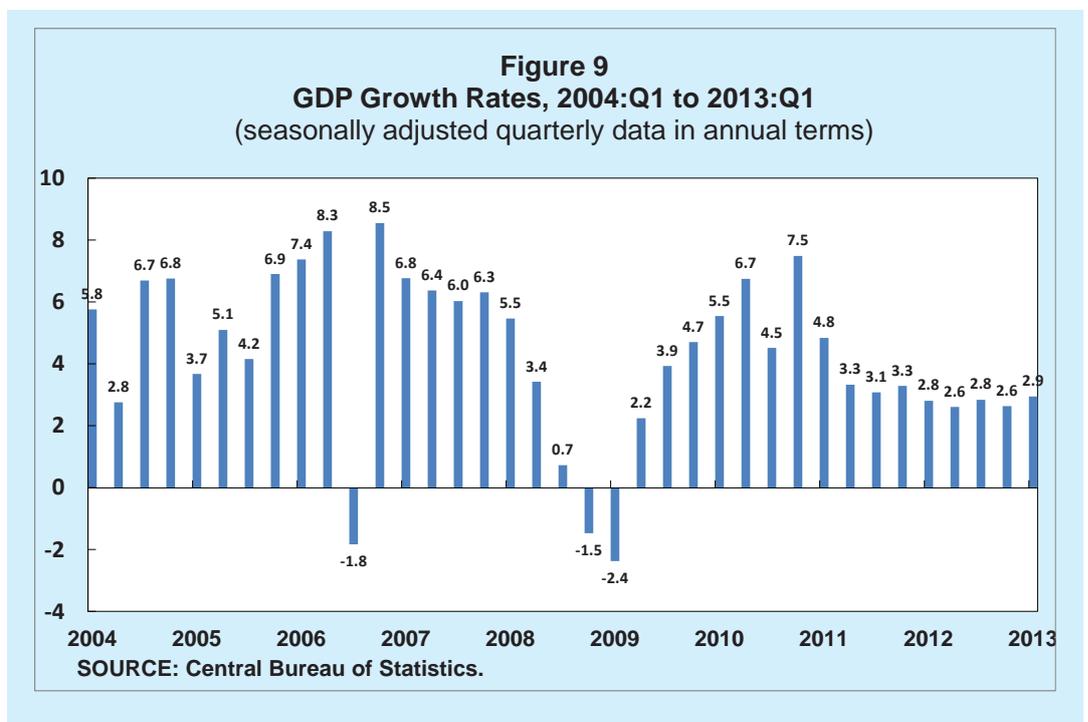


Table 1
National Accounts, 2012-2013
(rates of change, percent, in fixed prices, in seasonally adjusted annualized terms)

	Each quarter compared to the previous quarter								Each quarter compared to previous year ^b	
	2012 ^{a,b}	2012				2013:Q1			2012	2013
		I	II	III	IV	First estimate	Second estimate	Third estimate	VI	I
Gross Domestic Product	3.2	2.8	2.6	2.8	2.6	2.8	2.7	2.9	3.3	2.1
Business Sector GDP	3.3	3.1	2.9	3.0	3.5	2.0	2.2	2.5	3.6	2.1
Private consumption	2.7	5.7	2.5	1.4	2.0	5.6	5.0	5.3	3.4	3.8
Gross domestic investment	11.6	91.7	-44.6	5.9	-11.1	-8.1	-18.8	-19.1	-6.2	-26.3
Fixed capital formation	4.0	3.3	-1.3	-4.7	-12.0	-14.7	-23.3	-20.0	-2.8	-9.5
Total exports	0.1	-0.7	19.6	-13.2	-6.8	13.5	12.8	15.2	-0.4	3.1
Goods and services exports excluding diamonds	4.3	7.7	29.5	-10.9	-8.9	12.1	11.9	14.9	3.3	5.8
Exports excluding startups and diamonds	3.6	5.3	23.4	-5.7	-9.8	0.9	0.9	4.3	2.7	3.3
Total imports	2.6	37.6	-13.0	-13.2	-16.2	2.5	-0.8	1.0	-4.3	-10.0
Goods and services imports excluding diamonds ^c	6.7	49.8	-8.7	-14.9	-15.9	-2.6	-8.8	-8.9	-1.4	-12.2
Public consumption	3.4	2.5	0.0	1.2	5.1	-7.3	-0.4	-0.4	4.4	1.3
Public consumption excluding defense imports	3.3	2.0	2.1	2.4	3.9	-4.8	-0.9	-0.9	4.0	1.6
Domestic uses	4.3	18.5	-8.5	0.8	-0.3	1.2	-0.2	-0.7	1.6	-3.4

a. Compared to previous year.

b. Original data.

c. Excluding defense imports, ships and planes.

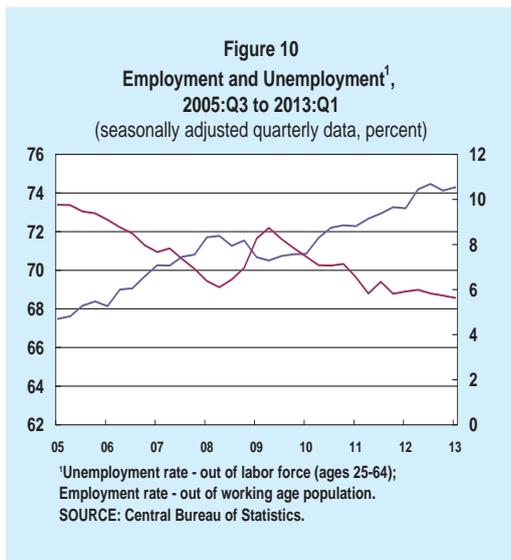
SOURCE: Based on Central Bureau of Statistics.

The most recent indicators of economic activity presented period a mixed picture. Indicators of expected activity showed the possibility that there was a further slowdown in the pace of expansion of economic activity in recent months. The most prominent negative developments were: (a) the decline in the Climate Index¹ to a level lower than it had been during the previous four months; (b) the downward revision of the Composite Index for recent months; (c) the decline in the Purchasing Managers' Index to below 50 points, the level that distinguishes between expansion and contraction in activity; and (d) the sharp decline

¹ The index is based on the Business Tendency Survey by the Central Bureau of Statistics.

in consumer confidence indices. On the other hand, indicators of private consumption showed an expansion of domestic demand. Among the most prominent positive indicators were: (a) the growth in sales in the trade and services industries; (b) the upward trend in the import of consumer products; and (c) the increase in local VAT revenue.

