Bank of Israel

# MONETARY POLICY REPORT
(Inflation Report)

2011 First Half

**PRELIMINARY TRANSLATION**

(Text only, for graphs and tables please see Hebrew version)

35

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**Letter of the Governor accompanying the Monetary Policy Report for January–June 2011**

The Monetary Policy Report for the first half of 2011 (the period reviewed in this report) 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.[1]

The Consumer Price Index (CPI) increased by 2.2 percent over the course of the first half of 2011. Contributing to the large increase (an annualized rate of 4.4 percent) was an increase of 3.5 percent in the housing component (representing rentals), as well as the food (4.4 percent) and energy (6.6 percent) components. The rise in prices during the period reviewed was affected by domestic factors, primarily housing, as well as by external factors—commodity and energy prices. In each month of the period reviewed, the price increase over the previous 12 months exceeded 3 percent—the upper limit of the 1–3 percent inflation target range. However, monthly figures (seasonally adjusted) show that in the last four months there has been a drop in the rate of price increases, compared with the months preceeding them.

The global recovery from the crisis of 2008 continues, with advanced economies growing slowly and emerging economies growing rapidly. According to an International Monetary Fund (IMF) forecast for 2011, advanced economies are expected to grow by 2.2 percent and emerging and developing economies are seen growing by 6.6 percent. In the period surveyed, commodity and crude oil prices rose, raising with them inflation forecasts for 2011 to 2.6 percent in advanced economies and 6.9 percent in emerging economies. With regard to interest rates, increases are not expected in the US in the coming year. In the eurozone, the European Central Bank

[1] Previously the Inflation Report. The name is changed to accord with the term in the new Bank of Israel Law that calls for a Periodic Report on Monetary Policy to be submitted by the Monetary Committee not less than twice annually. When the Monetary Committee is appointed, in accordance with the new Bank of Israel Law (5770-2010), interest rate decisions will be made by the Committee, and it will present the Monetary Policy Report.

(ECB) raised the interest rate for April and July by 0.25 percentage points each time, but there has been growing uncertainty there recently regarding the rate of growth and the future interest rate path; this stems from the increasing concerns over the debt crisis in several European countries which could also have an impact on global financial stability. The expanding national debt in most advanced economies and the high rate of inflation in emerging economies are expected to lead to policies of fiscal restraint (in advanced economies) and monetary tightening (in emerging economies), which may slow global growth. One of the expressions of these expectations is, apparently, a drop in prices of financial assets around the world in the period surveyed.

In the Israeli economy, the recovery in real economic activity and decline in unemployment continued in the first quarter of 2011. Growth was based on an increase in investment, as well as in exports, which were influenced by expanding global trade. Indicators for the second quarter point to a continued expansion of business activity, albeit at a slower pace than the first quarter.

In the period surveyed, prices of financial assets—mainly stocks and corporate bonds—fell, in line with similar developments of equity prices around the world. Nonetheless, house prices continued to rise in Israel—by 3.8 percent during the first four months of the year, and by 13.7 percent between April-May 2010 and April-May 2011. In light of the continued increase in the volume of variable rate mortgages, and in order to prevent the possibility of decline in the stability of banks, as of May 2011 the Bank of Israel limited the variable rate component to one third of each mortgage. A reporting requirement was also imposed on the banks, obliging them to advise borrowers who had already taken out housing loans at variable rates as to the effects of an increase in interest rates on their monthly payments.

In January, there was a marked depreciation of the shekel, apparently as a result of the growing instability in various Middle East countries, and as a result of steps taken by the Bank of Israel and the Ministry of Finance (see below). Later in the period surveyed, the appreciation of the effective exchange rate of the shekel resumed, due in part to the interest rate gap vis-à-vis the US and the eurozone. Overall, the shekel appreciated 0.8 percent during the period. In order to moderate the appreciation of the shekel, the Bank of Israel continued to buy foreign currency. At the same time, in order to moderate speculative short-term capital movements and increase financial stability, at the end of January, the Bank of Israel imposed on banking corporations a reserve requirement of 10 percent against nonresident transactions in foreign currency derivatives. The Bank of Israel also reported the imposing of a reporting requirement on transactions in foreign currency derivatives, and a reporting requirement on nonresident transactions in *makam* and short-term government debt, which came into effect at the beginning of July; this in order to track the entrance of capital into the economy. At the same time, the Ministry of Finance canceled nonresident investors' capital gains tax exemption in investments in *makam* and short term government notes, in order to moderate speculative capital flows.

During the period surveyed, the Bank of Israel accelerated the pace of interest rate hikes. The interest rate both for February and for March was raised 0.25 percentage points, the interest rate for April was raised 0.5 percentage points, and the interest rate for June was raised 0.25 percentage points, for a cumulative rise of 1.25 percentage points during the period, to a level of 3.25 percent in June. The reasons for the increases were the rate of inflation, measured over the previous twelve month period, which throughout the period was above the upper limit of the target range, the relatively high level of inflation expectations (for the next twelve months), both by forecasters and as derived from the capital market, as well as the continued economic growth, and the continued rapid rise in house prices. At the same time, the Bank of Israel continued to operate in the foreign currency market in order to moderate the appreciation pressures on the shekel. Toward the end of the period surveyed, the possibility of some slowdown in economic activity developed, and economic and financial uncertainty increased greatly, primarily in light of global developments and the regional geopolitical situation. Signs were also seen of a possible moderation in the rate of inflation. Against this background, the Bank of Israel kept the interest rate for July and August unchanged

The Bank of Israel Research Department forecasts that Israel's economy will grow 4.8 percent in 2011 and that the unemployment rate will fall to an average for the year of slightly below 6 percent (down from 6.6 percent in 2010). Inflation, as measured by the change in the CPI, over the next four quarters (beginning in the third quarter of 2011) is expected to decline to 2.9 percent, and over the course of the second half of 2012 to remain within the target range. The Research Department estimates that the Bank of Israel interest rate will rise gradually to a level of 3.9 percent in the second quarter of 2012. According to the forecast, the key contributing factors to the increases in prices, and the increase in the interest rate, during the coming year are expected to be a continued rise in rents and the high level of prices of commodities and energy, which are expected to remain in place over the course of the year.

