



Bank of Israel

INFLATION REPORT

July-September 2009

28

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2 November 2009

Bank of Israel

Letter of the Governor accompanying the Inflation Report for July–September 2009

This Inflation Report, covering the third quarter of 2009, is submitted to the government, the Knesset and the public as part of the process of assessing the inflation rate in relation to the inflation target set by the government. The Report was prepared in the Senior Monetary Forum of the Bank of Israel, headed by the Governor, the forum in which the Governor makes decisions on the interest rate.

Developments in the third quarter of 2009 bolstered the assessment that there has been a rapid turnaround in Israel's economic and financial environment. In the last quarter of 2008 and at the beginning of 2009 exports and GDP declined considerably, against the background of the global economic crisis, the CPI fell, and share prices and corporate bond prices slumped. At that time the crisis was expected to become more severe, with forecasts of further deterioration in the economic situation. Inflation was expected to be below the target range in 2009 or even negative. The situation began to change gradually at the end of the first quarter of 2009: the turnaround started with the recovery of the financial markets in March, with increases in share prices as well as a renewal of private bond issues; this was followed by an upturn in economic activity in the second quarter, and the rate of inflation increased and reached above the upper limit of the target inflation range.

The following selected facts demonstrate the speed and the strength of the turnaround:

In the third quarter the CPI rose by 1.3 percent, or at a 5.2 percent annual rate, whereas between April and August it had risen at an annual rate of 9 percent. The steep price increases were mainly due to non-recurring government policy measures—chiefly an increase in the VAT and a temporary surcharge on water prices in light of the drought—and to increases in the housing component which occurred despite the appreciation of the shekel vis-à-vis the dollar. This contrasts with the 2.2 percent reduction in prices in the last quarter of 2008 (annual rate, not seasonally adjusted). In December 2008 inflation expectations for the next twelve months derived from the capital market were of a negative 0.7 percent, below the target range of 1–3 percent annual rate. In the third quarter this reversed, and average expectations returned to close to the upper limit of the target range. More recently, inflation expectations have declined to 2.2 percent, close to the midpoint of the range.

In the last quarter of 2008 and the first quarter of 2009 GDP declined by 2.5 percent compared with its level in the third quarter of 2008, (annual rates, seasonally adjusted). However, in the second quarter of this year growth, at an annual rate of 1 percent, returned to the economy. At the time of the publication of the Bank of Israel Annual Report for 2008 (in April 2009), the Bank's forecast of GDP growth was of a negative 1.5 percent in 2009 and zero growth in 2010; in the most recent update, in September, the figures were revised upwards to zero growth in 2009 and 2.5 percent in 2010, figures which are at the lower end of the range of forecasts published by other professional bodies.

* This report incorporates the report on the rise in the money supply, in accordance with section 35 of the Bank of Israel Law, 5714–1954: in each month from April to June 2009 (inclusive) the money supply exceeded that in the preceding twelve months by more than 15 percent. The change in the money supply is discussed in section 1d in this report.

The sharpest change took place in the financial markets: in the period from the end of August 2008 to the end of February 2009 the Tel Aviv 100 index dropped by more than a third, and the Tel-Bond 60 index by more than 12 percent. Since the beginning of the recovery, in March 2009, these indices have started rising again, and they are currently higher than they were prior to the deterioration of the crisis in September 2008.

The change in the economic environment naturally led to changes in various aspects of economic policy. On the fiscal side, in the first quarter of 2009 assessments of the 2009 budget deficit reached close to 6 percent of GDP, based on the view that negative growth would substantially reduce tax revenues and would increase expenditures related to the system of automatic stabilizers, such as payments of unemployment benefits. The authorities also made plans for the possibility (that was not realized) that they would need to support the financial system, as indeed occurred in many other countries. By the end of the third quarter assessments of the budget deficit were and are lower than earlier forecasts, and the financial system is seen as being stable.

Monetary policy was also adjusted in light of the changes in the situation. When the crisis deteriorated in the last quarter of 2008 and the first quarter of 2009, the Bank of Israel pursued highly expansionary policies, which continued in the second quarter of 2009. In the third quarter, the Bank gradually began to reduce monetary expansion. Three monetary tools were used to effect these policies:

1. After reducing its interest rate rapidly in the last quarter of 2008 and the first quarter of 2009, from 4.25 percent in September 2008 to 0.5 percent in April 2009, it increased the rate for September to 0.75 percent. Nevertheless, the interest rate is still low, particularly in light of the improved economic situation, and it is aimed at continuing support for the recovery, which has not run its course.

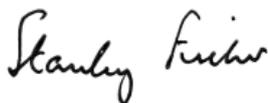
2. The revised assessments in the third quarter of GDP and export growth led to a change in the Bank's policy of intervention in the forex market. When it launched its policy, in March 2008, its purpose was to increase Israel's foreign exchange reserves, which at that time were low by international standards, and in light of the increased risks due to the crisis. When the reserves reached the stated target level, the Bank continued to buy dollars on the market at a fixed rate of \$100 million a day, in order to moderate the appreciation of the shekel and to soften the blow to exporters resulting from the crisis. Thus the reserves increased from \$28 billion in February 2008 to \$58 billion in August 2009. Over the first few days of August, the Bank phased out its policy of buying a fixed daily amount of dollars and replaced it by a policy of intervening in the market in the event of unusual movements in the exchange rate which are inconsistent with underlying economic conditions.

3. In August 2009 the Bank ended its activity in the government bond market, a policy it had adopted to lower medium and long-term interest rates. The Bank had started buying bonds in February 2009, when it announced its program of daily bond purchases of about NIS 200 million until it had purchased between NIS 15 billion and NIS 20 billion. The Bank reached this target in August, in line with the program, and stopped buying bonds.

The sharp and rapid change in the economic environment confronts monetary policy with a new challenge—to strike a balance between the aim of supporting the still fragile real recovery, and considerations of price stability and financial stability, in light of indications of increases in prices of commodities, services, and assets, and in particular, housing.

Decisions on the interest rate and intervention in the forex market will be taken in light of ongoing assessments of these opposite trends, with the intention of achieving the inflation target while continuing to support the recovery of real activity and financial stability.

Stanley Fischer



Governor, Bank of Israel

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Summary

- **Inflation:** The Consumer Price Index (CPI) rose in the third quarter of 2009 by a cumulative 1.3 percent. The factors providing the background to the price increases in this quarter were the government intervention in the form of temporary increases in indirect taxes, renewed increases in world energy and commodity prices, the continued expansionary monetary policy, and recovery in the financial markets, together with signs of a resurgence of real activity. In the last twelve months the CPI rose by 2.8 percent—within the price stability target range. Inflation expectations were below their level in the previous quarter, and are currently within the inflation target range.
- **The global environment:** In the quarter under review the risks to the stability of the global financial system eased, and real activity showed some recovery. The early signs of recovery appeared against the background of low rates of inflation, and monetary policy in many countries continued to maintain low interest rates, while employing quantitative expansion tools. Central bank interest rates are expected to remain at their low level for a considerable time, until the recovery in economic activity gathers momentum and excess capacity contracts significantly.
- **Real activity:** In the second quarter of 2009 real activity increased in Israel, following two quarters of contraction, and the rate of unemployment stabilized. The increase in demand in the third quarter helped to moderate the increase in excess capacity, but did not reduce it. This, together with the absence of pressure from the labor market that was reflected in reduced unit labor costs, meant that real activity did not constitute a source of inflationary pressure on the supply side.
- **The exchange rate:** In the third quarter, against the background of the worldwide weakening of the US dollar, the shekel showed a trend of appreciation against most currencies. Thus the transmission mechanism from the nominal effective exchange rate served to offset the global forces acting to increase prices in Israel.
- **The financial markets:** In the third quarter the financial markets continued along the upward path that started in the second quarter. Asset prices continued to increase, and reached their September 2008 level, prior to the deterioration of the crisis. In contrast, the risk premium on corporate bonds stabilized. Against the background of the expansionary monetary policy the real yield curves of government bonds shifted downwards.
- **Monetary policy:** In the third quarter of 2009 monetary policy was faced with the challenge of dealing with a sharp change in assessments of the economic situation, with the transition from a definite crisis and price falls at the beginning of the year to a recovery of economic activity, with the added complication that the recovery was accompanied by great uncertainty regarding its strength, weakness in the labor market, and a rise in the inflation environment that started at the beginning of the second quarter. The set of indicators available to the Bank of Israel during the third quarter supported the continuation of monetary expansion with some reduction in its intensity, in order to sustain the recovery in economic activity, stabilize the financial markets, and return inflation to within the legally defined target range. Monetary policy was expressed by changes in the mix of the tools the Bank had employed in the previous quarter: first, the Bank stopped buying government bonds, in line with the declared program, assessing that the program had indeed helped the market to start functioning properly again. At the beginning of August the Bank changed its method of intervention in the foreign exchange market: it moved from a daily purchase of a fixed amount of foreign currency to a variable intervention—with regard to timing and amount—whenever it considers that the exchange rate is not in accord with the fundamental economic conditions. Interest rate policy in the period reviewed was reflected in the interest rate

for July and August being held at the low level of 0.5 percent, and its increase by 0.25 percentage points for September, in light of the assessment that the previous level was no longer appropriate taking into account the turnaround in economic activity. Thus the interest rate at the end of the third quarter stood at 0.75 percent, and it remained at that level for November.

- Forecast: The output gap is expected to widen in the coming months, despite the recovery of domestic demand, as growth rates are still low compared with the economy's potential growth. GDP in 2009 is expected to be at the same level as in 2008, and unemployment to increase to 8.1 percent. In 2010 GDP is expected to grow by 2.5 percent., and inflation, measured over the previous twelve months, is expected to be close to the midpoint of the target range.

* The monetary regime within which the Bank of Israel operates is aimed at achieving price stability, defined as an inflation rate of between 1 percent and 3 percent a year. (For details see Box 1 on page 11 in the Bank of Israel Inflation Report No. 17, July–December 2005.)