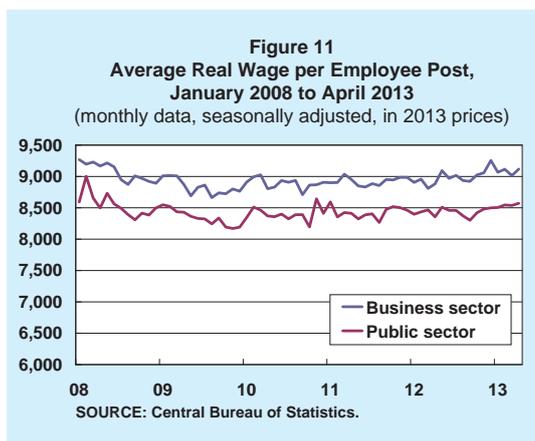
In April, natural gas production from the Tamar drilling site and its consumption by the Electric Company began. According to estimates by the Bank of Israel Research Department, natural gas production is expected to contribute about 1 percentage point to GDP growth in 2013 and 0.7 percentage points in 2014, mainly due to the savings to the economy in expenditures on imported energy products. However, since natural gas production requires a small number of workers, the expected short-term development in employment and in the unemployment rate will mainly be affected by the GDP growth rate excluding natural gas production.



The labor market

Labor force survey data for the first quarter indicates a continued decline in the unemployment rate, alongside a slowdown in the expansion of employment (Figure 10). The unemployment rate declined by 0.3 percentage points during the first quarter, to 6.5 percent. Among the principal working ages (25–64), there was a slight decline of 0.1 percentage points to 5.6 percent. In contrast, monthly data for April and May indicate an increase of 0.3 percentage points in the unemployment rate among the principal working ages.

Starting in the second quarter of 2012, there has been a slowdown in the expansion of employment, following accelerated growth in 2010 and 2011. This slowdown is derived from the stagnation—and even decline—in employment in the business sector against the background of the slowdown in activity and in exports, alongside moderate growth in employment in the public services, which was affected for the most part by growth in public expenditure. Real wages in the private sector declined slightly during the reviewed period, with some volatility (Figure 11). It is worth noting that the climate indices, which reflect the expectations of employers in the various industries, indicated stability in the labor market throughout the reviewed period, with an expectation that the number of job vacancies would increase.



c. Financial Developments

The risk level in the Israeli economy, as reflected in various indicators, continued to decline during the reviewed period, similar to the worldwide trend. The level of risk in the

economy, as expressed in five-year CDS contracts for Israel, declined to the levels that were prevalent at the beginning of 2011, prior to the worsening of the debt crisis in Europe (Figure 5). Short-term risks (up to one month), as reflected in the VIX index, continued to decline during the half year reviewed, and their rates of decline were even higher than the rates in most of the advanced economies (Figure 6).

Developments in domestic stock prices were in line with worldwide trends. From January to May, share prices increased nicely despite the decline in the level of corporate profitability. However, prices on the local stock market increased at a lower rate than on most stock markets in developed countries. In June, the trend on the local stock market reversed against the background of sharp declines that were recorded in stock markets worldwide (Figure 8).

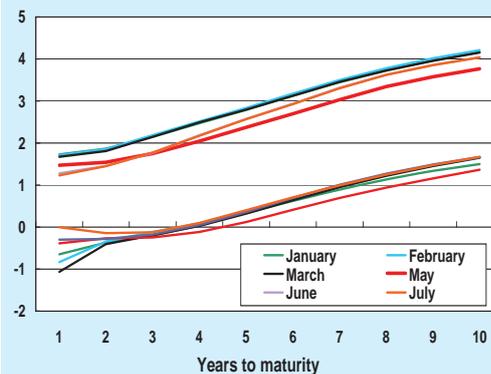
Real and nominal yields to maturity of medium and long term government bonds developed in a non-uniform manner during the reviewed period, and were affected by the development of yields worldwide (Figure 12). After yields remained almost unchanged from January to April, they declined in May and increased again in June following the increase in yields in the US that took place against the background of the expected reduction in quantitative easing. In contrast, real short-term yields (up to two years) trended upward throughout the reviewed half year, while nominal yields declined. This development reflected the decline in short-term inflationary expectations. The spread between yields on Israeli government bonds and yields on US government bonds continued to shrink during the reviewed period, reaching its lowest level since 2011.

The credit market

Credit to the business sector

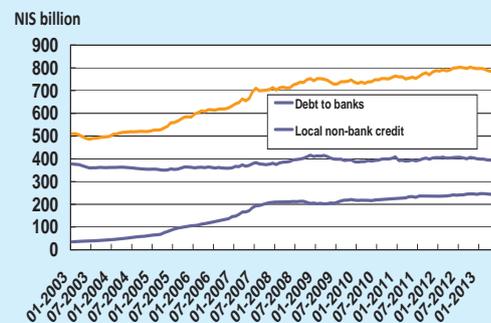
The balance of credit to the business sector declined moderately during the reviewed period, with a decline in bank credit and an increase in domestic non-bank credit (Figure 13). The increase in domestic non-bank credit was focused on direct loans provided to the business sector by institutional investors, while the balance of tradable debt declined slightly. The direct loans channel constitutes about 20 percent of the credit made available to the business sector by institutional investors, and enables the provision of credit on a relatively rapid track, without the Hodak Committee regulations applying to it. This is before regulations to limit the risks implicit in this channel have been completed.

Figure 12
Yield Curves of Indexed and Unindexed Government Bonds,
January, February, March, May, June and July 2013



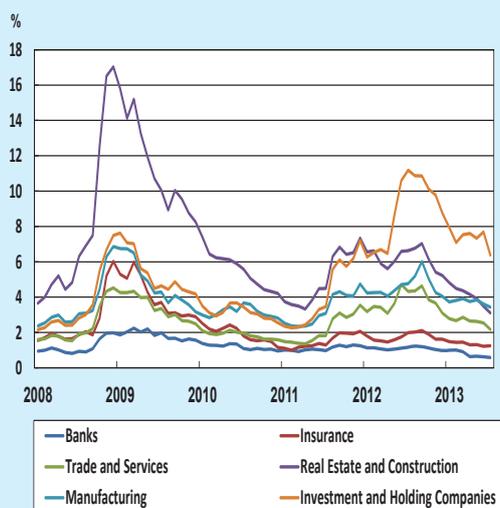
SOURCE: Bank of Israel.

Figure 13
Credit to the Non-Financial Business Sector,
January 2003 to May 2013



SOURCE: Bank of Israel.

Figure 14
Yield Gap¹ Between Corporate Bonds and Government Bonds by Industry,
January 2008 to July 2013
 (CPI-indexed yields excluding structured bonds and convertibles)



¹ Weighted average.
 SOURCE: Based on Tel Aviv Stock Exchange.

It also enables the credit risk to be spread out among the banks and the institutional investors, while making sources of credit from institutional investors accessible to companies that are not interested in, or are incapable of, using the bond market as a source for raising credit. In June, the Goldschmidt Committee to assess the market for private loans from institutional investors published its interim findings. The Committee expressed support for the continued development of the private loan market and recommended reducing the risks implicit in this channel by increasing transparency, having the board of directors limit exposure to borrowers in this channel, and setting rules for risk management in the institutional entities.

Against the background of the decline in the balance of credit, the question arose as to whether the business sector is suffering from credit distress. Business Tendency Survey data indicate that most of the business sector is not reporting a worsening of financing difficulties, but the small companies continued to report a worsening in their access to credit.