The Bank of Israel will continue to follow developments in Israel and worldwide, and to conduct policies which support growth and financial stability, at the same time as striving to return inflation to within the target range (expected, according to the Research Department staff forecast, during the course of 2012). The extent and timing of interest rate adjustments will be set according to inflation developments, the sustainability of growth in Israel and abroad, and developments in the exchange rate of the shekel, in asset prices, and in interest rates by leading central banks.

Stanley Fischer
Governor, Bank of Israel

**PRELIMINARY TRANSLATION**

## Summary[2]

- **Inflation:** In the first six months of the year, the Consumer Price Index (CPI) increased by 2.2 percent, and on a seasonally adjusted basis[3] it increased slightly less, by 1.9 percent (which is an annualized rate of 3.9 percent). The main factors behind the higher index were rises in the price of food, energy, and housing (rentals). The increase in the rate of inflation, on a seasonally adjusted basis, was not uniform through the first half of the year. The inflation rate on an annualized basis was higher than the upper limit of the target inflation range in the first two months of the year, while in the months of March through June it was within the target inflation range. The pace of inflation over the previous 12 months, as well as 12 month forward inflation expectations, were above the upper limit of the inflation target range in each of the first six months. In June, at the end of the period surveyed, inflation expectations began to decline, and in July they dropped slightly below the upper range of the inflation target range.

- **The global economic environment:** During the course of the period reviewed (the first half of the year) most countries in the world recorded positive growth, and this found expression in an increase in world trade. With that, against the background of high debts in some advanced economies, along with a rising rate of inflation in emerging economies, policies of fiscal and monetary restraint are expected. These policies are liable to slow the pace of global growth. The International Monetary Fund (IMF), in its most recent survey, noted that in its opinion, growth forecasts for 2011 and 2012, which will be published over the coming months, will be revised downward. Due to the increase in the pace of inflation, emerging economies continued to raise monetary interest rates. In contrast, the US is only expected to raise the fed funds rate at the end of 2012. In the eurozone, the interest rate was raised twice since the beginning of the year, in April and July. With that, in light of the debt crisis in several countries in Europe, the pace of interest rate hikes in the eurozone is expected to be moderate.

- **Real economic activity:** Economic activity continued to expand in the first quarter of 2011, and GDP grew 4.6 percent (annualized rate, seasonally adjusted). The increase was contributed to primarily by a 26.1 percent increase in investment in fixed assets, and a 12.0 percent increase in exports. Indicators of second quarter economic activity point to continued expansion, albeit at a more moderate pace.

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2 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 in the Bank of Israel Inflation report No. 17, July–December 2005.)

3 The seasonally adjusted CPI figures are based on Bank of Israel calculations. For a more detailed discussion on the approach to seasonal adjustment, and on the main impetus for its adjustment, please see Box 1 in Inflation Report No. 30 (January–March 2010).

- **Exchange rate:** The nominal effective exchange rate reflected significant depreciation of the shekel in January, against the background of geo-political uncertainty in Arab countries, and policy measures by the Bank of Israel and the Ministry of Finance. The shekel then continued its appreciation, similar to its trend in 2010. The appreciation trend continued, among other things, against the background of a widening interest rate gap between Israel and developed economies. Bank of Israel activities in the foreign currency market and policies intended to restrain the inflow of short term capital into Israel weakened the shekel appreciation pressures. By the end of the first half of the year, the shekel showed a moderate appreciation of 0.8 percent.

- **Financial markets:** In the first half of the year, against the background of increasing uncertainty in the world and rising interest rates in the economy, equity prices reversed course and they began to decline. Yield spreads between CPI-indexed corporate bonds and CPI-indexed government bonds responded with a delay to developments in financial markets, and despite widening recently, they remain low. The expansion of credit to the business sector continues. According to the Bank of Israel Companies Survey, it appears that companies are not facing credit constraints.

- **Mortgages and house prices:** House prices continued to rise at a rapid pace. In the first four months of the year, the index of house prices rose 3.8 percent, and in the past 12 months it rose 13.7 percent[4]. The rapid pace of increase of home prices is expressed in the widening gaps between house prices and rental levels and between house prices and average wage levels. In light of the continuing rise in the volume of variable rate mortgages, the Bank of Israel limited, beginning in May 2011, the proportion of a mortgage at variable rate interest. In addition, the directive imposes on the lenders a disclosure requirement, according to which they must notify customers who took out a mortgage with a variable interest rate, based on the prime interest rate, not indexed to the CPI. This was with the goal of increasing banks' and the public's awareness of the consequences of a rise in the interest rate on the ability of mortgage borrowers to repay their loans.

- **Monetary Policy:** During the first half of 2011, the Bank of Israel accelerated the pace of interest rate hikes. The Bank of Israel raised its interest rate during this period by a total of 1.25 percentage points, to a level of 3.25 percent. The pace of inflation over the previous 12 months, and inflation expectations above the upper limit of the target range, the rapid growth of real local economic activity and the increase in house prices all supported an increase in the monetary interest rate in order to return inflation to within the target range and maintain financial stability. At the same time, the Bank of Israel operated in the foreign currency market in order to restrain the appreciation pressures on the shekel. Bank of Israel activity in the foreign currency market included purchase of foreign currency, and the publication of macro-prudential policy directives, including imposing on bank corporations a reserve requirement of 10 percent against nonresident transactions

[4] Due to the delay in publication of the data, the figure refers to April–May 2010 through April–May 2011.

in foreign currency derivatives, and imposing a reporting requirement on various transactions.

- **Forecast:** The Research Department staff forecast is that inflation in the next twelve months will be 2.9 percent, slightly below the upper limit of the inflation target range. The inflation rate over the next twelve months' being at the upper limit of the target inflation range is explained by the continued rise in the housing component (rents) and stronger demand, as well as by the increases in recent months in the prices of commodities and energy. The economy is expected to grow at 4.8 percent in 2011 and at 3.9 percent in 2012. The forecast is that the interest rate will rise gradually to about 3.9 percent over the next year, as part of Bank of Israel policies to return inflation to within the target range.