Figure 1
GDP Growth rates in Advanced Economies, 2005:Q1 to 2009:Q3 (annual rates, seasonally adjusted)

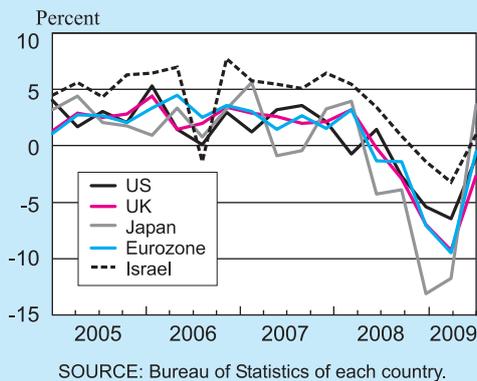


Figure 2
World Trade in Goods and Services (quarterly rates of change, 1971:Q1 to 2009:Q2)

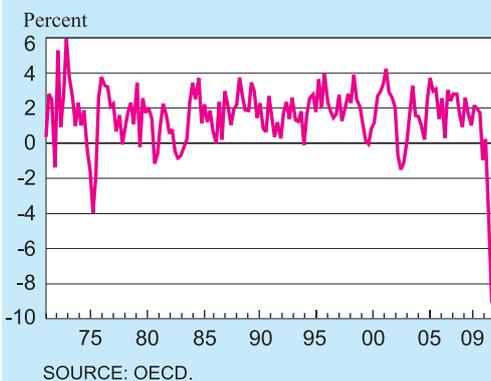


Figure 3
Share Price Indices around the World, January 2008 to September 2009 (adjusted by dollar exchange rate, daily data, 15 Sep 2009 = 100)



1. THE BACKGROUND AND INFLATION

In order to manage its interest-rate policy the Bank of Israel monitors developments in the global environment and real economic developments in Israel; it also tracks various economic indicators derived from the capital, money, and foreign-exchange markets. By monitoring a range of developments it is possible to constantly examine the markets' responses and their implications for expected inflation, thereby determining the appropriate level of interest for attaining the price-stability target in the near future while stimulating employment and growth and maintaining the stability of the financial markets. During 2009:Q3 (the period reviewed) the Bank of Israel adopted a policy that is consistent with assessments of the effects of the following on inflation: (1) the positive turnaround in global activity in 2009:Q3 in both the financial and the real economic spheres; (2) the recovery in domestic economic activity, together with considerable uncertainty regarding its intensity; (3) specific shocks, such as changes in tax rates; (4) the temporary rise in the inflation environment alongside the existence of an output gap that acted to moderate inflationary pressures also in the third quarter. The main developments in the global economy, the exchange rate, and real economic activity are described below, together with the monetary indicators in the context of which the Bank of Israel's interest-rate decisions were made in the period reviewed.

a. The global environment

(1) Financial stability and real economic activity world wide

During the period reviewed—in contrast with developments at the beginning of the year—the immediate risks to the stability of the global financial system which had soared since 2008:IV diminished. Central banks and governments world wide took unprecedented policy actions: massive capital injections into the markets by means of direct transfers and short-term loans, the implementation of programs to reactivate credit lines by removing toxic assets from banks, extending guarantees, and introducing regulatory changes aimed at regulating and tightening the supervision of financial institutions. These actions succeeded in calming the pessimism that had prevailed in the markets due to the exacerbation of the financial crisis at the end of the previous year, and contributed inter alia to the stability of the banking system, the easing of liquidity pressures, the revival of nonbank

financial intermediation, and the reduction of concern over the realization of counterparty risks.¹

Expectations that the global economic crisis would worsen abated in response to the exceptional fiscal and monetary measures adopted, so that uncertainty declined and investors were able to return to the financial markets. In the corporate bond market there were indications of a gradual rehabilitation: yield spreads against government bonds narrowed at most rating levels, and the extent of issues continued to grow. Global markets rose in the period reviewed (Figure 3),² as a result of the improvement in the global economic environment and the rise in investors' risk appetite³ at the expense of liquidity positions, which were reduced. However, the realization of accrued profits, seasonal factors, the erosion of the element of surprise in the positive financial reports, as well as expectations of solid background conditions for the financing of future economic activity, all served to amend the trend which had emerged in the stock markets at the beginning of 2009:Q2. Moreover, against the backdrop of the deviation of various financial measures⁴ from their historical values there were apprehensions of an upward over-reaction in the stock markets, excessive risk-taking, and a continued rapid rise in the indices in the period reviewed as well as in the coming months.

Despite the turnaround in the systemic risk environment, most conditions have remained tight, and the situation in the financial markets is far from being fully normalized. Banks' balance sheets have not been entirely cleansed of toxic assets, and many institutions are still undergoing a process of rehabilitation. The slowdown in the supply of bank credit to the private sector in the developed economies has persisted as deleveraging pressures persisted. The contraction of credit in those countries also led to a decline in the extent of international credit and a sharp reduction in direct investment in the emerging economies⁵—a development which has reduced their future repayment ability. In addition, the continued dependence of the financial sector on extensive public

¹ As expressed in the reduction of differentials in CDS and the Libor-Overnight Index in the last few months.

² The global MSCI index (in which the developed markets have additional weight) reached its highest level in 11 months in the period reviewed. The equivalent index for the emerging markets has doubled since March.

³ The term 'risk appetite' embodies a reference to both the element of uncertainty that depends on the macroeconomic environment and the element of uncertainty that depends on risk-aversion. In contrast to risk-aversion, which does not change in the short term, risk appetite reacts to shifts in financial distress or the level of macroeconomic uncertainty, and hence is inherently more volatile.

⁴ Such as dividends, price/equity ratios, etc.

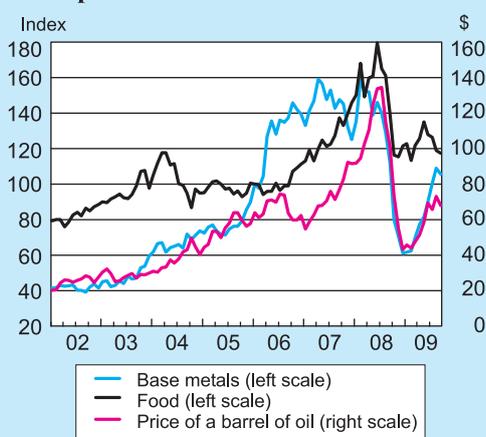
⁵ One of the most significant indications of the impairment of activity in the credit markets is the 30 percent drop in the extent of global FDI and the reduction of MNC activity in emerging economies during the past year.

support led to the unbalanced transfer of risks from financial institutions to the public sector and impaired fiscal sustainability. Alongside the changes in the financial climate, green shoots of recovery have been evident in real economic activity. Positive indicators were found in the development of emerging markets in Asia, while data from the US, Japan and the Eurozone (especially Germany and France) showed improvement in several parameters—primarily in manufacturing, real-estate, purchasing managers’ indices,⁶ exports, and GDP (Figure 1).⁷ However, irrespective of the indications that the recession is easing, there is general agreement that it cannot be said to have come to an end and that the process of recovery from it (with all the difficulties that this entails) will be slow. Exceptional unemployment figures, described as the ‘third wave’ of the current crisis, overshadow the recovery and confront policymakers in various countries with a tremendous challenge when it comes to deploying programs to cut the deficit and reduce liquidity in the markets in the future.⁸

(2) Global inflation

During the period reviewed inflationary pressures did not develop globally because of the slack nature of global economic activity. Nevertheless, the renewed rise in prices of goods and fuel served to moderate downward pressure on prices. Continuing the trend that emerged in 2009:Q2, global energy and goods prices rose (Figure 4)⁹ in the wake of the rapid recovery of economic activity in Asia, the improved level of optimism in the markets, and the weakening of the dollar; the contraction of supply also contributed to the rise in energy prices. The turnaround in the development of goods and energy prices served to offset the downward pressure on prices, due to the excess capacity resulting from the ongoing contraction of real economic activity worldwide. Evidence of the effect of these prices on the trend of inflation globally (Table 1) may be found in indices of the core inflation rate (indices adjusted for food and energy prices) in various countries: the rates at which these indices rose in the US, Japan, the Eurozone, and the OECD

Figure 4
Price Indices of Base Metals and
Food (January 2006 = 100), and the
Price of Oil, January 2002 to
September 2009



SOURCE: Bloomberg

⁶ For example, the index of US purchasing managers showed growth for the first time in eighteen months. The Shiller 20 index of house prices in the 20 largest cities in the US also rose in the period reviewed—after declining consistently since 2006.

⁷ Thus GDP in Germany, France, and Japan rose by 1.3, 1.4, and 3.7 percent respectively in annual terms.

⁸ A rise in the unemployment rate is expected to increase the extent of banks’ debt write-offs (losses, especially in the US due to the excessive leverage by consumers), thereby affecting the level of certainty in the system and the supply of bank credit required to sustain the global recovery.

⁹ The index of basic metals prices rose by 26 percent, the index of fuel prices rose by 16 percent, while the index of food prices fell by 6 percent.

Table 1
The CPI and Selected Components in Israel and Abroad, 2008 and 2009

	(percent change)											
	Israel				US				Europe			
	2008	2009*	2009: Q2**	2009: Q3**	2008	2009*	2009: Q2**	2009: Q3**	2008	2009*	2009: Q2**	2009: Q3**
CPI	3.8	2.8	9.4	5.1	0.1	-1.3	5.7	0.5	1.6	-0.3	2.5	-1.2
Energy	-9.5	-6.8	36.0	8.6	-21.3	-21.6	79.5	-6.0	-3.7	-11.0	13.0	-4.9
Food (excluding fruit and vegetables)	9.1	1.6	0.4	6.0	5.9	-0.1	-1.5	-0.9	3.5	0.5	0.4	0.3
Fruit and vegetables	-2.0	-2.0	7.5	18.9	3.4	-6.4	-3.1	-7.1	2.8	-1.3	-1.1	-9.8
CPI excluding energy, food, and fruit and vegetables	3.6	4.4	9.1	4.0	1.8	1.5	1.2	1.6	1.8	1.1	0.7	0.0

* In previous 12 months.

** In annual terms.

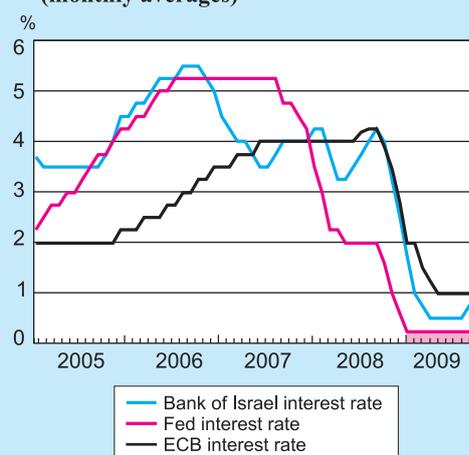
SOURCE: Based on Central Bureau of Statistics, ECB, Eurostat, and US Bureau of Labor Statistics data.

countries were lower than the general inflation rate in the period reviewed. The increase in inflation expectations in this period attests to assessments that the deflationary pressures on the eve of the period reviewed were transitory.