During the reviewed period, the downward trend in spreads in the corporate bond market—a trend that started back in October 2012—continued (Figure 14). The level of the average spreads in the market (excluding bonds of financial corporations) reached about 4.4 percent in May 2013, compared to 7.1 percent in September of 2012. This was despite the deterioration in the financial strength of a number of leading companies, with IDB Holdings—the parent company of the largest business group in the economy—even entering debt restructuring proceedings. It is worth noting that the decline in spreads in the local bond market was sharper than the decline in spreads in worldwide bond markets. The local decline is derived for the most part from a decline in the risk assessment in the local market, and not from a decline in the risk premium of the economy, as can be seen from the development of the gap between yields on Israel government bonds and the yields on US government bonds. This gap shrank by more moderate amounts during that period.

The volume of business sector net issuance in the bond market totaled about NIS 13 billion during the reviewed period, and was at a slightly higher level than it had been in the previous two years. The continued flow of issuances, and its expansion to companies with lower ratings, was made possible because the yields declined continuously and reached levels that were reasonable for raising debt.

Credit to households

During the reviewed half year, the increase in credit to households continued, though at a more moderate rate than in previous years (Figure 15). The growth in credit to households derived almost completely from housing credit. It is worth noting that despite the fact that there was relatively rapid growth in credit to households in recent years, the debt of this sector in relation to GDP is noticeably lower than in other countries, particularly when compared to countries that experienced a crisis in the housing market. While the macroprudential steps taken by the Supervisor of Banks in the housing credit market contributed to a certain reduction of the risks implicit in new mortgages, which was reflected in a decline in the Loan to Value (LTV) ratio, the pace of growth of the housing credit balance remained high. In addition, the average payment to income ratio in new mortgages remained at high levels, and this data—combined with the high weight of variable rate mortgages within the balance of housing credit—increases the sensitivity of the borrowers' repayment ability to an increase in the interest rate and a slowdown in economic activity, and particularly an increase in unemployment.

d. Fiscal policy

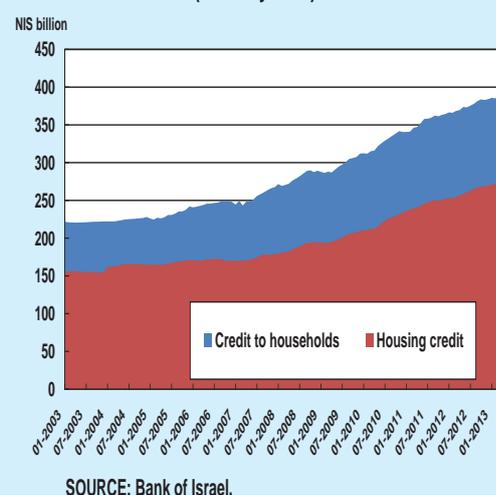
Since the 2013 budget has still not passed the Knesset, the government transitioned to operating each month within 1/12 of the 2012 budget until it passes. However, in contrast with similar situations in the past, this transition did not create a significant limitation on government expenditures, mainly due to the expected decline in repayments on government debt.²

The period that preceded the government's approval of the 2013 budgetary plan was characterized by uncertainty regarding how the new government would deal with the need to adjust the budget to the deficit and expenditure limits, and there was a concern that continuing to exceed the deficit limit would negatively impact the credibility of budgetary policy. Such an impact could be reflected in an increase in financing costs on the government debt. Against the background of this uncertainty, the S&P rating company lowered Israel's credit rating in local currency at the beginning of May to A+.

At the beginning of May, the government approved the budgetary plan for 2013 and 2014. Should the plan gain

² Since the expenditure rule is applied to total government expenditure, including debt repayment, and since debt repayment during this period was lower than in previous years, this limit was not significant as long as the government intended to maintain the expenditure ceiling.

Figure 15
Credit to Households, of which Credit for Housing,
January 2004 to May 2013
(monthly data)

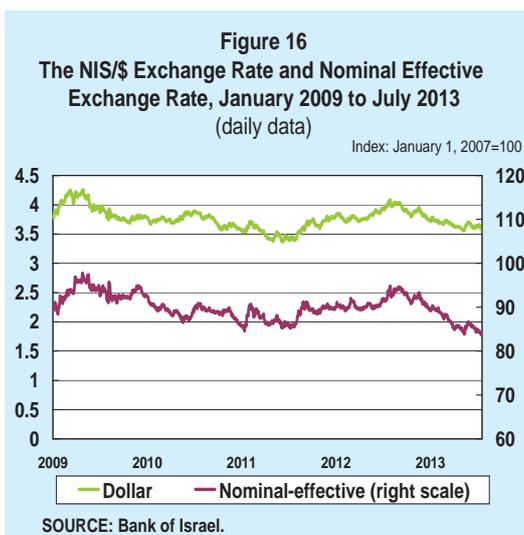


Knesset approval, it is expected to limit the deficit to 4.65 percent of GDP in 2013, and 3 percent of GDP in 2014. The budgetary plan includes a reduction of government expenditure programs and an increase in taxes totaling more than NIS 30 billion combined. Due to the late approval of the measures in the budgetary plan, the government was forced to exceed the expenditure ceiling on a one-time basis, and also raised the deficit ceiling to 4.65 percent of GDP.³ During the legislative approval process for the budget in the Knesset, some of the permanent measures proposed by the government were replaced by one-time measures, and these in turn increase the budgetary adjustments that will be required in 2015.

The government’s approval of the plan lessened the concern over a negative impact to the credibility of policy, but in the short term, implementation of the plan is expected to moderate demand in the economy. According to estimations by the Bank of Israel’s Research Department, the measures in the government’s budgetary plan are expected to moderate growth by about 0.7 percent in 2014 compared to estimates conducted before the plan was approved. This is mainly due to the increase in taxes and the reduction in child allowance benefits, since these are expected to negatively impact demand via private consumption and, to a lesser extent, via investments. Despite this price, the deficit reduction plan was necessary, since without it, the deficit would have been expected to reach almost 6 percent of GDP in 2014. This would have threatened the financial stability of the economy, led to an increase in the cost of government debt, and had a prolonged negative impact on the level of activity in the economy.

e. The exchange rate

The development of the shekel exchange rate during the reviewed period was affected mainly by expansionary monetary policy worldwide and by expectations of an improvement in the current account following the start of natural gas production from the “Tamar” well. The accommodative monetary policy of the leading central banks, particularly the quantitative easing programs, led to an expansion of the effective gap between the Bank of Israel interest rate and the interest rates in main economies worldwide. Against the background of the relatively good performance of the Israeli economy, this expansion led to an increase in capital inflows



3 See Recent Economic Developments 135, 2013.

into the economy. This factor—alongside greater expectations that the shekel would strengthen in light of the expected improvement in the current account as a result of the production of local natural gas—increased the pressure for appreciation. Between the beginning of the year and the middle of May, the shekel strengthened by about 4.7 percent compared to the dollar and by about 6 percent compared to the effective exchange rate, which reached its lowest point since 2008 (Figure 16). There were two main sectors that contributed to the strengthening of the shekel: institutional investors, which reduced their exposure to foreign currency by expanding their currency hedging against the background of appreciation expectations, and foreign residents, who converted high volumes of foreign currency and increased their investments in short-term debt instruments against the background of the expansion of the interest rate gap. In addition, a number of large-scale direct investments also contributed to the strengthening of the shekel.