## 1. THE BACKGROUND AND INFLATION

**There is a range of factors that influence the Bank of Israel's monetary policy decisions.** In managing monetary policy, the Bank of Israel monitors developments in the global environment, in inflation and in real and financial activity in Israel. The Bank continuously monitors market forces and their expected effect on inflation, and sets the level of the interest rate in order to achieve the inflation target within one to two years, while encouraging employment and growth and maintaining stability in the financial markets. During the first half of 2011 (the period reviewed), the Bank of Israel continued to raise the interest rate and to do so at a more accelerated pace than in the past, while adopting a policy that takes into account the effects of the following economic developments: 1) the increase in the pace of inflation to above the upper limit of the inflation target range; 2) the rapid growth in aggregate demand and the shrinking of the output gap; 3) geopolitical uncertainty and rising energy and commodity prices; 4) the increased risk of a slowdown in the global growth rate; 5) the record-low central bank interest rates in the leading economies; 6) the continuing and rapid increases in house prices; and 7) the weakening of the forces acting to appreciate the shekel. Following is a description of the main developments in the global economy, the exchange rate, real activity, financial activity and inflation, which were the basis for Bank of Israel monetary policy decisions.

### a. The global environment

#### *(1) Real activity*

**During the first half of 2011, global growth continued though the rate of growth slowed somewhat.** National account figures for the first quarter of 2011 indicate that the global recovery is continuing and that the rate of growth is positive in most of the developed economies. The US rate of growth slowed relative to the fourth quarter of 2010 and was lower than forecasted. On the other hand, it appears that economic activity is becoming more robust, which can be seen in increased private demand and the improvement in employment. This situation is contributing to the decreased dependency of the American economy on the continuation of the government expansion program. European growth was surprisingly high, though it was not uniform across the euro area countries and was concentrated primarily in the core countries. The emerging economies, led by China, continue to lead world growth (Figure 1). Early indicators of global macroeconomic activity during the second quarter point to continued expansion, though at a slower rate than during the first quarter. Growth in the first quarter of the year was reflected in a rapid expansion of global trade; however, in recent months the G3 Trade Index[5] has pointed to somewhat of a slowdown in the rate of expansion (Figure 2).

**Despite the increase in the indexes of real activity, the contractionary measures that are called for in both developed and developing countries are expected to slow the pace of global growth.** The high levels of debt in some developed countries and the high rates of inflation in developing countries have necessitated the adoption of fiscal and monetary restraint, and as such threaten the continuation of global growth. The debt crisis in some of the EU countries continues to constitute the major risk to the continent's economies. The combination of continued deterioration in the economic indicators of the countries in crisis and the fiscal restraint called for in those countries casts doubt on their ability to avoid defaulting on sovereign debt. Alongside the debt problem in Europe, increasing attention has recently been given to the level of the US deficit and its total debt. In April, the S&P rating agency reduced its long-term outlook of the rating of US debt from "stable" to "negative" and in June, Moody's warned of a possible future lowering of the US debt rating. The fiscal restraint needed in coming years in order to avoid a debt crisis threatens continued growth. Expectations of slowed growth have increased in the developing economies as well due to their contractionary monetary measures, which are intended to moderate inflation. The high prices of commodities (which are used as raw materials) are increasing the cost of production and constitute a negative supply shock that is dampening optimism regarding the continuation of rapid growth in the developing economies. The IMF has lowered slightly its forecast of growth for 2011 and has stressed that there is a high probability that the growth forecasts for 2011 and 2012 will be lowered again in future revisions.

### *(2) Financial markets*

**The optimism that had characterized global financial markets waned during the first half and stock prices leveled off.** Uncertainty in global financial markets increased during the first half of 2011. As a result, the standard deviation of options on leading global indices rose and the increase in stock prices came to a halt (Figure 3). The increased uncertainty was a result of a series of shocks that dampened optimism regarding continued global growth. The geopolitical unrest in the Middle East and the acceleration of commodity price increases during the first quarter raised uncertainty, particularly in developing countries, and reduced the optimism regarding the continuation of their growth. The tsunami in Japan and its effect on the global production chain and the increased concerns regarding the high levels of the US deficit and its national debt increased uncertainty in the developed countries. At the

[5] The G3 Trade Index is a weighted measure of the total foreign trade of the US, Germany and Japan. The index serves as an early indicator for global trade.

same time, there are signs of deterioration in the situation of a number of countries that are at the center of the European debt crisis. In recent months, the EU countries decided to increase the budget of the aid fund for the crisis countries. Nonetheless, the indices of risk and CDS spreads of Greece, Portugal and Ireland continued to rise, which is an expression of the lack of confidence among investors with regard to the ability of assistance programs to prevent the need for debt rescheduling (Figure 4). In June, the S&P credit rating agency lowered the rating of Greece's debt and stated that the present rating embodies its belief that there is a high probability that Greece will be forced to reschedule its debt in the near future. In July, after the period being reviewed, Moody's lowered its rating on the debt of Ireland and Portugal. In addition, they warned that the rating of Italy's debt may be lowered due to indications of deterioration in its debt. The IMF announced that in order to prevent a debt crisis, Italy will be required to make additional budget constraints. In light of the mixed trend in share prices during the period reviewed, the rapid rate of increase that characterized the second half of 2010 was halted.

*(3) Global inflation*

**The rate of inflation has increased in both the developed and developing countries.** During the first half of 2011, the rate of inflation measured over the previous 12 months increased in both the US and the euro area, with their CPIs increasing by 3.6 and 2.7 percent, respectively. On the other hand, the rate of increase in the core indexes in the developed countries was moderate relative to that in the overall CPI (Table 1). The developing countries were characterized by high inflation as a result of increased demand and the high rates of growth. High prices of commodities (which are also used as raw materials), though they have recently declined, are increasing inflationary pressures worldwide as a result of their influence on production costs.