(3) Monetary policy around the world

The object of the monetary policy adopted by central banks all over the world in 2009:Q3 was—in addition to its traditional purpose of maintaining price stability—to stabilize and stimulate market activity while preventing the undermining of financial stability. Central banks continued to conduct an expansionary monetary policy while also operating various aid packages intended to increase liquidity in the markets. The US Fed left the interest rate in the 0 to 0.25 percent range (Figure 5), hinting that as an exceptional measure it would leave it at a low level for some considerable time, while extending the emergency program for purchasing mortgage-backed bonds until March 2010. By doing this the Fed continued to rely mainly on the quantitative easing package (purchase of assets program)¹⁰ as the principal instrument for contending with the crisis. The Fed's announcements state that inflation is expected to remain moderate for some considerable time—because of the slack pass-through from the underlying forces (mainly demand) to the level of prices, as well as the forecast long-term inflation rate, which

Figure 5
Short-Term Interest Rates in Israel, the US, and the Eurozone, 2005 to October 2009
(monthly averages)



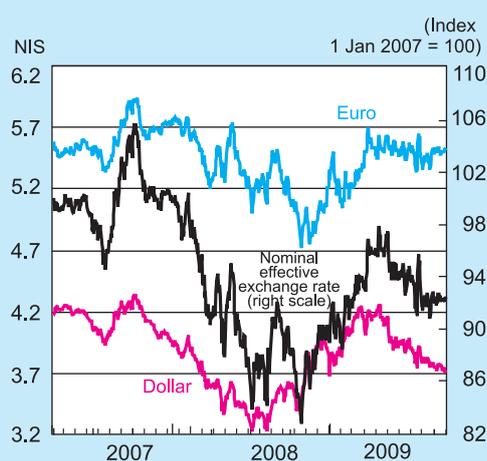
SOURCE: Bank of Israel, the ECB and the FED.

¹⁰ For example, TARP (troubled assets relief program).

remained stable. The central banks of Japan and the Eurozone also adopted a policy of leaving the interest rate unchanged in the period reviewed, in accordance with the unique nature of the developments in the domestic markets—a policy which was expressed in the fact that the interest rate remained at 0.1 and 1 percent respectively.

A wider examination of the pass-through from global developments to the level of domestic prices¹¹ indicates that during the period reviewed the imported inflation component had only a moderate effect on the level of domestic inflation. The pass-through from the changes in the global economic environment to the development of domestic prices went through several principal channels. The initial recovery of global trade, whose influence on the rise in domestic prices has been moderate to date because of the weak demand for Israel's output. This had a direct effect via the prices of imported goods and an indirect one via production costs, which are partly derived from the price of imported inputs; their effect on domestic price increases was moderate because the increase in goods prices began only in the preceding quarter, and their impact is felt with a lag. These effects were offset by the domestic interest and exchange rates—which are derived from cross rates, interest rates abroad, and global risk assessments—due to the strong NIS in the period reviewed. In general, economic developments worldwide in the period reviewed contributed to a moderate extent to the rise in the level of domestic prices.

Figure 6
The NIS/\$, NIS/Euro and the
Nominal Effective Exchange Rate,
2007 to October 2009 (daily data)



SOURCE: Bank of Israel.

b. The development of the NIS exchange rate

During 2009:Q3 the NIS rose against most world currencies, and in particular against the dollar. The effective nominal exchange rate (Figure 6) rose by 2.3 percent in 2009:III (September average vis-à-vis June average)—expressing inter alia appreciation against the euro and the dollar of 0.8 and 4.5 percent respectively. During the period reviewed the effective real exchange rate also rose by 1.3 percent, while its development path in the last twelve months remained stable.

Most of the underlying factors acted to generate local-currency appreciation, and some of them had begun to do so even before the period reviewed. They included the following: (1) The surplus in the current account (Figure 7),¹² which rose by a marked \$4.4

¹¹ As a small open economy, Israel is exposed to a great extent to developments in the global economic environment.

¹² For the year as a whole the current account surplus is likely to be NIS 7.3 billion.

billion in the second half of 2009 in comparison with a \$1.7 billion increase in the second half of 2008 due to the sharp rise in the goods and services account; this was partially offset by the increase in the deficit in the revenues account and the contraction of the surplus in current transfers; (2) The fact that Israel's credit rating remained at A; (3) The slight change in the interest-rate spread between Israel and the rest of the world (primarily the widening of the spread vis-à-vis the US and its narrowing vis-à-vis the Eurozone)—due to the increase in the September interest rate; (4) The GDP growth rate and optimistic assessments of the speed at which the domestic economy will emerge from the crisis relative to other economies; (5) The weakening of the dollar worldwide. Two forces acted in opposition to these forces to weaken the domestic currency against the leading currencies—foreign-exchange purchases¹³ by the Bank of Israel and net capital exports.¹⁴

c. Real economic developments

The trend of recovery in economic activity, signs of which were evident in the second quarter of 2009, continued in the third quarter. Nevertheless, there is great uncertainty about the strength of the recovery, due to the dependence of Israel's exports—which is the economy's main engine of growth in the long run—on the sturdiness of the resurgence of global activity. According to the National Accounts figures for the second quarter of 2009, GDP increased at an annual rate of 1 percent, and business sector product at a rate of 1.3 percent, after only two quarters of steep drops in economic activity. It seems that the positive fundamentals of Israel's economy¹⁵ at the outbreak of the crisis helped to soften the impact of the global recession on the performance of the economy. The growth of GDP and business sector product in the third quarter were based mainly on the upturn in world trade, and was supported by the Bank of Israel's stabilization policy and a fiscal policy that was consistent with the goals set. The improvement in the terms of trade in the second quarter should support the resurgence of domestic activity, and even partially to offset the negative effect of the increase in world prices of energy

¹³ For a more detailed explanation, see the chapter on monetary policy in this report.

¹⁴ For the first time in many years foreign investors realized almost all the components of their portfolio, alongside the revival of investment abroad by Israeli residents.

¹⁵ For example the robustness of the banking system and its low exposure to the main sources of the financial crisis, the responsible fiscal policy, the reliance on the high-tech industries as the main driving force behind economic growth, and the current account surplus.

Figure 7
The Current Account, Running
Four-Quarter Totals,
2003:Q1-2009:Q2 (quarterly)

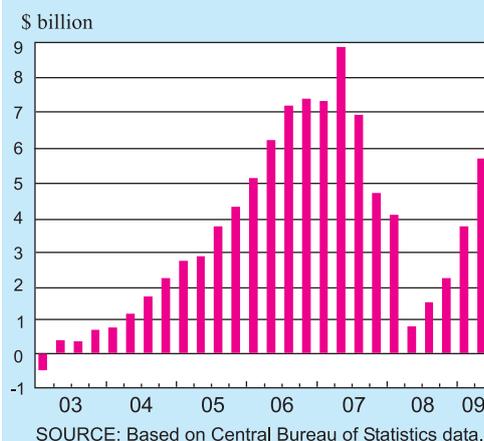


Table 2
GDP, Imports and Uses, 2007-2009:Q2

(volume change from previous period, percent, seasonally adjusted, in annual terms)

(quarterly percent change)

	2007	2008	2008:Q2	2008:Q3	2008:Q4	2009:Q1	2009:Q2
GDP	5.2	4.0	3.6	0.8	-1.6	-3.3	1.0
Business sector output	5.6	4.5	3.9	0.2	-2.7	-5.0	1.3
Imports excluding defense imports, ships, aircraft and diamonds	13.6	7.2	-6.0	-1.5	-6.2	-45.8	3.2
Private consumption	6.3	3.6	-3.4	1.5	-2.6	-4.1	5.6
<i>of which:</i> Private consumption excluding consumer durables	5.1	2.7	-0.3	7.1	-0.1	-0.4	3.8
Public consumption	3.4	2.1	-9.7	3.5	-0.8	-4.7	12.1
<i>of which:</i> Public consumption excluding defense imports	4.1	2.2	-3.2	8.4	-1.7	-6.5	20.7
Gross domestic investment	10.1	1.4	27.6	-12.5	22.1	-19.1	-54.9
<i>of which:</i> Fixed investment	15.3	4.4	-3.2	-14.9	-4.8	-15.2	2.0
Exports excluding diamonds	10.4	10.5	-5.4	7.3	-22.9	-30.3	26.3
<i>of which:</i> Exports excluding diamonds and start-ups	10.9	9.7	-0.3	9.1	-24.5	-31.7	34.2

SOURCE: Based on Central Bureau of Statistics data.

products and commodities in the third quarter. The rise in the composite state-of-the-economy index in the third quarter, which mainly reflected the increase in goods and services exports, also pointed to a positive turnaround in economic activity, although not all the components of the index support this assessment.¹⁶ In addition, the Bank of Israel Companies Survey for the third quarter indicates that the expansion of business sector activity continued in the third quarter, and encompassed most of the principal industries. The overall net balance¹⁷ of the business sector reported in the survey became positive for the first time since the second quarter of 2008.

The recovery in activity in the third quarter was based on the increase in exports (of goods and services) and on the increase in domestic uses, in particular private and public consumption. Despite the marked increase in the level of economic activity, there is concern as to whether the trends in the main components will persist. Moreover, despite the fact that certain indicators such as the increase in imports of capital goods and raw materials signal a potential expansion of production in the near future, the continued reduction in gross domestic investment

¹⁶ The index of manufacturing production and the index of trade and services revenue, which constitute the core of the index, prevent the conclusion being drawn about a continuous recovery, as they declined in August.

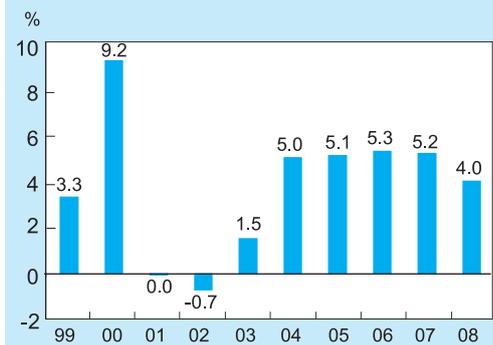
¹⁷ The net balance is the difference between the number of companies reporting an increase and those reporting a decrease.

