**BANK OF ISRAEL**
Office of the Spokesperson and Economic Information

December 10, 2018

# Report on the Bank of Israel's discussions prior to deciding on the interest rate

**The discussions took place on November 25 and 26, 2018.**

## General

The Monetary Committee sets the interest rate in a process that includes two discussions—the first in a broad forum, and the second in a narrower one.

In the broad-forum discussion, the relevant background economic conditions are presented, including the real and financial-monetary developments in Israel's economy, and developments in the global economy. Participants in this discussion include the members of the Monetary Committee, senior representatives from the various departments of the Bank, and economists from the economic departments (Research and Market Operations), who prepare and present the material for discussion.

In the narrow forum—which consists of the Monetary Committee and the Director of the Research Department—the Research and the Market Operations Departments present their views of the main considerations that should guide the setting of the monetary policy. An open discussion on monetary policy follows, which ends with a vote on the level of the interest rate. According to Section 18(c) of the Bank of Israel Law, 5770–2010, the decision on the interest rate is reached by majority vote of the members of the Monetary Committee who participate in the voting.

A summary view of the economic situation available at the time of the Committee's discussion is presented in the notice regarding the interest rate decision, which was published on November 26th, and in the data file that accompanied the notice.

## THE NARROW-FORUM DISCUSSION

The members of the Monetary Committee participating in the discussion decide on the appropriate rate of interest. After the discussion, it was decided to increase the interest rate by 0.15 percentage points, to 0.25 percent. Four Committee members supported this decision, and one Committee member supported keeping the interest rate unchanged.

The discussion focused on several main issues: (1) real economic activity, (2) the inflation environment, (3) the global environment and the exchange rate, and (4) financial stability.

## Main points of discussion

In their discussion on economic activity, the Committee members said that indicators of activity show that it moderated but that the economy continues to grow at a pace close to its potential rate. The members assessed that the slowdown in the second and third quarters apparently derived partly from the growth rate declining from the high rate of recent years, to its potential environment, and partly from transitory factors—the volatility in vehicle imports. One Committee member noted that the initial estimate of third quarter National Accounts data should not be given considerable weight as it is expected to be revised and because the other indicators remained positive. Another member added that the accuracy of seasonal adjustment of third quarter data may have been impacted by the Jewish holiday season occurring essentially entirely in September this year. All Committee members agreed that initial indicators of fourth quarter data—including the Composite State of the Economy Index, the Purchasing Managers Index, and the Business Tendency Survey—support the assessment that the economy continues to grow at close to its potential rate. As for the composition of GDP, the Committee members examined the trends that arise from National Accounts data—the continued contraction in investment, the moderate increase in private consumption, and the weakness in goods exports—and discussed the question of whether they indicate supply constraints that derive from the proximity to full employment; they assessed that at the current time it is difficult to determine that such is the case. The Committee also referred to the labor market and noted that its data indicate that it remains tight—high employment and participation rates, a low unemployment rate, an increase in the job vacancy rate, and wages that continue to increase at a solid pace, led by the business sector, across a wide range of industries and all wage levels.

The Committee noted that the data that became available since the previous interest rate decision support the assessment that inflation is stabilizing in the bottom part of the target range. It was noted that the annual inflation rate has been within the target range for the past five months, semiannual inflation (seasonally adjusted, in annual terms) has been above 1 percent for close to a year already, and the adjusted indices are around the lower bound of the target. The members noted that the CPI readings for July and August were lower than expected, and it was unclear at the time if these were a transitory deviation from the inflation trend, or a decline in the trend; however, currently the data indicate that there is not a downturn in the inflation trend and that the deviation was transitory: when examining the tradable and nontradable price indices, inflation is found to be more homogeneous. They also noted that in accordance with the forecasts for the coming months, annual inflation is expected to remain within the target range. However, in contrast, they noted that the 1-year expectations derived from the capital market moderated since the last interest rate decision, though they remain around the lower bound of the target range. As for forward expectations for medium and long terms, the members said that they remain entrenched within the target range. The Committee assessed that the forces supporting an increase in the inflation rate remain in place—including, among other things, the wage increases in the economy, inflation abroad, the expansionary fiscal policy, and the fact that monetary policy worldwide has become more hawkish. Moreover, in recent years several factors acted to lead to a decline in inflation, including, among other things, the measures adopted by the government to reduce the cost of living, the enhancement of competition in the economy, and the appreciation of the shekel, and recently, the effect of some of those factors weakened. The sharp decline in oil prices could impact on expectations, but its effect on inflation should be properly analyzed as a one-off factor. The members were of the opinion that there is a relatively low probability of a prolonged decline of inflation to below the lower bound of the target.