**Global inflationary pressure was reflected in increased commodity prices.** Commodity prices rose during the first half of the year, a continuation of their upward trend since the beginning of 2009. During the first six months of the year, the prices of food, basic metals and energy increased by 6.3, 0.6 and 23.5 percent, respectively (Figure 5).[6] The increase in commodity prices was partly the result of the rapid rise in global demand, particularly in the developing countries, and reflected inflationary pressures. Nonetheless, it is worth mentioning that commodity prices dropped significantly over the course of the second quarter. This was due partly to the drop in demand in the developing countries, which was the result of monetary restraint meant to moderate inflation, and was also due to the reduced expectations of future growth rates. The price of energy was influenced not only by the demand side but also by fears of a contraction in supply as a result of the political uncertainty among petroleum exporters in the Middle East. In July, after the end of the first half, the drop in food and basic metals prices halted, and prices again began to rise.

*(4) Monetary policy worldwide*

[6] Average for June 2011 relative to the average for December 2010 in dollar prices.

**Monetary policy in the developed countries remained expansionary though there are signs of a reduction in the monetary expansion.** In view of the surplus in productive capacity and the slow rates of growth, developed countries are maintaining their expansionary monetary policies. Nonetheless, as a result of inflationary pressure and the signs of recovery in real activity, there were increasing signs during the second quarter that monetary expansion would be curtailed. The Fed left its fed funds rate unchanged at a near zero level during the period being reviewed and is only expected to raise the interest rate at the end of 2012. However, there were indications to the markets of some scaling back of monetary expansion in the near future with the conclusion of the second "quantitative easing" (QE2) in June, as planned, and the Fed's declarations that there will not be any additional such program. The European Central Bank raised its monetary rate of interest in April by 0.25 percent to 1.25 percent, which was the first increase since the onset of the crisis. In May and June, it left the level of interest unchanged since some peripheral European countries are still suffering from a debt crisis that is weighing down on their economic activity (Figure 6). In July, following the period being reviewed, the European Central Bank again raised the interest rate (Figure 6).

**The central banks in the emerging and peripheral economies are maintaining a policy of monetary contraction.** During the first half, emerging economies saw a continuation of accelerated growth, an increase in commodity prices and accompanying inflationary pressures. Many of their central banks continued to maintain a contractionary monetary policy. Thus, China raised its monetary rate of interest for the fifth time since the beginning of the year and similarly Taiwan, Brazil, Chile, Thailand, Korea, Colombia and Russia raised their interest rates several times. As in developing countries, the countries on the periphery of Europe that were not at the focus of the global crisis, including Sweden, Norway, Denmark and Poland, continued to retreat from their expansionary monetary policies.

### b. Development of the shekel exchange rate

**In the beginning of the first half, there was depreciation in the nominal effective exchange rate[7], followed by a renewed trend of appreciation.** During the first half of 2011, the nominal effective shekel exchange rate appreciated moderately by 0.8 percent and the trend of appreciation that characterized 2010 leveled off to a large extent (Figure 7). The trend in the shekel exchange rate during the period reviewed was not uniform. Thus, the effective nominal exchange rate depreciated significantly in January against the background of geopolitical instability in the Arab countries, the fear of deterioration in Israel's security situation, and policy measures by the Bank of Israel and the Ministry of Finance. In the following months, there was a renewal of the trend of appreciation. The renewal of appreciation was primarily the result of the continued widening of the interest rate gap between Israel and the developed countries and the strengthening of the shekel against the dollar as the dollar weakened worldwide.

[7] The nominal effective exchange rate is calculated as the weighted average of the shekel exchange rate against 28 currencies (representing 38 countries) weighted by Israel's trade with those countries.

**There were forces for depreciation during the period reviewed which offset the continuing pressure for appreciation.** The continuing surplus in the current account and the continued widening of the interest rate gap between Israel and the developed countries, which encourages the import of short-term capital into Israel, continued to power the appreciation of the shekel during the period being reviewed (Figure 6 and 8). Nonetheless, there were also forces working toward depreciation, which partly offset the pressures for appreciation. At the beginning of the year, the geopolitical unrest in the Middle East and the increase in energy prices raised uncertainty and worked to weaken the local currency. The activity of the Bank of Israel in the foreign currency market and the policy measures that were meant to moderate the pressures for appreciation, created by the import of short-term capital into Israel, also contributed to the weakening of the shekel.[8]

### c. Real economy developments[9]

**The rapid growth in economic activity continued in the first quarter of 2011 and was based on continued expansion of local demand and exports.** The National Accounts figures for the first quarter of 2011 indicate a rapid expansion in most of the components of aggregate demand. Local demand continued to rise at a rapid pace, a continuation of the trend in the previous quarter, and this was particularly evident in investment. Investment in fixed assets rose by 26.1 percent, primarily due to the increased investment in machinery and equipment. This was seen in a marked rise in the import of investment assets. The continued rapid increase in investment signals an expectation of continued growth in demand, and in order to meet it there is a need to increase the economy’s productive potential, which cannot be fully provided by local capital or by local manpower. Private consumption continues to rise rapidly, at a rate of 9.0 percent, although current consumption rose at a lower rate of 3.0 percent. Alongside private consumption, public consumption rose by 2.9 percent. Adding to the expansion of local demand was a large increase of 12.0 percent in the export of goods and services, excluding diamonds, which was supported by global growth and the expansion of global trade (Table 2).

**The growth in demand resulted in the expansion of output and an increase in imports.** GDP grew by 4.6 percent during the first quarter of 2011 relative to the previous quarter (Figure 9) and business sector product grew by 5.2 percent. The growth in GDP was low relative to the increase in demand in the economy, which was met in part by imports. There was an accelerated increase of 35.5 percent in non-defense imports during the first quarter of 2011, encompassing all of its components, which indicates that growth is being driven by local demand. The initial indicators for the second quarter of 2011 point toward a continuation of this growth, though at a slowed pace. The more moderate rate of growth is indicated by the Composite State of the Economy Index, the Survey of Business Trends and the Companies Survey. According to the responses of firms in the Survey of Business Trends and the Companies Survey, the more moderate rate of growth in local production is to a large

[8] For further details of the Bank of Israel’s monetary policy in the foreign currency market, see the section on monetary policy in this report.
[9] The data in this section are expressed in annualized seasonally-adjusted terms.

extent the result of the drop in demand for exports. This view is in line with foreign trade figures, which show a drop in exports alongside slower expansion of global trade.