In mid-May, the Bank of Israel announced a lowering of the interest rate and the implementation of a foreign currency purchasing program intended to offset the effects of natural gas production on the exchange rate. The market’s response to the Bank of Israel’s steps was rapid, and during the two weeks following the publication of the announcement, the shekel depreciated by about 3.9 percent against the dollar and by about 3 percent against the effective exchange rate. The depreciation was led mainly by foreign residents, who sold high volumes of their investments in government bonds. At the beginning of June, the shekel strengthened once again against the background of continued pressure for appreciation on the part of long-term factors, including the continued inflow of direct investments into the economy and the improvement in the Current Account.

f. Inflation

During the reviewed period, the slowdown in the inflation rate continued, although it was mostly influenced by one-time processes and global factors (Figure 17). The Consumer Price Index increased by 1.3 percent during the reviewed period, and its seasonally adjusted increase was 1.1 percent. Actual inflation (in the past 12 months) continued to decline during the reviewed period, and was below the lower bound of the price stability target range in April. However, in June, actual inflation again increased to the center of the target range due to the relatively high index reading, which was partially influenced by the increase in VAT. Forecasters’ predictions, and expectations of inflation for the next

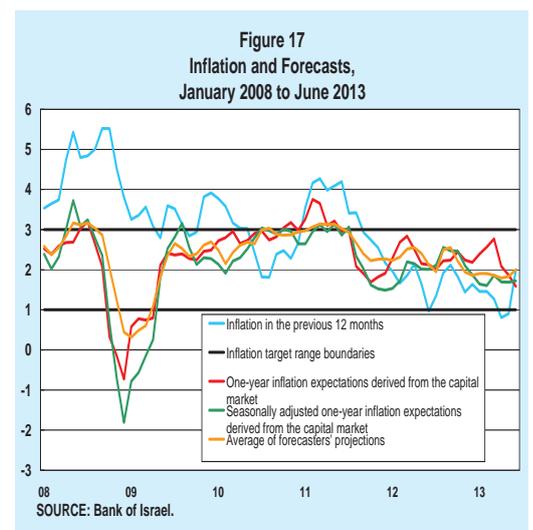


Figure 18a
Cumulative Rates of Change in CPI Components
 (percent, in annual terms)

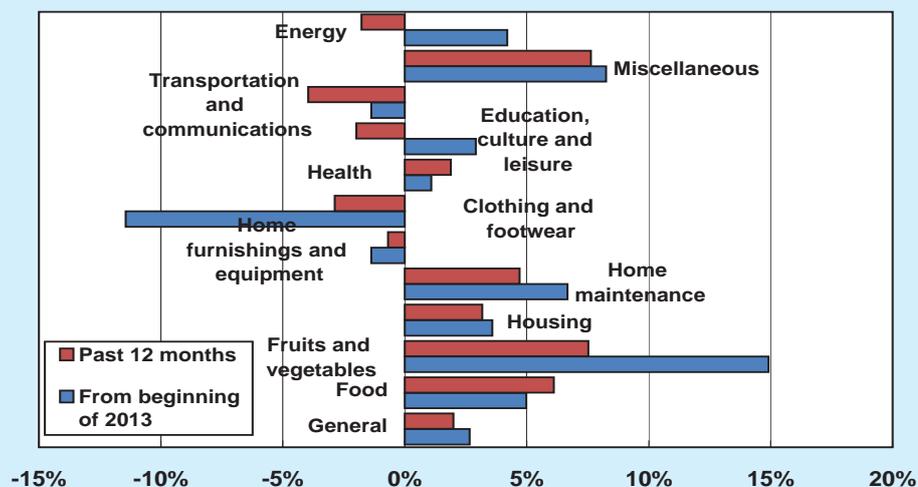
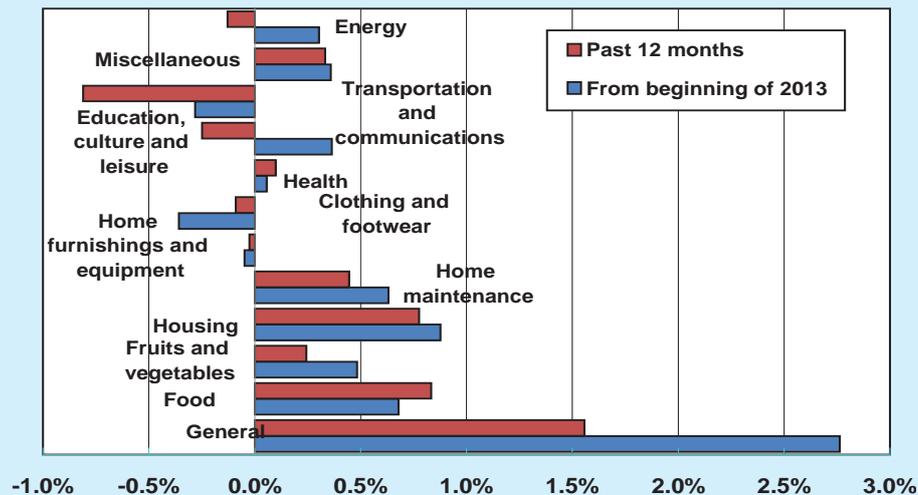


Figure 18b
Contribution of CPI Components to Changes in the CPI
 (percent, in annual terms)



SOURCE: Based on Central Bureau of Statistics.

12 months as derived from the capital market⁴, ranged slightly below the center of the target range throughout the period.

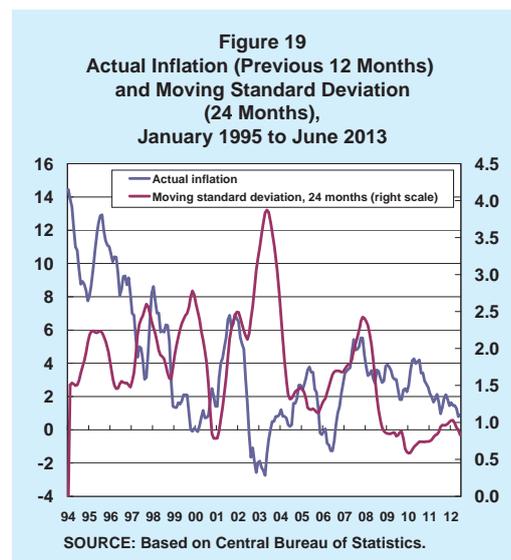
The components that contributed prominently to the decline in the pace of inflation are (Figure 18): the decline in energy prices during most of the reviewed period, which was influenced by the

4 Expectations derived from the capital market are amended in accordance with the effects that seasonality in the Consumer Price Index has on real yields. The Monetary Policy Report for the second half of 2012 contains a discussion of the methodology used to derive expectations of inflation from the capital market.