(−54.9 percent annual rate in the second quarter together with the steady level of fixed capital formation (an increase of 2.1 percent, at an annual rate, in the second quarter) do not enable conclusions to be drawn at this stage about the strength of the recovery.

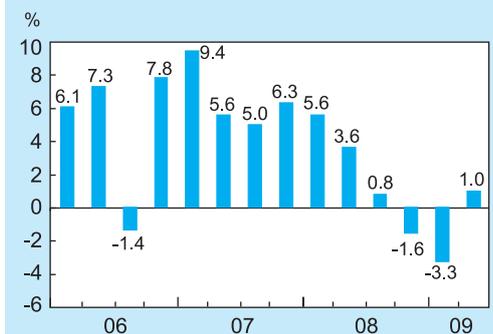
The increase in private consumption at an annual rate of 5.6 percent in the second quarter was affected by the sharp increase in consumption of durables during part of the period reviewed—due to the low-interest-rate environment and purchases being brought forward because of the changes in taxation—and cannot be interpreted as a jump in the public’s expectations regarding the strength of the economic recovery. Current consumption, with a notable increase of 3.8 percent (annual rate) in the second quarter that resulted from increases in the consumption of services and in retail trade, provides grounds for no more than cautious optimism. This, against the background of the slow general reaction of the labor market to the expansion in activity, the public’s reduced earning capacity, and in particular the lack of significant change in the degree of employment uncertainty. The decline in the consumer confidence indices in September also indicates the dampening of the optimism regarding a sharp turnaround in consumption in the near future.

The main reason for the 12.1 percent increase in public expenditure¹⁸ in the second quarter was the surge in domestic defense expenditure, while civilian consumption rose by only a moderate 1.7 percent. The continued modest growth of civilian public expenditure in the last few months is the renewed underspending of the budget also after the approval of the budget by the Knesset. Fiscal policy conducted during the period could be described as neutral, although the increase in the expenditure ceiling, which was in accordance with the temporary increases in tax rates, was partly intended to boost the help afforded via credit to exporters and small and medium-sized businesses in the context of the steps taken to boost economic activity.¹⁹ The nature and strength of this policy was determined by the economy’s fundamentals and by the effects of the global crisis, so that unlike in other economies, in Israel no massive intervention by the government was necessary. Budget expenditure in the third quarter increased in line with the signs of economic recovery, so that the increase in tax revenues, from both direct and indirect taxes, will enable the government to meet the deficit target of 6 percent of GDP, even if the budget is spent in full. We would emphasize that the effect of the increase in indirect tax rates is a

Figure 8
GDP, Annual Growth Rates, 1999–2008



Quarterly Growth Rates,
2006:Q1–2009:Q2
(in annual terms)

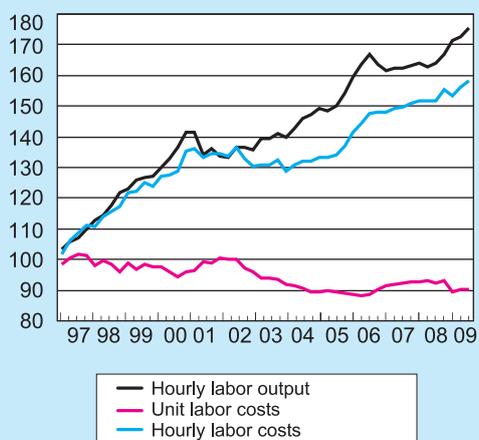


SOURCE: Central Bureau of Statistics.

¹⁸ Public expenditure cannot constitute the basis for sustainable growth.

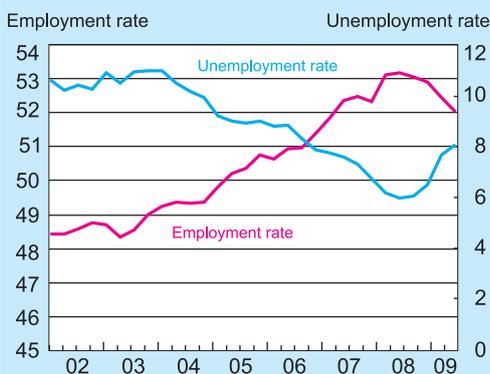
¹⁹ The effect of these programs was minimal because of their small scale.

Figure 9a
Index of Gross Unit Labor Costs in the
Business Sector, 1997 to June 2009
 (quarterly, seasonally adjusted, nominal)
 (1997:Q1=100)



SOURCE: Based on Central Bureau of Statistics data.

Figure 9b
The Employment Rate and the
Unemployment Rate,^a
2002:Q1-2009:Q2
 (seasonally adjusted, quarterly, percent)



^a Unemployment rate, percent of labor force; employment rate, percent of working-age population.

SOURCE: Labour Force Surveys of the Central Bureau of Statistics.

temporary rise in the price level, and is not expected to cause a continued increase in the inflation rate.

The notable 26.3 percent increase in exports (excluding diamonds) in the second quarter of 2009 was based on the expansion of services exports (which constitute 30 percent of total exports), particularly tourist services, as a result of the easing of the security situation, and business services, a possible indication of a turnaround in real economic activity. In the last few months goods exports also increased, but this was almost entirely the result of a sharp increase in exports of the electronic components industry, and a modest 1 percent rise in manufactured exports (excluding diamonds and electronic components) which accounts for about half of total exports. Exports of the chemicals industry are still at a standstill following their dive during the global crisis, and the situation is similar in most of the other industries. The future development of exports, and in particular of goods exports, depends on the pace of the recovery of global activity from the recession. Exports by country of destination show that at present they match the pace of recovery in Israel's main trading blocs, with the increase being in exports to Asia (59.5 percent increase, annual rate, in June–August compared with the previous quarter, the US (31.8 percent), and the euro bloc (20.2 percent).

The recovery of real activity started to have an effect also on the labor market, as can be seen from the stability of the unemployment rate at 7.9 percent from April. At the same time the number of new work-seekers, which essentially reflects the number of unemployed persons entitled to unemployment benefits, also stabilized and even declined, indicating a fall in the rate of dismissals. Most indices of demand for labor (such as that of the Manpower company) in the last few months show an increase in demand for workers in most industries. Wage data also contain early signs of improvement, with a slowing of the rate of decline and even a small increase in the last few months—health tax revenues suggest an increase in total wage payments. Wage developments may have an indirect effect on the inflation rate, via their impact on production costs. Thus the rise in productivity (product per employee post) in the third quarter, together with the modest (0.3 percent) increase in the nominal wage since the beginning of the year served to lower unit labor costs, thus preventing upward price pressure.

The Bank of Israel assessment is that the current crisis did not affect the potential growth rate of business sector product. This is because the impact on the accumulation of physical capital and the erosion of the stock of human capital due to the drop in employment were not significant. In addition, the rate of

expansion of domestic demand in the period reviewed did not have a significant contractionary impact on the output gap, as the rate of increase of potential output was still faster than that of actual demand. Hence, in the absence of pressure from the labor market, as can be seen from the fall in unit labor costs, there was no perceptible inflationary pressure from the supply side. The forces acting to lower prices in the period reviewed moderated, however, due to the increase in demand.

d. Financial developments

Developments in the financial markets in Israel in the third quarter of 2009 continued the trend observed at the beginning of the previous quarter, and were expressed in increases in prices of financial assets. The path followed by share price indices around the world since the outbreak of the crisis proved that the feeling that the crisis was a global one was correct, with all the indices, in advanced economies and emerging markets, showing almost perfect correlation, thus preventing a geographical dispersion of risk. The share markets in Israel also acted similarly to those around the world, and followed the same trends as the international markets in the period reviewed—a sharp increase in July, and wide fluctuations in August–September. This occurred together with a marked increase in daily turnover, despite its being the period of the summer vacation. Most of the factors affecting the indices in Israel were the same as those in other markets: a rise in risk appetite among those investing in Israel due to the high level of liquidity in the system and the lack of attractive alternative investments due to low yields on risk-free assets. This trend was supported by the favorable basic financial conditions of the domestic economy, worldwide optimism, better-than-expected financial statements for the second quarter, and signs of improvements in Israel’s macroeconomic indicators. Nonetheless, labor market data and profit-taking acted to dampen the trend in the share markets. It is worth noting that the strength of the domestic market’s reaction was similar to that in the emerging markets in which significant increases were recorded—the Tel Aviv 100 index surged by 57 percent from the beginning of the year (compared with an average rise of 12 percent in the advanced economies), to stabilize at the level it had reached in the months prior to the collapse of Lehman Brothers. That said, the current level of the index is still 30 percent lower than the peak recorded in the last quarter of 2007. The current interest environment, the

Table 3
The Domestic Assets Markets, April to September 2009

	04/09	05/09	06/09	07/09	08/09	09/09
Yields to maturity (monthly average, percent)						
3-month <i>makam</i>	0.4	0.4	0.3	0.4	0.5	0.7
1-year <i>makam</i>	0.9	1.1	1.3	1.3	1.6	1.7
Unindexed 5-year bonds	3.7	4.3	4.6	4.2	4.4	4.0
Unindexed 20-year bonds	5.5	6.0	6.3	6.3	6.2	6.1
CPI-indexed 1-year bonds	0.1	-0.9	-1.1	-1.1	-0.8	-0.5
CPI-indexed 5-year bonds	1.3	1.6	1.8	1.5	1.6	1.5
CPI-indexed 30-year bonds	3.6	3.8	3.9	3.9	3.7	3.7
private bonds rated AA–AAA ^a (percentage points)	2.9	2.2	1.8	2.0	1.6	1.5
private unrated bonds excluding real estate ^a (percentage points)	17.2	16.2	12.9	13.6	13.0	13.6
Share market (percentage change during the month)						
General share price index	8.2	8.0	1.2	9.0	-0.4	3.4
Tel Aviv 25 index	11.5	8.5	-2.2	10.2	-0.5	7.4
Foreign currency market (percentage change during the month)						
NIS/\$	-0.6	-4.9	-1.0	-3.3	0.6	-1.0
NIS/€	-0.9	-0.9	1.1	-3.4	1.8	1.0
Nominal effective exchange rate	0.6	-2.5	0.2	-2.9	0.8	0.4
Risk indices derived from the trade in NIS/\$ options in the Tel Aviv Stock Exchange (monthly averages, percent)						
Implied standard deviation	11.9	13.9	14.8	13.5	15.0	11.7
Probability of depreciation greater than 3%	6.0	8.1	9.1	8.7	10.1	5.7
Probability of appreciation greater than 3%	6.1	10.4	10.9	8.6	11.1	4.6

^a CPI-indexed bonds, excluding convertibles, with a yield of up to 60 percent, and with a duration of more than one year.
 SOURCE: Bank of Israel.

indices that showed the greatest gains,²⁰ as well as the risk level in the global system, and the economy's heavy dependence on the improvement in the real global economy, all these point to the relatively high risk level and give rise to concern regarding the rally in Israel's share market.