**The growth of the economy was accompanied by an increase in the demand for labor, while the size of the labor force remains unchanged, thus contributing to the continuing decline in the rate of unemployment.** Employment grew by 14,800 during the first quarter and the number of unemployed declined by a similar number (14,400). The size of the workforce remained unchanged and therefore the rate of participation declined. In contrast, the demand for labor, which is measured by the number of vacant posts, grew during the first quarter, continuing the upward trend that began in the second half of 2009. The increase in the demand for labor alongside the stability in the size of the workforce are evidence of surplus demand for workers and this has been manifested in a decrease in the rate of unemployment to 6 percent (Figure 10). During the second quarter, the number of individuals requesting unemployment benefits continued to drop while the proportion of vacant posts within the total number of posts rose, indicating a continuation of the downward trend in the rate of unemployment, despite its low level. The drop in the unemployment rate is also seen in trend figures, which show that the unemployment rate dropped to around 5.7 percent in June. The continuing upward trend in the demand for labor alongside the decrease in unemployment are expected to work towards an increase in real wages. This will contribute to inflationary pressures, both due to increased production costs and increased demand for consumption.

**Indicators in the labor market show that the economy is approaching full employment.** The approach of the economy to full employment is reflected in the continuing fall in the rate of unemployment, which reached 6 percent during the first quarter of 2011. This follows the increase in the number of vacant posts, the shortening of time spent in job search and an increase in average wages, which have been rising continuously since the second half of 2009. On the other hand, real wages still do not reflect this trend and they rose at only a moderate rate.

**The developments in the real economy reflect a decline in the economy's surplus productive capacity.** With the recovery from the crisis that began in the second quarter of 2009 and the transition to growth, the economy's surplus in productive capacity has been continuously shrinking, as reflected in the rate of growth in demand, which has been increasing faster than the factors of production. This development has been manifested in, among other things, the increase in investment and the import of investment goods, the accelerated rate of increase in the utilization of capital, according to the Companies Survey, and the drop in the rate of unemployment. This is in line with the indicators in use by the Research Division of the Bank of Israel, which show the output gap to have narrowed during the first quarter.

### d. Financial developments

**The upward trend in stock prices reversed itself during the period reviewed.** As in stock markets worldwide, the rapid growth in stock prices that characterized the

TASE during the second half of 2010 came to an end during the first half. Overall, the Tel Aviv 100 Index fell by 7.9 percent over the first six months of the year (Figure 3).[10] This change in trend is partly the result of increased geopolitical unrest in the Middle East, the fears of a deterioration in Israel's security situation and reduced optimism regarding continued global growth. The drop in the demand for stocks was also contributed to by the increase in interest rates in the economy (primarily in the second quarter), which increased the relative attractiveness of investments in the money market, which has been manifested in positive inflows into money market funds and negative net investment into mutual funds specializing in shares.

**The yield spreads between corporate and government bonds have widened although they still remain at low levels.** The corporate bond market reacted with a lag to the increased uncertainty in the financial markets and the spread in yields between corporate CPI-indexed bonds and CPI-indexed government bonds widened only at the end of the period reviewed (Figure 11). The yield spreads between indexed government bonds and highly-rated indexed corporate bonds grew during the first six months of the year by an average of 0.4 percentage points while the yield spreads between the former and unrated corporate bonds fell by 1.4 percentage points. The level of the yield spread in the corporate bond market is lower than prior to the crisis in 2007 despite a certain increase at the end of the period being reviewed.

**The nominal and real yield curves of government bonds shifted upward, primarily in the short-term and medium-term ranges.** The real and nominal yield curves of government bonds flattened during the first half, as a result of the increase in yields that was concentrated in the short term and medium term ranges. The changes in the yield curves reflect an increase in the interest rates in the economy and their approach to long-term levels (Figure 12). In reaction to the 0.5 percentage point increase in the monetary rate of interest in April, the real annual interest rate rose and became positive for the first time since the second quarter of 2009. However, the level of real yields remained low relative to the past. This is the result of the negative levels of real short-term interest rates worldwide, such that in a small and open economy like Israel's, in which there are few constraints on international capital flows, the real domestic interest rate is affected by alternative yields abroad.

**The volume of new mortgages is increasing even though their monthly payments have risen.** The continued increase in the price of houses alongside the increased rates on various indexed mortgages is raising the monthly payments on new mortgages and thus should be dampening the demand for them. However, the volume of new mortgages continued to rise during the past 12 months (Figure 13 and 14). The directive of the Supervisor of Banks to restrict, starting from May, the proportion of a variable-interest-rate mortgage to one-third of a housing loan is expected to increase average monthly mortgage payments, since the payments of variable-interest-rate mortgages ("prime mortgages") are still low relative to other indexed mortgages, and so help in lowering demand for these mortgages. Thus, in June, at the end of the period being reviewed, there were indications that there had been a drop in the volume of mortgages granted, although it was still too early to tell whether this represents a change in trend.

[10] The average for June 2011 relative to the average for December 2010.

**Credit to the business sector continues to grow.** The volume of credit to the business sector grew by 4.4 percent during the past 12 months and domestic credit, which is not influenced by changes in the exchange rate, grew by 6 percent. Since the rate of growth in business product exceeded the growth in business credit, it appears that the supply of credit did not constitute a significant constraint on economic activity. This can also be seen from the responses to the Survey of Companies which does not point to any shortage of financing, as well as figures on the issue of bonds by the business sector, which rose continuously until April and remained at a high level in May and June as well.

### e. Inflation and inflation expectations

**During the six-month period from January to June, the CPI rose by a rate that implies an annual inflation rate exceeding the upper limit of the inflation target range.** During the period January to June, the CPI rose by 2.2 percent. In seasonally-adjusted terms,[11] the CPI rose slightly less, 1.9 percent, which translates into an annual rate of 3.9 percent, exceeding the upper bound of the inflation target range of 1-3 percent. The increase in the CPI was mainly the result of increased food and energy prices, which followed the continuing upward trend in commodity prices worldwide, and the rise in housing prices (Figure 15). The seasonally-adjusted increase was not uniform over the period being reviewed: its rise during the first two months of the year indicated a deviation from the inflation target while its rise during the months March to May were consistent with the inflation target. Thus, the seasonally-adjusted CPI rose by 1.2 percent during the months January-February while during the four months from March to June it rose by only a combined 0.7 percent.