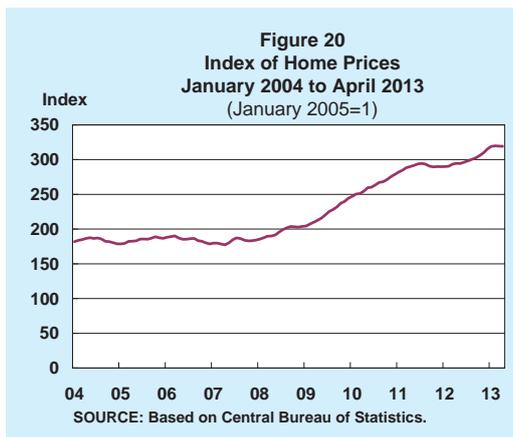
worldwide decline in energy prices and by the sharp appreciation in the exchange rate; the continued decline in communications prices following the structural measures that led to increased competition in the cellular communications industry; the decline in clothing and footwear prices that was mainly the result of seasonal effects in the industry; and the continued moderation of the increase in housing prices (rent), which led the increase in the CPI in recent years. At the same time, it is worth noting that the pace of housing price increases is still high. In contrast, the increase in food prices, together with increases in VAT and taxes on tobacco products and alcoholic beverages, contributed to an increase in the pace of inflation.

It is worth noting that food prices continued to increase during the reviewed period despite the decline in the prices of agricultural goods worldwide and the sharp appreciation of the shekel. However, since there is a gradual pass-through mechanism⁵ between the global prices of agricultural goods and the local prices, it is possible that the increase in food prices during the reviewed period was still influenced by the sharp increase in global prices recorded during the last quarter of 2012.

During the reviewed period, the standard deviation of the rate of inflation was at historically low levels, continuing the trend that began in 2009 (Figure 19). The level of inflation has some effect on its volatility, so it could have been expected that the disinflationary process that began in the 1990s would be accompanied by a decline in the standard deviation. In practice, until mid-2009, the standard deviation was highly volatile, occasionally reaching historically high levels. It seems that the reason for this is that until that period, there was a high pass-through between the exchange rate, which is characterized by a relatively high level of volatility, and inflation. The high pass-through was mainly the result of linking mechanisms to the dollar exchange rate that were customary in many industries, particularly in the housing market. Against the background of the continued appreciation in the shekel exchange rate between 2003 and 2007, the linking mechanisms began to be gradually reduced to the point where they were almost completely gone in 2008. As a result, the pass-through rate between the exchange rate and inflation declined markedly in recent years, as reflected in the moderation of inflation volatility.



⁵ Details are in Box 12 of the Monetary Policy Report for the first half of 2012.



g. The housing market

The housing market remained a main topic of public discussion during the reviewed period, in view of the continued sharp upward trend in home prices—a trend which renewed itself in the second half of 2012 in parallel with the increase in the volume of mortgages and number of transactions. Between June 2012 and February 2013, home prices increased by about 8.7 percent, continuing the accumulated increase of 58 percent between 2008 and 2011 (Figure 20). The ratio between the average home price and the average wage for a salaried position continued to increase during the reviewed period, reaching a level similar to the level that was prevalent at the height of the wave of price increases in the 1990s (Figure 21). In March and April, there was a slight decline in home prices, but it is still too early to assess whether there has been a turnaround in the housing market, since the decline in prices was accompanied by an increase in sales of second-hand homes. This in turn was apparently derived from the attempt by sellers to sell homes before the temporary order relating to betterment tax expired.

The growth in demand in the housing market that took place in recent years was influenced by a number of factors, including population growth, the increase in the standard of living, and the decline in all of the interest rates and alternative yields in the economy, similar to what has transpired in the world since the outbreak of the financial crisis in 2008. The combination of these developments with a continued increase in rental prices strengthened demand for homes as an investment asset, which was reflected in an increase in the rate of investors participating in real estate transactions. This phenomenon is not unique to Israel, and has also been observed in other advanced countries where the financial system did not collapse during the global crisis.

Despite these developments, the pace of building starts stabilized during the reviewed period at levels that were lower than those that were prevalent in 2011. In the 12 months ending in the first quarter of 2013, building starts were at a cumulative level of about 40,000 units, compared to 45,000 units at the end of 2011. In view of the resumption of price increases during the recent period, we can assess that the current level of building starts does not provide a sufficient response to the growing demand. Another piece of data that could worsen the problem of the future supply of homes is the decline in the number of building permits issued during the past year.

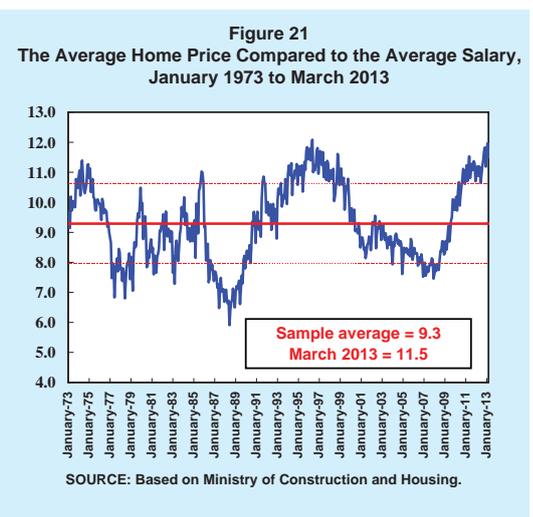
While the lack of available land for construction, the long planning process and the delays in issuing permits are slowing

the adjustment of the supply of homes to the increasing demand, credit data from the banking system and the tendency evaluation survey indicate that the availability of credit for construction does not constitute a significant limitation on the expansion of supply. Alongside the sharp growth in mortgages in recent years, there has also been an increase in the volume of credit for construction, despite the high risk inherent in this industry. Moreover, the findings of an analysis of the Business Tendency Survey indicate that the main limitations in the construction industry are the delays in issuing permits and the lack of available land, while the limitation of credit is relatively moderate. It is worth noting that the government is promoting measures to reduce impediments to construction, to reduce the planning and construction bureaucracy, and to strengthen the marketing of land. As part of these measures, the government established the National Housing Cabinet in May. In addition, the budget plan approved by the government includes a number of taxation measures intended to moderate demand in the housing market.

2. MONETARY POLICY AND ITS IMPLEMENTATION

a. Monetary policy

The Monetary Committee lowered the interest rate for the months of January, May and June by 0.25 percentage points each time, reaching 1.25 percent for July. In view of the continued appreciation of the shekel, the Committee decided in April to intervene in the foreign currency market, and in May it decided, in addition to lowering the interest rate, to implement a foreign exchange purchasing program in order to offset the effect of local natural gas production on the exchange rate. These measures were intended to strengthen the economy's ability to deal with the possible ramifications of the deepening slowdown in the global economy, and to moderate the pressure for appreciation, that derive from accommodative monetary policy worldwide and from the expected improvement in the balance of payments as a result of the natural gas production. This is against the background of the continued moderation in the inflation environment and the continued moderate growth in the economy. In contrast, the risks implicit in the continued increase in home prices, along with the slowdown in building starts and the increase in the number of transactions and the volume of mortgages, gave the Committee another element to consider when deciding to lower the interest rate. In view of the accelerated growth of housing credit in recent years, with the accompanying



increase in risk, the Supervisor of Banks published a directive in February to increase the capital buffer and the provisions required in respect of the risks inherent in the housing credit portfolio. The interest rate for August was left unchanged at 1.25 percent.