Raising credit from non-bank sources continued in the third quarter at the same rate as in the second. Non-bank credit continued to expand in the third quarter (by about NIS 11.4 billion), with the yield gap between corporate bonds and government bonds of all ratings remaining stable or even widening slightly.²¹ It should be stressed that the recovery of the non-bank credit market (excluding credit raised by banking institutions) since the beginning of the year is evident in only a small sample of companies, so that it is too soon to generalize about overall

²⁰ Oil and gas exploration indices and the real estate index.

²¹ The gap stabilized at its level in the first half of 2008.

economic activity.²² Moreover, the trend of raising capital by means of corporate bonds in the last few months persisted even though the background gave rise to questions about the implementation of conclusions drawn from the financial crisis. Thus, capital was raised in the third quarter also via bond issues by real estate companies and by companies with medium ratings; some issuing companies encountered difficulties in their issues; some bond series were downgraded; and there expectations of difficulties in future repayments of debt by companies affiliated with certain business groups, such as the Africa-Israel group or Zim (part of the Ofer group). Debt arrangements are expected to have far-reaching effects on the activity of the financial markets in the future because of their relevance to moral hazard in the system.²³ Concurrently with the development of the non-bank credit market in the third quarter, the standstill in bank credit to the business sector persisted, while credit to households continued to increase, mainly due to the increase in mortgages. The average cost of total unindexed bank term credit dropped to a level of 3.46 percent in the last few months, and with it the margin between interest on credit and deposits narrowed. The balance of bank credit stood at NIS 713 billion in July, almost the same as at the beginning of the year. These are figures of an equilibrium in the bank credit market created over time, and on the one hand could indicate a fall in demand—a conclusion supported by company reports of a continued easing of the financing constraint,²⁴ and on the other hand (or in addition), the adjustment of supply to the new risk levels in the economy, by means of changes in the credit conditions (despite the lowering of the interest level). The increase in non-bank credit does not offset the continued decline in bank credit, so that total credit is still falling.

The slope of the real yield curve of government bonds moderated during the period reviewed. Trade in government bonds in the third quarter fluctuated due to the change in

²² Companies that issued bonds constitute 3.3 percent of all listed companies, and most of them are large, highly rated companies that appear in the banks' lists of groups of large borrowers. Thus, given that most groups of borrowers come within the legal large borrower limitation, their raising of capital cannot be interpreted as leading to the freeing of bank sources for small borrowers, or therefore as easing the credit squeeze.

²³ The fact that they became "too big to fail," could encourage the business sector to take excessive risks knowing that they cannot go bankrupt, and affect savers' decisions regarding financing such activity. Any adverse effect on risk pricing is likely to be reflected in the allocation of sources based on the profitability of supporting affiliated companies instead of more productive projects. In addition, the rapid growth of the non-bank credit market also affects the risks of the banks themselves, so that a negative impact on the activity of the large groups reduces the value of their collateral.

²⁴ Small companies, however, for whom bank credit constitutes the major source of finance, still report increased severity of the financing constraint.

Figure 10
The Average Weighted Yield Gap between CPI-Indexed Corporate Bonds, by Rating, and Galil-type Government Bonds, July 2005 to October 2009

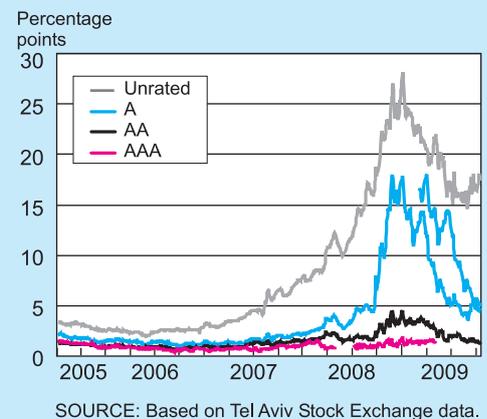


Figure 11
Yield To Maturity Curve of Unindexed Bonds, June to September 2009 (monthly averages)

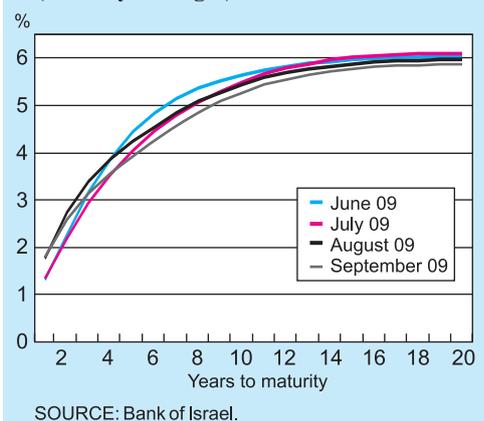
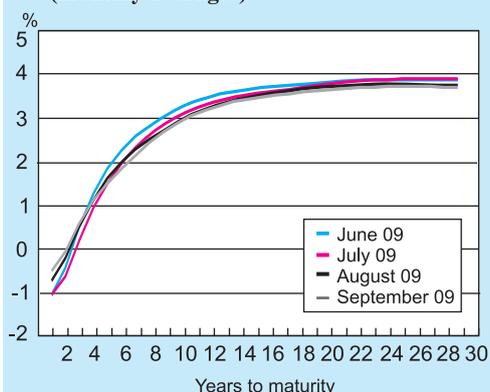
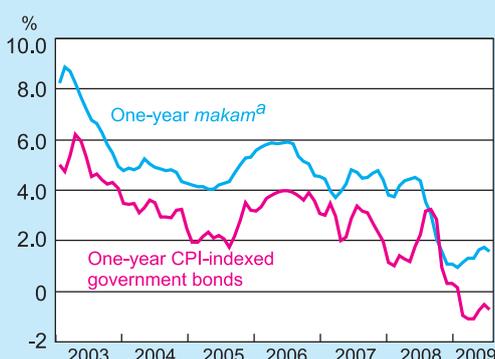


Figure 12
Yield To Maturity Curve of CPI-Indexed Bonds, June to September 2009 (monthly averages)



SOURCE: Bank of Israel.

Figure 13
Nominal and Real Yields to One Year, January 2003 to October 2009 (monthly averages)



^a Unindexed bonds.
SOURCE: Bank of Israel.

investors' inflation expectations in July–August, and due also to the ending of the Bank of Israel's program of intervention in the bond market, which until then had acted to reduce long-term yields. The change was reflected in some reduction in the slope of the curve and a moderate decline in the long part of the curve. Thus the gap between short-term yields (1–2 years to maturity) and real yields on medium- and long-term bonds (up to 10 years) narrowed, and in September reached 3 percentage points.

Against the background of the expansionary monetary policy the monetary aggregates continue to increase. The annual rate of increase in the monetary base fell in the third quarter. At the same time the move from short-term deposits to current accounts persisted, as could be seen from the acceleration in the rate of increase of the M1 money supply and the slower rate of increase of the M2 aggregate. The upward trend in the money supply that started at the beginning of 2009 continued in the period reviewed, despite the increase in the interest rate in August.

e. Inflation and inflation expectations

The Consumer Price Index (CPI) rose by a cumulative 1.3 percent during the period reviewed. The rise in the CPI was affected mainly by temporary factors such as the increase in indirect taxes and seasonal factors. Seasonally adjusted, the CPI rose by 0.7 percent in the period reviewed. The items whose contribution to the rise in the CPI was significant were home maintenance (contributing 0.53 percentage points), which was affected inter alia by the drought levy, housing (0.48 percentage points), and fruit and vegetables (0.22 and 0.16 percentage points respectively), because of seasonal factors. Energy prices, which rose by 2.1 percent in the period reviewed, also contributed to the increase in the CPI; these acted directly via the home-maintenance and transport items, and indirectly via the increased cost of factor inputs. The wholesale price index rose by 2.5 percent for the second quarter in succession, as real economic activity revived and goods prices rose.

The development of the CPI in 2009:Q3 indicates an annual inflation rate that is in line with the price stability target of 1 to 3 percent. During the last twelve months the annual inflation rate has been around 2.8 percent (Figure 17). The core indices, namely, prices adjusted for volatile items such as fruit, vegetables, food, and energy, also rose, albeit at higher rates than the general CPI, and amounted to 4.2 percent on average. In retrospect, the gap between the core indices and the general CPI stemmed from the fall in prices of energy and goods worldwide in the period which

began in 2008:Q3 and persisted until 2009:Q2. Adjusted for seasonal items and price increases due to government intervention²⁵ (an increase in the tax on cigarettes and fuel, higher VAT, and the drought levy), which have contributed 1.2 percent to the general price increase since the beginning of the year, the CPI has risen by 1.9 percent (in annual terms) since the beginning of the year, and is now in the middle of the target range.

The increase in the housing index, which contributed half a percent to the rise in the general CPI in this period, played a prominent role in the development of its components. The housing index also contributed to the rise in the CPI in the last twelve months: the CPI without housing rose by 0.8 percent, compared with an increase of 2.8 percent, as stated, in the CPI. The continued rise in the housing item (2.3 percent in July–September compared with 1.5 percent in the preceding quarter),²⁶ reflects mainly changes in renewed rental contracts, which occurred concurrently with the rally in the NIS during the period reviewed. Despite findings regarding the existence of a correlation between the exchange rate and housing prices,²⁷ the developments of the last few months constitute another indication of the weakening of this link.²⁸ Calculated annually, the housing index rose by 10.4 percent, but was affected to a great extent by price increases in specific months in 2008. The development of the housing index in the period reviewed may be attributed to high inflation expectations, which came near to the upper limit of the target range in the period reviewed, as well as to the seasonal nature of rental contracts, i.e., to the steep increases in the summer months. The housing index is also influenced by the dynamics of the real-estate market: apartment prices, which rose in the course of 2008, reflected the sharp fall in the supply of new apartments for sale as well as in the stock,²⁹ on the one hand, and the acceleration of demand due to the low interest-rate environment, the fact that purchases were brought forward due to the expected increase in VAT, and possibly also the reorganization of the asset portfolio—the diversion of investments from financial to real assets, on the other hand.