**The year over year rate of inflation exceeded the upper bound of the inflation target range.** The rate of inflation measured over the previous 12 months rose to above the upper bound of the inflation target range and later on in the period reviewed stabilized at its high level. Thus, in each of the months January to June, it remained above the target range (Figure 16). The stabilization of the rate of inflation at its present high level occurred at the same time as the approach of the economy to full employment and reflects the increase in food and energy prices worldwide. Housing prices also contributed to the rise in the CPI over the previous 12 months and without them the CPI would have risen by 3.6 percent during that period. The CPI without housing, food and energy rose by only 2.8 percent during the past year.

**House prices continued to rise at a rapid pace and the ratio between of house prices to the cost of renting and to the average wage increased.** The Housing Price Index, according to the CBS Survey of Owned Housing Prices, increased by 3.8 percent[12] since the beginning of the year and by 13.7 percent[13] during the last 12

[11] The figures for the seasonally-adjusted CPI are based on calculations by the Bank of Israel. For further details on the method of seasonal adjustment and the main motive for it, see Box 1 in Inflation Report 30.
[12] Due to the delay in the publishing of the Housing Price Index, we relate to the period between mid-January and mid-April.
[13] Due to the delay in the publishing of the Housing Price Index, we relate to the period from April-May 2010 to April-May 2011.

months. During the period being reviewed and continuing the trend that began in the second quarter of 2010, the rate of growth in house prices slowed markedly. Nonetheless, their rate of increase exceeds that of the CPI and of rents and the average wage, following the trend that began in 2008. As a result, the gap between house prices and the economic fundamentals continues to widen (Figure 17). House prices relative to rent and the average wage are at record levels.

**The 12-month forward inflation expectations rose to above the upper bound of the inflation target range during the period being reviewed.** The 12-month inflation expectations, which are derived from capital market data, stood at an average of 3.3 percent during the period being reviewed, which exceeds the upper bound of the inflation target range. The expectations of inflation derived from the capital market rose up until the 0.5-percent hike in the interest rate in April, reaching a level of 3.7 percent in March. Following the hike, expectations fell to the vicinity of 3.1 percent, apparently due to a rate hike which was steeper than expected. The average forecast of inflation by private analysts for the next twelve months increased by a smaller amount to a level of 3.1 percent and stabilized there during the period from March until May. In June, expectations of inflation and analysts' forecasts started to decline, and in July, following the period being reviewed, they fell to 2.9 percent, slightly below the upper boundary of the inflation target range (Figure 18).

**The expectations of inflation for the medium and long terms are within the upper bound of the inflation target range.** The expectations of inflation for terms of between three and eight years fell during the period being reviewed while expectations for terms of nine and ten years rose. With the increase in expectations for the long term, the whole inflation expectation curve rose to the upper area of the inflation target range, above 2.5 percent (Figure 19). The upward shift in the long-term expectations curve points to the possibility of an increasingly inflationary environment as perceived by the public.

**Box**

**The effect of foreigners' activity on *makam* yields**

- Against the background of a widening interest rate gap between Israel and the developed countries, the activity of foreigners in the Israeli money markets has grown. Thus, the proportion of *makam* held by foreigners rose from 2 percent in August 2008 to 35 percent in May.
- The increase in nonresidents' activity in the *makam* market has worked to reduce their yield.
- The drop in returns in the *makam* market apparently led to some pressure downward on the estimate of inflation expectations derived from the capital markets.

As a result of the rapid recovery of the Israeli economy from the financial crisis and the acceleration of inflation, the Bank of Israel began raising the monetary rate of interest in September 2009. As monetary policy became less and less expansionary, the interest rate gap between Israel and the developed countries widened, and the inflow of capital increased. From August 2009 until April 2011, the value of the asset portfolio of nonresidents grew by 700 percent. Most of the activity of nonresidents is concentrated in money market - *makam* and short-term government bonds. Thus, the share of foreigners in the *makam* and short-term government bond markets grew from 1.8 and 0 percent in August 2008 to 34.5and 17.2 percent in May 2011, respectively. In other investment channels, there has been no major change with respect to the share of foreigners.

The large volume of imported capital intensifies the pressures for an appreciation of the shekel exchange rate and also raises the demand for financial assets. With the increase in the share of foreigners’ holdings in the *makam* market, the impact of their demand on yields has grown.

In order to estimate the effect of foreigners’ activity in the *makam* market on yields in that market, a comparison was carried out between the changes in the yield on one-year *makam* and changes in the one-year Telbor rate, which is calculated as an average of the rates of interest at which the banks are willing to provide a loan in the interbank system. The Telbor is quoted daily for a number of maturities: one business day, one week, one month, two months, three months, six months, nine months and twelve months. Therefore, it embodies the information existing in the market and the banks’ demand and supply of liquidity. The Telbor rate therefore serves as an estimate of the market interest rate, in a similar manner to the *makam* yield. Therefore, changes in the gap between the Telbor rate and the *makam* yield are explained by changes in the demand and supply of *makam*.

The effect of nonresidents' activity on the 12-month yields in the *makam* market began to be felt starting in September 2010 due to the increase in their share of holdings to almost 30 percent. During this period, foreigners increased their holdings in 12-month *makam* and a gap opened between the Telbor rate and *makam* yields (Figure A). During the period being reviewed, the maximum gap was about one-half of a percent. It appears that the spread is highly correlated with the volume of nonresidents' activity in the market (Figure B). Thus, during the 12 months between April 2010 and April 2011, there was a correlation of 0.93 between the volume of foreigners’ activity and the gap between the Telbor rate and the *makam* yield. This high level of correlation is evidence that the activity of foreigners during this period contributed to the drop in yields in the *makam* market.

In summary, one of the effects of the interest rate gap between Israel and the developed countries is the entry of foreigners into the Israeli money markets. Their large share in the *makam* market has increased their influence on yields in that market and therefore has pushed down interest rates in the economy. Since the yields on 12-month *makam* are used to derive the expectations of inflation in the capital market, it is possible that the estimate of inflation expectations has also been biased by the activity of foreigners in the *makam* market. With that, it is possible that the downward shift in *makam* yields has worked to reduce yields on CPI-indexed government bonds and shekel denominated non-indexed government bonds. Thus, if there was any shift in the estimation of expectations of inflation, it would be smaller than the shift in *makam* yields.