The Committee discussed developments in the global economy, and assessed that the risks have grown and momentum has slowed. The members noted that the US economy continues to grow at a solid pace but they pointed to several risks that are liable to weigh on the continuation of the growth trend—in particular, (1) the worsening of the trade war, and (2) the declines in US equities markets and the rise in spreads (risk off), primarily in the high tech sector. One of the members noted that it appears that the decline in the equities market is only a correction, as it does not come in tandem with a decline in corporate profits. In terms of the European economy, the Committee assessed that the decline in growth occurred against the background of changes in auto industry regulation, progress on Brexit, and the recent increase in the tension between Italy and European authorities as the Italian government's proposed budget includes an increase in the deficit. In contrast, the Committee assessed that the weak euro strengthens the European market compared with the rest of the world. With regard to China, the Committee noted that there is some slowdown in the growth rate but it remains high. The Committee said that monetary policy worldwide remains accommodative from a historical perspective, but the trend of monetary contraction continues, and additional central banks raised their monetary interest rate since the previous interest rate decision. The Committee members assessed that the US is expected to continue the normalization process for the federal funds rate, and that the worldwide quantitative easing is expected to continue contracting as the US Federal Reserve reduces its balance sheet and the ECB plans to end its asset purchase program in 2019.

In terms of the exchange rate, the Committee members said that since the last interest rate decision, the shekel weakened by 3.6 percent in terms of the nominal effective exchange rate, and by a similar rate (3.2 percent) against the dollar. The shekel remained appreciated from a historical perspective, though the appreciation in terms of the real effective exchange rate is more moderate than in terms of the nominal rate. The Committee members assessed that the main risk to the continued entrenchment in the target range is appreciation of the shekel.

The Committee members discussed housing market developments and home price data. They noted that the most recent data on the number of transactions point to stabilization, after the figures rose in the beginning of the year. With regard to home prices, the members said that in recent months stability is apparent. The stabilization in new mortgage volume was also discussed, against the background of the rise in the interest rate on mortgages. With regard to financial developments in Israel, the Committee noted that nonfinancial business credit continues to expand and that there is a slight rise in corporate bond spreads.

As noted, the decision reached at the discussion was to increase the interest rate by 0.15 percentage points, to 0.25 percent, after the interest rate had been left unchanged since March 2015. Four of the five Committee members supported the decision to raise the interest rate. They assessed that the economic considerations are the decisive factors in reaching the interest rate decision, and not the fact that the Bank is in a period of transition between governors. They explained that the conditions had ripened for the beginning of the process of withdrawing from the very accommodative policy that had been adopted in recent years. At the previous interest rate decision, there was uncertainty regarding the development of the upcoming consumer price indices, and the assessment that was formulated was that annual inflation may decline temporarily to below the lower bound of the target range. However since then data became available that support the assessment that inflation is stabilizing in the lower part of the target range, and in their evaluation, the probability of a prolonged decrease to below the lower bound is relatively low. Some of the members were of the opinion that the low interest rate—the nominal interest rate of 0.1 percent and the real interest rate of -1 percent—is not appropriate for the economy's parameters, particularly an economy that is growing at around its potential rate and is accompanied by an accelerated pace of wage increases, and leaving it low for a prolonged time is liable to create negative impacts in the long term. One Committee member supported leaving the interest rate unchanged, at 0.1 percent. In his assessment, it is a borderline situation and either decision—increasing the interest rate to 0.25 percent and leaving it unchanged—can be justified. However, he claimed that it is appropriate that the withdrawal from the accommodative policy be initiated by the Committee headed by the new Governor.
The Committee emphasized that the continued withdrawal from the accommodative policy is contingent on economic indicators, and that the decisions in the future will continue to be made in accordance with developments in inflation, the real economy, financial markets and the global economy, with the goal of attaining the monetary policy targets. The Committee members assessed that the continuation of the normalization process will be carried out gradually and cautiously.

**Participants in the narrow-forum discussion:**

**Members of the Monetary Committee:**
Dr. Nadine Baudot-Trajtenberg, Deputy Governor, under whose authority as Acting Governor serves as the Chairperson of the Monetary Committee in this decision
Mr. Andrew Abir, Director of the Market Operations Department
Prof. Reuben Gronau
Prof. Moshe Hazan
Prof. Zvi Hercowitz

**Other participants in the narrow-forum discussion:**
Eddy Azoulay, Chief of Staff to the Governor
Ari Kutai, Economist in the Research Department
Esti Schwartz, Secretary of the Monetary Committee
Yoav Soffer, Bank of Israel Spokesperson
Prof. Michel Strawczynski, Director of the Research Department