²⁵ By law, the government is limited in time.

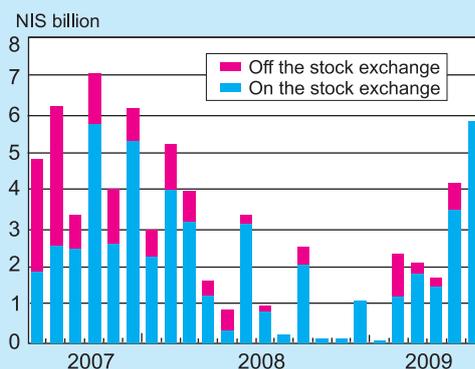
²⁶ The main contribution to the rise in this index came from the sharp increase in the housing index in August, after moderate increases of about 0.5 percent in each month from April to July.

²⁷ For a more detailed explanation, see Recent Economic Developments no. 125.

²⁸ For further elucidation, see Inflation Reports for 2008:Q3 and 2009:Q2, as well as Recent Economic Developments no. 125.

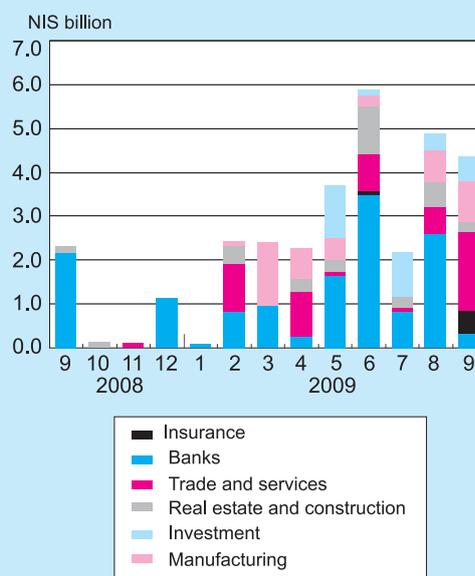
²⁹ At the end of August the stock of new apartments for sale was 30 percent lower than in the equivalent period in 2008.

Figure 14a
Capital Raised from Nonbank Sources,
July 2007 to June 2009



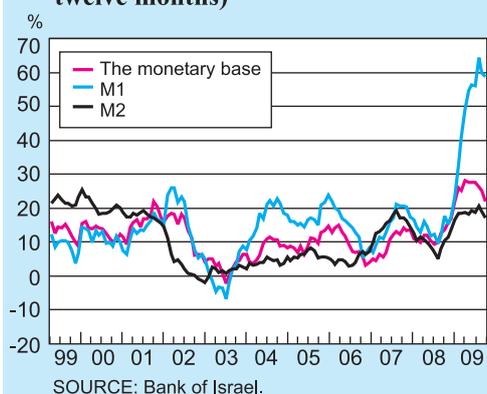
SOURCE: Based on Tel-Aviv Stock Exchange data.

Figure 14b
Issues of Corporate Bonds,
September 2008 to September 2009



SOURCE: Based on Tel-Aviv Stock Exchange data.

Figure 15
The Monetary Aggregates,
March 1999 to October 2009
(rates of change over previous
twelve months)



The main elements that operated to moderate the rate of price increases in the period reviewed were the strengthening of the NIS vis-à-vis the currency basket and the continued widening of the output gap. The development of the exchange rate was not uniform throughout 2009:Q3, but at the end of the period the NIS rallied, thereby serving to moderate the rate of price increases. The output gap also contributed to the moderation of price rises despite the fact that its rate of expansion slowed and unit labor costs declined. On the other hand, forces were at work to raise prices: the renewed increase in energy prices, which returned to their level in 2008:Q3, and government intervention, which was expressed in tax increases, although its effect was restricted to a given point in time.

During 2009:Q3 inflation expectations derived from the capital market and forecasters' predictions stabilized in the middle of the inflation target range. At the beginning of August expectations for the next twelve months, which are derived from the capital market, rose to the upper level of the target range. In the latter half of the month these expectations began to fall, apparently because of expectations that the Bank of Israel would raise the interest rate. In September expectations for the next twelve months, as derived from the capital market, were concentrated around the middle of the target range. The average of forecasters' predictions of expected inflation for the year ahead also fell from 2.8 percent in 2009:Q2 to 2.2 percent in the period reviewed. By contrast, the inflation forecasts for 2009 deviate from the target and stand at 3.7 percent. Note that the range of forecasters' predictions of inflation during the coming year expanded to 2.5 percentage points (Figure 19), attesting to the increase in uncertainty regarding expected inflation in the year ahead. The inflation forecasts and the expectations derived from the capital market are near the middle of the price-stability target range

Table 4
Changes in Selected Components of the Consumer Price Index (CPI), their Weights, and their Contribution to the CPI,

	Weight in index	Previous 12 months		2009:Q3 ^a	
		Rate of change in index	Contribution to CPI	Rate of change in index	Contribution to CPI
CPI	100.0	2.8	2.8	5.1	5.1
Housing	20.7	10.4	2.2	9.6	2.0
Food (excl. fruit and vegetables)	14.8	1.6	0.2	6.0	0.9
Energy	7.7	-6.8	-0.5	8.6	0.7
Fruit and vegetables	3.6	-2.0	-0.1	18.9	0.7

^a Annual rate.

SOURCE: Based on Central Bureau of Statistics data.

and reflect the shift in economic activity. The stabilization of expectations in the middle of the target range is also consistent with the historical path of their development before 2008, and attests to the credibility of monetary policy.

Inflation expectations for the long and medium terms are entirely in the upper part of the target range.³⁰ In September the expectations curve dipped throughout its extent for the longer terms, especially for 1–3 years. As a result, inflation expectations for these terms reverted and fell to within the inflation target range, after overshooting its upper limit in August. Expectations for longer terms are all entirely within the target range, though in its upper part.

2. MONETARY POLICY

In the third quarter of 2009 monetary policy continued to act with the aim of achieving price stability, in the context of the Bank of Israel's commitment to the inflation targeting regime.³¹ The policy steps taken by the Bank's in the third quarter were consistent with the flexible inflation targeting approach: as the Bank's other goals are to encourage employment and growth and to support the stability of the financial system, with occasional substitution between these goals, the flexible approach allows a gradual return of inflation to within the target.

The range of economic indicators available to the Bank of Israel in the third quarter supported the continuation of monetary expansion. The output gap, reflected by, among other things, a high rate of unemployment, uncertainty regarding the strength of the recovery in Israel's economy because of its dependence on the global recovery, the stabilization of the inflation environment and inflation expectations within the target range together with the low level of interest rates around the world, and the appreciation of the shekel, all these supported the Bank's decision to persist with its expansionary monetary policy. The quarter under review was the second in a row in which there were positive indicators regarding real activity and also on the financial side. These indicators proved that the feeling of a turnaround in economic activity and the start of a gradual recovery from the effects of the crisis was right.

The Bank of Israel's monetary policy in the third quarter was based on two main tools—the interest rate and purchases of foreign currency. The intensity of the policy was determined according to the analysis of the current developments, forecasts

³⁰ It is reasonable to assume that they incorporate a risk premium element.

³¹ See footnote 1 on page 9 above.

Figure 16
The Volume Change in Fixed-Time Deposits and Checking Accounts (previous twelve months)

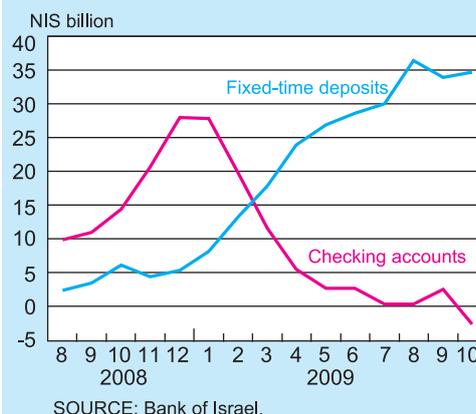


Figure 17
Inflation in Previous 12 Months, Inflation Expectations and Inflation Targets, 2001 to October 2009 (monthly averages)

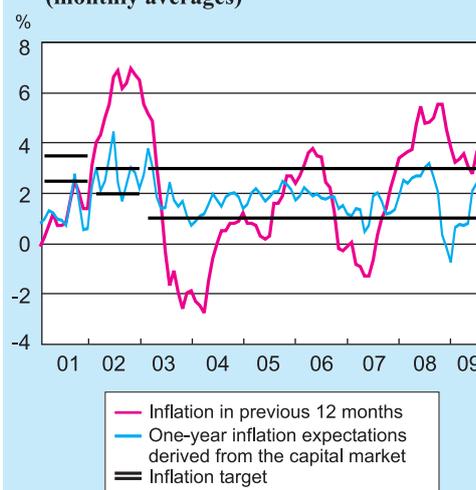


Table 3
The Domestic Assets Markets, April to September 2009

	04/09	05/09	06/09	07/09	08/09	09/09
Yields to maturity (monthly average, percent)						
3-month <i>makam</i>	0.4	0.4	0.3	0.4	0.5	0.7
1-year <i>makam</i>	0.9	1.1	1.3	1.3	1.6	1.7
Unindexed 5-year bonds	3.7	4.3	4.6	4.2	4.4	4.0
Unindexed 20-year bonds	5.5	6.0	6.3	6.3	6.2	6.1
CPI-indexed 1-year bonds	0.1	-0.9	-1.1	-1.1	-0.8	-0.5
CPI-indexed 5-year bonds	1.3	1.6	1.8	1.5	1.6	1.5
CPI-indexed 30-year bonds	3.6	3.8	3.9	3.9	3.7	3.7
private bonds rated AA–AAA ^a (percentage points)	2.9	2.2	1.8	2.0	1.6	1.5
private unrated bonds excluding real estate ^a (percentage points)	17.2	16.2	12.9	13.6	13.0	13.6
Share market (percentage change during the month)						
General share price index	8.2	8.0	1.2	9.0	-0.4	3.4
Tel Aviv 25 index	11.5	8.5	-2.2	10.2	-0.5	7.4
Foreign currency market (percentage change during the month)						
NIS/\$	-0.6	-4.9	-1.0	-3.3	0.6	-1.0
NIS/€	-0.9	-0.9	1.1	-3.4	1.8	1.0
Nominal effective exchange rate	0.6	-2.5	0.2	-2.9	0.8	0.4
Risk indices derived from the trade in NIS/\$ options in the Tel Aviv Stock Exchange (monthly averages, percent)						
Implied standard deviation	11.9	13.9	14.8	13.5	15.0	11.7
Probability of depreciation greater than 3%	6.0	8.1	9.1	8.7	10.1	5.7
Probability of appreciation greater than 3%	6.1	10.4	10.9	8.6	11.1	4.6