## 2. Monetary Policy

**The indicators that were available to the Bank of Israel during the period reviewed supported a reduction in monetary expansion while maintaining support for the exchange rate.**

The deviation of the pace of inflation and in inflation expectations above the upper limit of the target range, the rapid growth of local real economic activity and the increase in house prices—all supported an increase in the monetary interest rate, in order to achieve the inflation target and to maintain financial stability. This policy increases the pressure toward appreciation of the shekel, due to a widening of the interest rate gap vis-à-vis developed markets, and so the Bank of Israel remained active in the foreign currency market in order to moderate the appreciation of the shekel. Lack of geopolitical stability in the Middle East also worked toward weakening the appreciation pressures over the course of the period reviewed. Bank of Israel activity in the foreign currency market included purchases of foreign currency, as well as macro-prudential policies which included imposing on bank corporations a reserve requirement of 10 percent against nonresidents' transactions in foreign currency derivatives, and a reporting requirement on various transactions.

**Over the course of the period reviewed the Bank of Israel accelerated the pace of raising the interest rate**. After increases at a moderate pace since the fourth quarter of 2009, the Bank of Israel accelerated interest rate hikes in the two most recent quarters, and raised the interest rate by 1.25 percentage points over the first half of the year. The interest rate for February and March was raised 0.25 percentage points each time, and the interest rate for April was raised 0.5 percentage points, bringing the rate to 3 percent. After the interest rate for May was left unchanged, the interest rate for June was raised 0.25 percentage points—the fourth increase this year—to 3.25 percent. The faster pace of increase in the interest rate during the first half was necessary in light of the rise in the inflation environment, which was exemplified by the deviation of the rate of inflation over the previous 12 months and of inflation expectations above the upper limit of the inflation target range throughout the entire period reviewed. Other supporting factors for a faster pace of increase in the interest rate were continued rapid growth of house prices and rapid expansion of economic activity, through decline in the output gap. Toward the end of the period surveyed, the possibility of some slowdown in economic activity developed, and economic and financial uncertainty increased greatly, primarily in light of global developments and the regional geopolitical situation. Signs were also seen of a possible moderation in the rate of inflation. Against this background, the Bank of Israel kept the interest rate for July and August unchanged.

**The process of returning inflation to within its target range is gradual**. In order to bring inflation back to within the target range, the Bank of Israel is raising the monetary interest rate—its prime monetary policy instrument. As noted, raising the interest rate comes along with appreciation pressures on the shekel[14], and has the effect of moderating real activity. As such, a process of raising the interest rate is gradual, and therefore gradually returns inflation, in accordance with the Bank of Israel Law, to within the target range.

[14] The change in the exchange rate is essentially part of the pass through mechanism from monetary policy to prices.

**The Bank of Israel continued to purchase foreign currency, and imposed a reserve requirement on nonresidents' transactions in foreign currency derivatives.** The pace of foreign currency purchases was influenced during the period reviewed by various appreciation pressures. In January, the Bank of Israel purchased $2.085 billion, and in February and March, as appreciation pressures waned, it purchased a combined $200 million. In April, with renewed appreciation pressures, due to the widening interest rate gap vis-à-vis the advanced economies, foreign currency purchases were renewed, and the Bank purchased $1.495 billion. In May and June, a combined $600 million was purchased. At the end of June, the Bank of Israel's foreign currency reserves stood at $77.4 billion. At the end of January, the Bank of Israel imposed on banking corporations a reserve requirement of 10 percent against nonresident transactions in foreign currency derivatives. The Bank of Israel also reported the imposing of a reporting requirement on transactions in foreign currency derivatives, and a reporting requirement on nonresident transactions in *makam* and short-term government debt, which came into effect in the beginning of July. These steps—aside from their goal of reducing the worthwhileness of short term shekel savings by nonresidents, and as such moderating the appreciations pressures on the shekel—also have a stability-related objective, as they are expected to reduce the volatility in short term capital flows and provide better monitoring of the flows.

**Against the background of imposing a reserve requirement against nonresidents' transactions in foreign currency derivatives, there was somewhat of a decline in foreign resident activity in *makam*.** In September 2008, before the deterioration of the financial crisis, nonresident investors' share of outstanding *makam* market value was only 1 percent. With the opening of an interest rate gap with advanced economies, the local interest rate attracted nonresident investors for short terms, and their share of *makam* market value rose. In January 2011, right before the imposing of the reserve requirement, it had reached 36 percent. The reserve requirement reduces the shekel rate of return at a proportion equal to that of the reserve requirement, and so reduces the relative worthwhileness of the shekel deal. Therefore, with the imposing of the reserve requirement, the volume of *makam* purchases by foreign resident investors fell in February and March. Nonetheless, with the interest rate differential, and the current level of the reserve requirement, investing in *makam* remains attractive relative to alternatives in advanced economies, so it appears reasonable that part of this effect was based on the renewed assessment of the situation by foreign investors, as they worry that the level of the reserve requirement will be raised in the future, as well as by depreciation pressures, even if temporary, on the shekel, due to geo-political instability and somewhat of a deterioration in the security situation. After the interest rate increase for April, the volume of *makam* purchases by foreign investors again grew, and added to appreciation pressures on the shekel. However, in May, purchases by nonresident investors dropped, and by the end of the month their holdings in the *makam* market were less than at the end of April.

**In the face of the continuing trends in the housing market, the Bank of Israel utilized macro-prudential tools, and limited the share of the variable rate interest portion of a mortgage to one third of the overall mortgage loan.** Beginning in May, the Supervisor of Banks issued a directive limiting the variable rate share of a mortgage to one third of the total housing loan that the bank extends to the borrower. The restriction was imposed on new housing loans in all variable interest rate tracks, in which the interest rate charged can change over a period shorter than five years. The directive was published in light of the continued trends in the market for houses, and primarily in light of the significant volume of mortgages extended at variable interest rates. Inherent in those loans is risk for the borrowers, and by extension for the banking system as a whole. In addition, the directive imposes on the lenders a disclosure requirement, according to which they must notify customers who took out a mortgage with a variable interest rate, based on the prime interest rate, unindexed to the CPI. The objective of the disclosure requirement is to increase for those borrowers the awareness of the possible consequences of an increase in the interest rate on the amount of their required monthly payment, in order to allow them an educated evaluation of this risk and the possibilities of reducing it.