The monetary interest rate affects individuals' consumption and savings decisions, the size of investments in the economy, the exchange rate and, through it, exports and imports. Through these channels, lowering the interest rate acts to increase activity in the economy, including in the construction industry. On the other hand, lowering the interest rate has a certain effect on the expansion of demand in the housing market through its effect on alternative yields and interest rates in the mortgage market. The Committee estimated that a higher interest rate would help moderate demand in the housing market, thereby supporting a slowdown in the pace of home prices increases. On the other hand, a higher interest rate—while worldwide interest rates are at low points—would have strengthened the pressure for appreciation of the shekel and had a negative impact on exports, private consumption and investments. It would have thereby acted to moderate activity in the economy and increase the unemployment rate. Moreover, the Committee estimated that the macroprudential measures adopted by the Supervisor of Banks in order to reduce the financial risks in the mortgage market, particularly the limitation of the share of floating rate mortgages alongside the LTV limitations, markedly reduced the effect of the Bank of Israel interest rate on the housing market. In light of this, and in view of the estimation that the rapid increase in home prices was to a large extent affected by the lack of supply of homes, the Committee emphasized that the expansion of the supply of homes, through an increase in the amount of land available for construction and speeding up the planning processes, is the major step necessary in order to support a slowdown in the pace of price increases.

In February, by the authority granted it by the Bank of Israel Law, the Monetary Committee decided not to issue interest rate decisions close to the Passover and early autumn holidays. The Committee's reason for this is that due to the Passover and early autumn holidays, the data regarding the weeks preceding these interest rate decisions are received with a lag and characterized by a lack of clarity. Accordingly, the Committee announced that it would not make decisions on the interest rate at the end of April or the end of September. This means that the interest rate set at the end of March would be valid through April and May, and the interest rate set at the end of August would

be valid through September and October. At the same time, the Committee emphasized that its weekly meetings would take place as usual during the months when no interest rate decision was made. The Committee also noted that it reserves the right set in the law to change the interest rate even on dates that are not set in advance, as it did in May.

The following is a review of monetary policy on a monthly basis, and the Research Department's staff forecast which was known at the time. The staff forecast is one of the important inputs guiding the Monetary Committee in its interest rate decisions. It is updated on a quarterly basis, and is based on a wide range of sources of information on the global and domestic economies. The forecast also reflects the judgments of those who prepare it, and is formulated with the aid of a structural macro-econometric model developed by the Research Department. The model provides a framework for analyzing the forces affecting the economy, and also serves to examine the effect of interest rate changes on the economy, and to analyze risks.

The interest rate decision for January

In December 2012, the Bank of Israel interest rate was 2 percent. Ahead of the decision on the interest rate for the month of January, the Consumer Price Index for November surprised to the downside, following similar surprises in five of the previous seven CPI readings. This development, alongside the fact that expectations of one-year-ahead inflation declined to below the center of the inflation target range, indicated moderation in the inflation environment and an apparent weakening of local demand.

Even though macroeconomic data in the US and China surprised to the upside, macro data in Europe, and particularly in the core countries, indicated an expansion of the slowdown and the beginning of a recession. There was also increased uncertainty in relation to the fiscal cliff in the US and the debt crisis in Europe, and an accompanying increase of concern over the beginning of another recession. In order to support the economic recovery in the US, the Federal Reserve announced that it would increase the quantitative easing program, and that the low interest rate would remain as long as the unemployment rate remained in excess of 6.5 percent and on condition that inflation forecasts for one to two years ahead would not exceed 2.5 percent.

At the same time, the Research Department revised its growth forecast for 2013, excluding the effect of natural gas production, downward from 3 percent to 2.8 percent. The downward revision of the forecast reflected a worsening of activity

worldwide and the continued negative impact of Operation Cast Lead on incoming tourism. The inflation forecast for 2013 was also revised downward—by about 0.4 percentage points to 1.8 percent, against the background of the appreciation of the shekel exchange rate, the continued slowdown in global economic activity, the moderation of goods prices worldwide, and the continued moderation of the increase in rental prices.

In view of these developments, the Committee decided to lower the interest rate for January by 0.25 percentage points to 1.75 percent, against the background of the need for further support of economic activity and the absence of inflationary pressure.

The interest rate decisions for February to May

The interest rates for February to May were left unchanged.

From the beginning of the year until the interest rate decision for April-May, most of the indicators of the level of activity in the economy indicated stability and even a slight improvement. However, the increasing number of signs of a deepening slowdown in the global economy, and the continued slowdown in the inflation environment, did not support the estimation that there had been a turnaround in real activity in the economy.

During these months, the inflation environment, as reflected in indices and inflation expectations, continued to be moderate. Inflation in the previous 12 months continued to decline, and forecasters' projections and expectations of inflation for the next 12 months ranged below the center of the target range. In view of these factors, the Monetary Committee estimated that inflation does not constitute a risk vis-à-vis the goals of monetary policy.

The shekel exchange rate continued to strengthen during this period against the background of accommodative monetary policy worldwide and expectations of appreciation due to natural gas production. The Committee expressed the concern that against the background of the expected slowdown in global demand, the continued strengthening of the shekel may weigh down on exports.

During this period, the monthly indicators of activity in the economy indicated an improvement compared to the last quarter of 2012. However, at the time the decisions were made, it was still not possible to determine whether the indicators reflected a positive turnaround in the level of activity, which was expected to continue expanding, or whether it was a temporary correction following relatively weak growth in the previous quarter as a result of security incidents. The information received at that

time was mixed: on one hand, the effect of the security incidents on the economy was relatively moderate, making it difficult to attribute the entire improvement in economic activity to a correction following Operation Pillar of Defense. In addition, the indicators of private consumption signaled optimism regarding a continuation. On the other hand, at the time the decisions were made, there were no material changes recorded in the global economy that supported a change in trend. It was therefore possible to estimate that the increase in export volume was a correction and not a turning point.

The risks of stress events in the eurozone declined markedly during this period, and the uncertainty surrounding the issue of the fiscal cliff in the US was removed for the most part. But alongside the slow recovery in the American economy, the signs of a deepening recession in the eurozone and of its spread to the core countries multiplied.

In view of the high rate of the government deficit in 2012, there was uncertainty during this period regarding how the new government would deal with the need to adjust the budget to the deficit and expenditure limits. The Committee expressed the concern of a negative impact on the credibility of fiscal policy, which may be reflected in an increase in the costs of financing the government debt. These concerns derived from the fact that, in the Committee's estimation—which was supported, *inter alia*, by the relatively low unemployment level—most of the deficit is structural and not cyclical.

Home prices continued to increase, alongside a slowdown in building starts. The rate of new mortgages taken out remained high, even though the measures adopted by the Banking Supervision Department in the mortgage market, which were mainly intended to maintain financial stability, were expected to act to moderate demand in the housing market. However, the Committee estimated that, following the limitations placed on the portion of variable rate mortgages, the pass-through between the Bank of Israel interest rate and the interest rate on mortgages weakened.