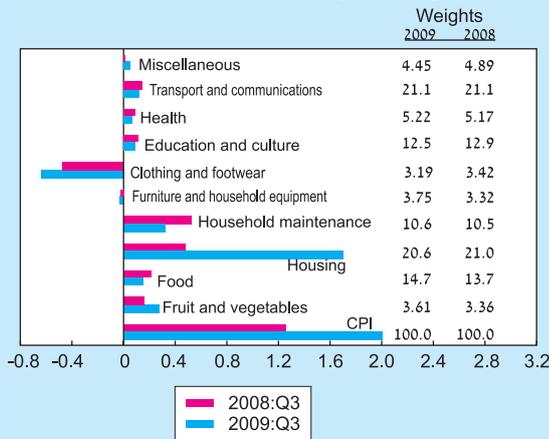
^a CPI-indexed bonds, excluding convertibles, with a yield of up to 60 percent, and with a duration of more than one year.

SOURCE: Bank of Israel.

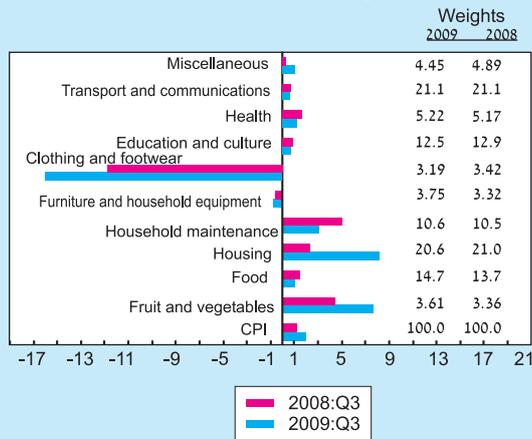
of real activity, inflation expectations derived from the capital market, and econometric models. The policy was not applied with uniform intensity throughout the period, and at the end of the quarter changed from being expansionary to being less expansionary. Following the cut in the interest rate for May by 25 basis points, to 0.5 percent, the rate was held at that level till September. The interest rate decisions in those months were taken against the background of assessments regarding the forces acting to moderate price increases in Israel, such as the widening of the output gap, the high rate of unemployment, and uncertainty about the sustainability of the economic recovery. In July the Bank of Israel announced that it was ending its program of purchases of government bonds, in accordance with the program as originally stated and in light of the assessment that the program had indeed helped the market to start functioning properly again, and in particular in light of the renewal of bond

Figure 18

Contribution of the Components of the CPI to the Changes in the CPI, 2008:Q3 and 2009:Q3 (percentage points)



Changes in the Components of the CPI, 2008:Q3 and 2009:Q3 (percent)

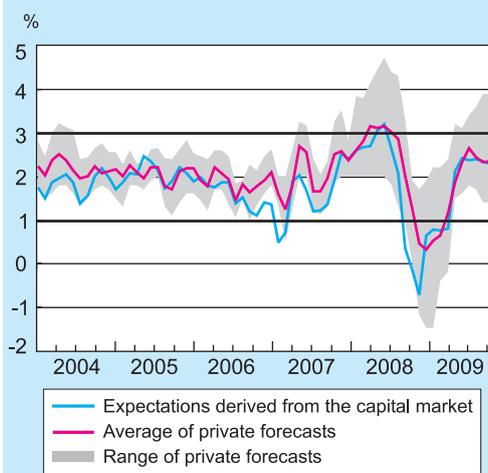


SOURCE: Based on Central Bureau of Statistics data.

issues and capital raising by the business sector. Since then the main tools used by the Bank in conducting its monetary policy have been the interest rate and purchases of foreign currency.

The Bank of Israel increased the interest rate for September 2009 by 25 basis points, thereby making its monetary policy somewhat less expansionary. This change was the outcome of several considerations: first, inflation measured over the previous twelve months was close to the upper limit of the price stability target range, even after deducting the effect of the non-recurring factors such as increases in indirect taxes and the imposition of the water surcharge. Second, it was taken into account that the decline in twelve-month-forward inflation expectations to the proximity of the midpoint of the target range did not result only from the continued widening of the output gap, but also from expectations of an increase in the Bank of Israel interest rate in the coming months. Third, in light of the current indicators, assessments firmed that the slowdown in real economic activity had halted and that activity was gradually moving onto a growth path, developments that could create inflationary pressures that would combine with the effect of imported inflation. The decision on the September interest rate was consistent with the assessment regarding economic activity, and with the conclusion that interest rates, both nominal and real, which had reached their low levels as a result of the policy response to the crisis, were not appropriate following the sharp change in the current activity environment. Even after the increase, the interest rate still expressed an expansionary, albeit a little less expansionary,

Figure 19
Inflation Expectations for the Next Year Derived from the Capital Market and According to Private Forecasters, 2004 to October 2009^a



^a From April 2007, the real yield used in the calculation of inflation expectations is based on the entire yield curve.

SOURCE: Private forecasters' reports and Bank of Israel.

monetary policy. This can be seen from the level of real interest (Figure 20), which remained negative even after the increase in the nominal rate, and which is one of the lowest world wide.

As the Bank of Israel assessed that the effect of government steps on actual inflation was temporary, and as the annual rate of inflation seasonally adjusted and twelve-months-forward inflation expectations were within the target range, the Bank of Israel decided to leave the interest rate for October unchanged at 0.75 percent. Additional factors in favor of that decision were the assessments of the forces acting to moderate inflationary pressures—the output gap resulting from weak economic activity in the previous quarters, the high rate of unemployment, and, primarily, the appreciation of the shekel in terms of the effective exchange rate in the third quarter. In addition to these factors, the uncertainty about the recovery of global economic activity also played a role. In light of all the above, the Bank left the interest rate unchanged for November.

In August the Bank of Israel changed its method of intervening in the foreign exchange market. When the Bank embarked on its steady intervention in the market in March 2008, the purpose was to strengthen the economy's financial resilience by increasing the foreign exchange reserves, and thereby to moderate the effect of the global crisis on domestic activity. As the crisis became more severe, the Bank continued to buy a fixed daily amount of foreign currency even after its declared target for the reserves had been achieved, so that by the middle of the period reviewed the reserves had increased by about \$ 30 billion. In August the Bank announced that it was switching from daily purchases of a fixed amount to indeterminate intervention—with regard to timing and extent—and that only when it considered that abnormal exchange rate movements were not in accord with the fundamental economic conditions, or when the market was not functioning properly. In considering the changes in the exchange rate of the shekel, it was not only the NIS/US dollar rate that was taken into account, but also the exchange rate of the shekel against other currencies, because in addition to the US, the eurozone and the Asian markets are among Israel's main trading blocs. Against this background, the Bank's policy of forex purchases, as well as increasing the reserves to boost Israel's financial resilience, was intended to weaken the short-term forces tending to cause over-appreciation of the shekel compared with the exchange rate level derived from

estimates of the equilibrium range.³² In retrospect, in light of the extent of the Bank's intervention in the forex market,³³ it may be assumed that its purchases did prevent steeper appreciation, and thus contributed to economic stability by dampening the effect of the global slowdown in activity on Israel's exports. The Bank continued to absorb the surplus liquidity created by its forex purchases mainly by means of monetary deposit auctions.

Table 6
GDP Growth in 2008, and IMF Forecasts for 2009 and 2010

	2008	2009	2010
Average GDP growth, percent			
Global	3.0	-1.1	3.1
Advanced economies	0.6	-3.4	1.3
US	0.4	-2.7	1.5
EU	0.7	-4.2	0.3
Japan	-0.7	-5.4	1.7
Emerging markets	6.0	1.7	5.1
Inflation (annual average, percent)			
Advanced economies	3.4	0.1	1.1
US*	3.8	-0.4	1.7
EU*	3.3	0.3	0.8
Japan*	1.4	-1.1	-0.8
Emerging markets	9.3	5.5	4.9

* World Economic Outlook, April 2009.

SOURCE: IMF World Economic Outlook Update, July 2009.

3. REVISED FORECASTS

a. The global environment

The worldwide economic crisis reached its lowest point, after which the slow, gradual recovery of global economic activity began. This recovery was made possible by extensive fiscal incentives which were intended to stimulate demand, reduce uncertainty, and lessen systemic risk in the financial markets. In view of the indications of a turnaround in global economic activity, international organizations adjusted their forecasts of global economic growth for 2010 upwards. Thus, according to the IMF, global GDP next year will grow by 3.1 percent. The figure

³² The real exchange rate is determined by productivity: the productivity gap between the tradable and nontradable sectors (in the long term) and the share of investment in GDP (the medium-term effect). For a fuller discussion see Box 2.2 in the Bank of Israel 2008 Annual Report.

³³ At the end of the third quarter the reserves stood at about \$ 60 billion.

that is most prominent in forecasts is the sharp shift in the developed economies, especially the US and Japan, from a deep recession to positive growth rates (expectations of a 1.3 percent growth rate). This comes alongside the predicted growth rate of the emerging economies (influenced primarily by the expected improvement in China and India) of 5.1 percent. The pessimistic forecast for 2009 has also been revised upwards, so that the contraction of global GDP is expected to be only 1.1 percent (compared with an assessed 1.3 percent as reported in the previous Inflation Report). The main reason for the contraction is the drastic decline (11.9 percent) in the extent of global trade in 2009.

Against the backdrop of the revival of global economic activity, it is expected that world prices of energy and goods will rise in the coming year. Their development will depend inter alia on the level of demand in the emerging economies, the intensity and timing of the global recovery, and the value of the US dollar relative to other currencies. The IMF predicts that oil prices will rise by 24.3 percent in annual terms in 2010, alongside a 2.4 percent increase in goods prices.

Bank interest rates are expected to remain at their current low levels for quite some time—until the economic recovery gains momentum and as long as the excess capacity is not reduced substantially. This is also due to the absence of indications of a marked improvement in the labor market, which is still characterized by exceptional unemployment rates. The creation of inflationary pressures in the future, alongside the reduction of the fiscal packages, should have an effect on considerations regarding the continuation of expansionary monetary policy.

b. Real economic activity in Israel

2009 is expected to end with the stabilization of economic activity at the average level evident in 2008. Economic recovery is expected for 2010. The forecast of real economic activity has been revised upwards from the forecast in the previous Inflation Report by virtue of positive data regarding economic activity in 2009:Q2 in Israel and worldwide, and in view of the improvement in forecasts regarding economic growth and world trade. In the context of the gradual global recovery from the repercussions of the recession, economic activity in Israel is also expected to remain moderate in the course of the year, even though the figures indicate that the decline in GDP has been checked. All in all, GDP in 2009 is expected to stabilize at its 2008 average, with the unemployment rate rising to an average of 8.1 percent, compared with 6.1 percent in 2008. In addition, a large surplus is expected to accrue in the current account of the balance of payments, and it is presumed that this will reach \$7 billion—due to the marked improvement in

Table 7
Economic Indicators for 2008, and Bank of Israel Forecasts for 2009 and 2010

(rates of change, percent, unless stated otherwise)

	Actual	Forecast	
	2008	2009	2010
GDP	4.0	0.0	2.5
Private consumption	3.6	-0.6	3.6
Gross domestic investment	1.4	-7.6	1.9
Public consumption	2.1	1.6	1.5
Imports (civilian, excluding diamonds)	7.2	-15.2	7.3
Exports (excluding diamonds)	10.5	-11.5	6.2
Current account (\$ billion)	1.6	7.3	4.9
Unemployment rate	6.1	8.1	8.3
Public deficit (percent of GDP) ^a	2.3	5.4	4.5
Gross debt/GDP ratio (percent of GDP) ^a	77.0	81.4	81.5

^a Excluding the Bank of Israel.

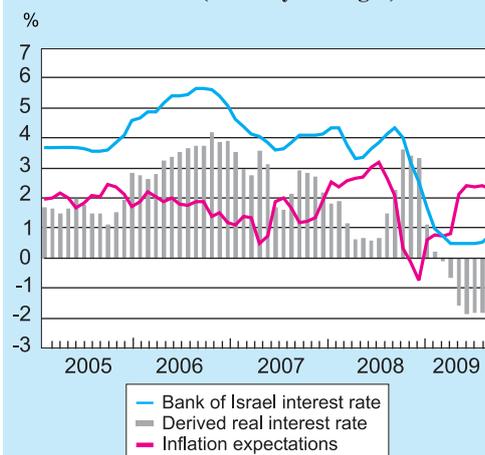
SOURCE: Central Bureau of Statistics and the Bank of Israel.

the terms of trade and the sharp contraction of imports. The budget deficit is expected to reach 5.5 percent of GDP as a result of the decline in tax receipts. Recovery is expected in 2010, against the backdrop of assessments regarding the improvement in indices of global trade and a rise in private consumption, so that GDP will expand by an average of 2.5 percent. However, the unemployment rate is expected to rise slightly and reach 8.3 percent. The consequence of these developments, if they occur, is that inflationary pressures will be created on the supply side.

c. Assessments regarding the exchange rate and the balance of payments

The surplus in the current account and the pressures to weaken the dollar worldwide are expected to strengthen the NIS. In 2009 a surplus of \$7.3 billion is expected in the current account, compared with \$1.6 in 2008, in the context of an improvement in Israel's terms of trade. The moderation of global economic activity is expressed in foreign trade both in the contraction of imports and in a more moderate fall in exports. The current-account surplus, alongside the weakening of the dollar globally, is expected to support the trend of effective appreciation of the local currency. On the other hand, the purchase of foreign exchange by the Bank of Israel, if this continues, will help to offset pressure for local-currency appreciation.

Figure 20
The Bank of Israel Interest Rate,^a Inflation Expectations,^b and the Derived Real Interest Rate, 2005 to October 2009 (monthly averages)



^a The effective interest rate in the Bank of Israel auctions.

^b For 12 months, derived from the capital market.

SOURCE: Bank of Israel.

d. Assessments regarding the development of inflation and the balance of its risks

According to market assessments, the inflation rate in the twelve months ahead is expected to be in the middle of the inflation target range. In view of the recovery of the financial markets, the positive turnaround in economic activity, and the rise in the actual inflation rate, the forecasts made by the various entities regarding inflation in the twelve months ahead have been raised to the center of the inflation target range, i.e., to an average of 2.1 percent (Table 8). Note that the forecasts in the Companies Survey are higher, namely, 3.25 percent on average (compared with 2.8 percent in 2009:Q2), above the upper limit of the target range. The distribution of assessments also shifted upwards in the period reviewed: about 47 percent of the participants in the survey estimated that inflation in the next twelve months would overshoot the upper limit of the target range, compared with 30 percent in the previous survey; 51 percent estimated that inflation would be within the target range, compared with 65 percent in the previous survey; and 2 percent estimated that inflation would undershoot the lower limit of the target range, compared with 12 percent in the previous survey.

The forecast of the DSGE³⁴ structural model used, *inter alia*, by the Bank of Israel to create the inflation-rate and interest-rate fan charts (Figures 21 and 22) is that inflation will be 1.2 percent in the twelve months ahead and that the interest rate will rise gradually during 2010. The EC structural model,³⁵ which assumes the relatively strong inertia of inflation, predicts a higher inflation rate, and also an interest rate that rises more quickly than that of the DSGE model. The change in the background economic conditions during 2009:Q3 led to a decline in the

Table 8
Assessments of Inflation over Next Twelve Months (percent)

	Target	Capital market	Private forecasters	Companies Survey	Bank of Israel's model
Average	2	2.3	2.6	3.24	1.2
Range	1–3		1.5–3.0	1.1–5.0 ^a	

^a Covering 90 percent of the inflation expectations (excluding the tails).

SOURCE: Bank of Israel.

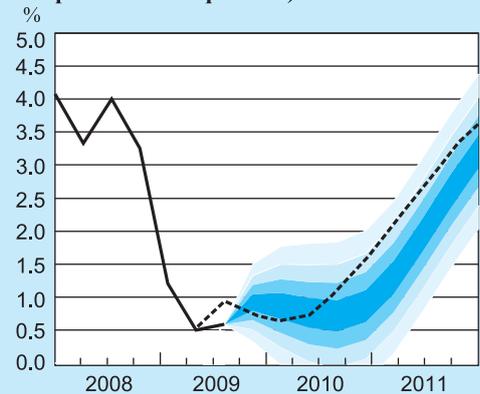
³⁴ For a detailed discussion see D. Elkayam et al., (2007), A Small Macroeconomic Model to Support Inflation Targeting in Israel, Bank of Israel Monetary Department.

³⁵ E. Barnea and J. Djivre, Challenges in Monetary and Exchange Rate Policies and the Transmission Mechanism in Israel, 1989:IV–2002:I, Discussion Paper Series, No. 2004.13, October 2004, Bank of Israel Research Department.

forecasts of the inflation and interest rates derived from the Bank of Israel's models relative to those of the preceding quarter. The revised forecast assumes inter alia that the extent of trade with the industrialized countries will contract by an average of 14 percent in 2009 and rise by 7 percent in 2010; that central banks worldwide will continue to keep interest rates low until the end of 2009, and will raise them gradually from 2010; that the global economic crisis will continue to have an adverse effect on real domestic economic activity via the export component; and that global goods prices will continue to rise in the near future, too. From these assumptions a forecast inflation rate of 1.2 percent in the next twelve months is obtained, compared with 1.6 percent in the previous report. The downward revision of the forecast stems largely from the decline in the path of price increases of goods and fuel worldwide relative to that predicted in the previous report, as well as from the expected path of foreign interest rates—which is lower for a longer period. Indirect taxes have a nonrecurring effect on the level of prices, and hence in the measurement of the change in the CPI over twelve months their effect disappears, and the inflation path derived from the model declines as of 2010:II. In the wake of the lower inflation forecast, the expected interest-rate path is also lower now than it was in the previous report.

In the period reviewed inflation risks declined slightly, and current trends indicate that inflation will be close to the lower limit of the inflation target range. The slow pace of recovery from the global crisis, which was reflected by the continued widening of the output gap, alongside the absence of pressures from the labor market and basic factors which support the trend whereby the NIS is strengthened, should all be expressed, in a twelve-month measurement, in an inflation rate that is below the target. However, the marked rise in energy and goods prices, due to the accelerated rate of global recovery and the increased pace at which local asset prices rose, could lead to a rise in inflation. In addition, the excess liquidity in the hands of the public is expected to create inflationary pressures once domestic demand recovers. Given the current forecasts, it would seem that the scenario of inflation close to the lower limit of the inflation target range is more probable.

Figure 21
Actual Inflation and Fan Chart^a
of Expected Inflation,^b 2008–11
(rate of cumulative price increases in
previous four quarters)

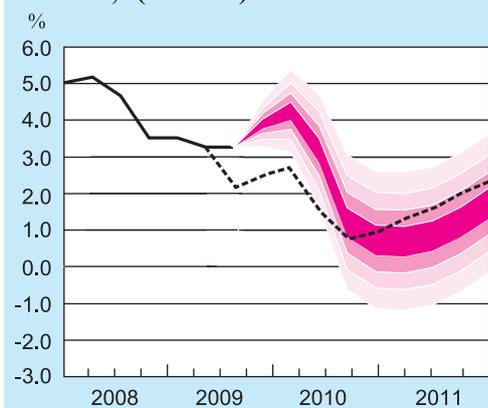


^a The full fan covers 66 percent of the distribution of the expected inflation.

^b The dotted line is the middle of the fan chart shown in the previous Inflation Report (No. 27, April to June 2009).

SOURCE: Bank of Israel.

Figure 22
Actual Bank of Israel Interest Rate
and Fan Chart^a of Expected Interest
Rate,^b (2008–11)



^a The full fan covers 66 percent of the distribution of expected interest rate.

^b The dotted line is the middle of the fan chart shown in the previous Inflation Report (No. 27, April to June 2009).

SOURCE: Bank of Israel.