Against the background of the stability indicated in real activity, the uncertainty that was prevalent regarding fiscal policy, and the risks inherent in continued increases in housing prices, the Monetary Committee decided to leave the interest rates for February, March, April and May unchanged.

In view of the accelerated growth in housing credit, together with the increase in risk, that took place in recent years, the Supervisor of Banks published a directive in February to increase capital buffers and provisions required in respect of the

risks implicit in the housing credit portfolio. This step is part of a series of macroprudential measures taken by the Supervisor during the recent period in order to minimize the financial risks derived from the rapid increase in the volume of mortgages.

The May 13 interest rate decision

In April and May the global economy continued to present a mixed macroeconomic picture. Alongside a moderate improvement in activity in the US, the data indicated a deepening recession in the Eurozone and its spread to the core countries. The International Monetary Fund lowered its 2013 growth forecast for most of the major economies in April. Against the background of the continued worsening in the global economy, many central banks continued their accommodative monetary policy. Alongside the continued quantitative easing in the US, the ECB lowered its interest rate to the historically low level of 0.5 percent, and the Bank of Japan announced a doubling of the pace of its bond purchasing program. The monetary expansion measures in Japan accelerated the weakening of the yen and apparently caused other central banks to lower their interest rates and intervene in the foreign exchange markets.

The accommodative monetary policy of the leading central banks led to an expansion of the effective gaps between the Bank of Israel interest rate and the interest rates in the world's major markets. This expansion, alongside the increasing expectations of appreciation against the background of the expected improvement in the balance of payments as a result of local natural gas production, increased the pressure for a strengthening of the shekel. From the beginning of the year until the middle of May, the shekel strengthened by about 4.7 percent against the dollar and about 6 percent against the effective exchange rate, which reached its lowest level since 2008.

In view of the continued trend of appreciation in the shekel against the background of the beginning of natural gas production from the Tamar well, the monetary expansion adopted by many central banks, and the downward revision of global growth forecasts, the Monetary Committee decided on May 13—outside the regularly scheduled framework—to lower the interest rate by 0.25 percentage points to 1.5 percent.

In addition, the Committee decided to implement a long-term foreign exchange purchasing program in order to offset the effect of natural gas production on the exchange rate. According to the program, from 2013 until the Sovereign Wealth Fund starts operating, which is expected to be in 2018, the Bank of Israel

will purchase foreign exchange of an amount that it believes is appropriate to offset the effect of the natural gas production on the balance of payments. The amounts to be purchased as part of this program will be added to the Bank of Israel's foreign currency reserves, but will be managed separately and with a longer planning horizon. The Committee also emphasized that the Bank of Israel would continue acting in the foreign exchange market in cases of serious fluctuations that are not in line with the basic economic conditions, or when the market is not functioning properly.

The decision to lower the interest rate was made, for the first time since the Committee was established, after the members reached a tied vote: three of them voted for a reduction of just 0.25 percentage points, while three voted for a 0.5 percentage point reduction. In accordance with the Bank of Israel Law, when the votes are equal, the Chairman of the Monetary Committee (the Governor of the Bank of Israel) has an additional vote. Against the background of differences of opinion in the Committee, the publication of the minutes of the discussion strengthened market expectations—as reflected in the forecasters' interest rate projections—of a further reduction in the interest rate.

The interest rate decision for June

The foreign exchange market's reaction to the Bank's measures was not long in coming. From the date of the decision until the regular Monetary Committee discussion in May, the shekel weakened by 3.9 percent against the dollar and by 3.2 percent against the effective exchange rate.

Around that time, National Accounts data for the first quarter of 2013 were published, indicating continued moderate growth, similar to the average pace of growth in 2012. With that, the Committee estimated that the actual pace of growth was higher than reported, since the decline recorded in domestic defense consumption was expected to be revised downward later on.

At the beginning of May, the government approved the budget plan for 2013 and 2014. If the plan is approved by the Knesset, it is expected to limit the deficit to 4.65 percent of GDP in 2013 and to 3 percent of GDP in 2014. While the government's approval of the plan lowered concern of a negative impact on the credibility of policy, the Committee estimated that its implementation is expected to moderate demand in the economy.

Further to the measures adopted in the previous interest rate decision, the Committee decided to lower the interest rate for June by 0.25 percentage points, to 1.25 percent, thereby reducing

the gaps between the Bank of Israel interest rate and the interest rates in the major economies worldwide in order to weaken the factors for strengthening the shekel.

The interest rate decisions for July and August

The decline in the inflation environment continued in June. This decline was reflected in the low CPI reading for May, which surprised to the downside, and by the continued decline in inflation expectations for the next 12 months. Inflation in the previous 12 months was below the lower bound of the price stability target range for the second straight month. At the same time, the Committee estimated that inflation was expected to return to the center of the target range later on, following the increase in VAT in June and following the end of one-time processes that moderated the inflation rate during the past year.

Following nine consecutive months of increases in home prices, there was a slight decline in March and April (the data were published in June). However, since this is a single reading, the Committee believed that it is still early to estimate whether there has been a turnaround in the housing market.

Global macroeconomic data indicated a mixed picture in the US, a recessionary environment in Europe, weakness in the emerging markets, and—in contrast—recovery in Japan and England. The global growth forecast and forecasts for the main economies were revised mostly downward.

Against the background of the continued recovery in the US, and particularly against the background of the continued decline in the unemployment rate, the Federal Reserve announced that it would taper quantitative easing, subject to continuing improvement in the macroeconomic conditions in the US. As a result, yields on US government bonds increased sharply, followed by yields on most global financial markets. The Committee estimated that should this increase continue, it could moderate the pressure for strengthening of the shekel.

The various indicators of economic activity indicated the possibility that there was a slowdown in the pace of growth in activity in recent months. The more prominent negative developments were: (a) the decline in the climate index to a level lower than it had been in the past four months; (b) the downward revision of the composite index for recent months; (c) the decline in the Purchasing Managers' Index to below 50 points; and (d) the sharp decline in the consumer confidence indices.

Just prior to the interest rate decision, the Research Department's staff forecast was updated. The growth forecast for

2013 remained unchanged at 3.8 percent of GDP, with the main growth factors being the expected growth in public consumption and savings in expenditures on imported energy products due to the production of local natural gas. In contrast, a slowdown is expected in exports, private consumption, and investments. The forecast for 2014 was revised downward to 3.2 percent of GDP, mainly due to the restraining effects of the budget plan and the downward revision of the global forecast.

The Research Department projects that the rate of inflation during the next four quarters will be near the center of the price stability target range. The main factors in the expected increase in the pace of inflation are: the VAT increase in June, the expected increase in the housing component; and the end of one-time processes that moderated the inflation rate in the past year, including lower costs for communications services as a result of increased competition in the cellular industry and the decline in education costs with the implementation of the recommendations of the Trajtenberg Committee for Economic and Social Change. In contrast, the significant appreciation that took place in the last three quarters, as well as moderating demand, will continue to restrain inflation in the coming period.

Based on the staff forecast, the Bank of Israel interest rate is expected to remain at its current level during the next year. The relatively low domestic interest rate is intended to support activity in the economy against the background of the slowdown in the global economy, the restraining effect of fiscal policy, and moderation in the inflation environment.

Table 2 shows that, in relation to the coming year, the Bank of Israel Research Department's inflation forecast is similar to the projections of private forecasters and higher than inflation expectations derived from the capital markets, while the interest rate forecast is similar to the forecasters' projections and to expectations derived from the capital market. A possible explanation for this is that the expectations derived from the capital market relate to inflation during the coming year, while the forecasters' projections relate to the next 12 CPI readings. As a result, the June index reading, which is expected to be high due to the VAT increase, affects the forecasters' projections and the staff forecast more than expectations derived from the capital markets in June.

The Committee estimated that the two interest rate reductions made in the previous month should provide a response to the developments shown by the various indicators and to the additional slowdown expected later on according to the Research Department's estimations.

Table 2:
Forecasts of inflation rate and interest rate for the coming year
(percent)

	Bank of Israel Research Department	Capital markets ^a	Private forecasters ^b
Inflation rate ^c (range of forecasts)	2.1	1.6 ^d	2 (2.6-1.6)
Interest rate ^e (range of forecasts)	1.25	1.2	1.2 (1.25-1.00)

^a Average for the month of June.

^b Inflation and interest rate forecasts are after the publication of the CPI reading for May.

^c Inflation rate over the coming 12 months.

^d Excluding the seasonality factor inherent in the Consumer Price Index.

^e Interest rate at the end of the second quarter of 2014. Capital markets forecast derived from Telbor rates.

SOURCE: Bank of Israel.

Against the background of these developments, the Monetary Committee decided to leave the interest rate for July unchanged and to let the measures recently adopted run their course. The interest rate for August was left unchanged at 1.25 percent.

b. The implementation of monetary policy

The Bank of Israel conducts monetary policy that is intended to achieve the inflation target set by the government. It uses various monetary tools for this purpose, including monetary loans to banking corporations, monetary deposits of banking corporations with the Bank of Israel, a credit window and deposit window, *makam* issues, activity in the open market, and repo auctions.

During the reviewed period, the banking system had surplus liquidity, and the Bank of Israel absorbed it through monetary deposit tenders and *makam* issues to the public. As Table 3 shows, the Bank of Israel absorbed an average of about NIS 90 billion during the reviewed period through monetary deposits (of which NIS 30 billion were in monthly deposits, NIS 30 billion in weekly deposits and NIS 30 billion in daily deposits), and NIS 120 billion through *makam* issues to the public.

Table 3:
 Monetary policy tools—deposits and *makam*
 (monthly deposits, NIS million)

	Daily	Weekly	Monthly	Total deposits	Total makam
Jan-13	35	33	30	98	117
Feb-13	31	33	30	93	120
Mar-13	27	32	30	89	120
Apr-13	31	30	30	91	121
May-13	29	30	30	89	123
Jun-13	24	28	30	82	124
Average	29	31	30	90	121

Appendix Table 1
The Domestic Assets Markets, January to June 2013

	01/13	02/13	03/13	04/13	05/13	06/13
Yields to maturity (monthly average, percent)						
3-month <i>makam</i>	1.7	1.7	1.7	1.7	1.5	1.2
1-year <i>makam</i>	1.7	1.7	1.7	1.7	1.4	1.3
Unindexed 5-year notes	2.8	2.8	2.8	2.6	2.4	2.6
Unindexed 20-year bonds	5.2	5.3	5.4	5.3	5.2	5.3
CPI-indexed 1-year notes	-0.6	-0.8	-1.1	-0.4	-0.4	-0.3
CPI-indexed 5-year notes	0.3	0.4	0.3	0.3	0.1	0.4
CPI-indexed 30-year bonds	2.7					
Yield gap between government bonds and:	1.2	1.1	1.0	0.8	0.8	0.8
private bonds rated AA–AAA ^a (percentages points)	6.7	7.0	6.7	6.5	6.4	5.9
Stock market (percentage change during the month)						
General share price index	0.9	3.8	1.5	-1.5	2.3	-2.4
Tel Aviv 25 Index	-0.7	3.7	1.3	-2.5	2.1	-3.4
Foreign currency market (percentage change during the month)						
NIS/\$	-0.1	-0.5	-1.6	-1.5	2.5	-1.8
NIS/€	2.7	-3.8	-4.1	0.7	2.2	-1.6
Nominal effective exchange rate	0.6	-2.2	-2.8	-0.5	1.4	-2.1
Risk measures derived from the trade in NIS/\$ options in the Tel Aviv Stock Exchange (monthly averages, percent)						
Implied standard deviation	11.6	12.3	12.4	12.2	12.3	12.2
Probability of depreciation greater than 3%						
Probability of appreciation greater than 3%						

^a CPI-indexed bonds, excluding convertibles, with a yield of up to 60 percent, and with a duration of more than six month.
The gaps between each corporate bond series and Galil bonds with the same duration.
SOURCE: Bank of Israel.

Appendix Table 2
The Inflation Environment and Interest Rates

	(monthly averages)					
	01/13	02/13	03/13	04/13	05/13	06/13
Inflation environment (percent)						
Monthly change in CPI	-0.2	0.0	0.2	0.4	0.1	0.8
Forecasters' predictions of monthly CPI (average of forecasts prior to publication of CPI)	-0.0	-0.0	0.2	0.4	0.3	0.7
12-month change in CPI	1.5	1.5	1.3	0.8	0.9	2.0
One-year inflation expectations derived from the capital market	2.4	2.6	2.8	2.1	1.9	1.6
Forecasters' one-year inflation predictions	1.9	1.9	1.9	1.8	1.8	2.0
Inflation expectations for various terms						
Short term (second and third years forward)	2.5	2.4	2.5	2.4	2.3	2.3
Medium term (fourth to sixth years forward)	2.6	2.6	2.5	2.4	2.4	2.4
Long term (seventh to tenth years forward)	2.7	2.4	2.3	2.1	2.4	2.4
Interest rates and interest rate differentials						
Bank of Israel interest rate	1.75	1.75	1.75	1.75	1.66	1.25
Derived real interest rate	-0.65	-0.8	-1.1	-0.4	-0.4	-0.3
Short-term interest rate differential between Israel and the US (prior to decision on the next month's rate)	1.50	1.50	1.50	1.50	1.41	1.00
Short-term interest rate differential between Israel and the eurozone (prior to decision on the next month's rate)	1.00	1.00	1.00	1.00	1.15	0.75
Forecasters' predictions of change in Bank of Israel interest rate for next month (average forecast, prior to the decision)	-0.1	0.0	0.0	-0.1	0.0	
Forecasters' predictions of interest rate a year hence	1.7	1.7	1.7	1.8	1.6	1.2
Long-term (10-year) nominal interest rate differential between Israel and US	2.3	2.2	2.2	2.2	1.8	1.7
Long-term (10-year) real interest rate differential between Israel and US	2.2	2.2	2.3	2.2	1.8	1.5

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.