## 3. UPDATE OF FORECASTS[15]

### a. The global environment

**Global growth is expected to continue in an unbalanced manner, with slower growth in the developed countries and faster growth, accompanied by high inflation, in the developing countries.** According to the forecast of the IMF, the annual rate of growth in the developed countries over the next two years is expected to be 2.4 percent (Table 3). In view of the moderate level of aggregate demand and the expectation that energy and commodity prices will rise, consumption prices n the developed countries are expected to increase by 2.6 percent in 2011 and by 1.7 percent in 2012. With regard to the developing countries, IMF economists expect annual growth to be about 6.5 percent over the next two years and that demand will rise in these countries, leading to inflation at a rate of 6.9 percent in 2011 and 5.6 percent in 2012. Based on these forecasts, the rapid growth in global trade is expected to continue at an average rate of 7.5 percent over the next two years. The fiscal austerity that will be required in the developed countries and the continuing tight monetary policies in the developing countries are among the risk factors that could lead to less than forecasted growth. Against this background, the IMF stated in its last Survey that it is likely that the growth forecasts for 2011 and 2012, which are to be published in the coming months, will be revised downward.

**The investment banks expect the European Central Bank to raise the interest rate during 2011, while the interest rate in the US will be left at its currently low level until the end of 2012.** According to the average forecast of the investment banks worldwide, the US will not begin raising its interest rate until the last quarter of 2012. In Europe, the expectation that the interest rate would be raised by one-quarter of a percent at the beginning of the second quarter of 2011 was fulfilled and it is expected that the interest rate will reach about 2 percent by the end of the year.

[15] This section of the report is based on the macroeconomic forecast that the Research Department of the Bank of Israel prepares each quarter (the staff forecast). The forecast here is a macroeconomic forecast from the end of the second quarter based on indicators which were available by the date of the interest rate decision for August (reached on July 25, 2011). An explanation of the Staff Forecast and an overview of the models on which it is based can be found in Inflation Report 31 for the second quarter of 2010, section 3-C.

### b. Real activity in Israel

**Growth in GDP is expected to reach 4.8 percent in 2011, primarily due to the expansion of investment demand.** GDP is expected to grow by 4.8 and 3.9 percent in 2011 and 2012, respectively. During this period, the rate of growth in GDP is expected to slow as the economy approaches the limit of its production capacity. **The forecast for growth in 2011 has been revised upward** relative to that reported in the previous Monetary Policy Report (4.5 percent), due to the base effect of the high growth during the first quarter of the year (4.6 percent). Growth in GDP during 2011 is expected to be based largely on fixed capital investment, which is the result of the shortage in capital stock (particularly residential buildings) and is supported by a low real rate of interest relative to its long-term level. The end of the sharp decline in inventory that characterized 2010 will also contribute to the expansion of GDP in 2011. **Israel's exports are expected to grow by 5.2 percent in 2011,** which is an expected result of its rate of growth in the first quarter (11.3 percent in annual terms) and the more moderate growth subsequently, as a result of the continuing real appreciation.

**The expansion in demand is supported by the rapid increase in the labor force participation rate and in the capital stock, as well as the increase in imports.** The growth in GDP during 2011 is expected to be higher than its long-term rate, despite the approach of the economy to full employment. This growth is facilitated by the expansion of the supply side, which is made possible by the uninterrupted increase in the labor force participation rate (such that the rate of unemployment will fall slightly to below 6 percent during the rest of the year) and the growth in capital stock of about 7 percent, facilitated by the recovery in investment in fixed assets. The growth in demand is expected to be increasingly met by imports in 2011, which are expected to grow by 14.8 percent. This is due to the real appreciation, which brought down the price of imports relative to local production, the approach to full employment and the high import intensity of the uses that are growing rapidly (fixed capital investment and investment in inventory). The relatively rapid growth in imports and the deterioration in the terms of trade (due to the increase in the global prices of commodities and oil) are expected to bring about a significant decline in the current account surplus.

### c. Inflation estimates and the balance of inflation risks

**The Forecast of the Research Department of the Bank of Israel is that the rate of inflation in another 12 months will be at the upper boundary of the inflation target range and following that will decline towards the center of the range.** The rate of inflation during the last 12 months was 4.2 percent, which is above the upper boundary of the inflation target range. According to the forecast of the Research Department, the rate of inflation will remain high though it will moderate during the coming year. During 2011, the 12-month rate of inflation is expected to remain above the upper bound of the target range and to reach 2.9 percent in another year. The hike in the Bank of Israel interest rate from its present level of 3.25 percent to about 3.9

percent in another year is consistent with the stabilization of the inflation rate closer to the center of the target range towards the end of 2012 (Figures 20 and 21).

**This view reflects the combination of a number of economic forces, most of which are operating to sustain a high rate of inflation. These include an increase in the global price of commodities, the surplus demand for housing services and the expansion of demand for output.** A major source of inflation during this period is the high level of global energy and commodity prices. In recent months, these prices have risen sharply (to about $117 per barrel of oil (Brent crude) when the forecast was being prepared) and we estimate that they will remain in that vicinity. We assess that the housing market (rentals) will continue to be characterized by excess demand and rents will continue to rise. The growth in demand for output, which is reflected in the shrinking excess capacity, may push up inflation through the rise in the cost of local production outputs, particularly labor cost, and through the efforts of firms to increase their pricing margins. According to the estimates, the nominal wage is expected to continue rising this year at a relatively high rate, which is partly a reflection of the adjustment following the drop in the real wage in 2009 and its moderate increase in 2010 relative to the rate of increase in labor productivity. Thus, the level of wages is still not expected to create serious inflationary pressure. Inflationary pressures are liable to arise from the labor costs if demand continues to grow or as a result of wage settlements achieved by the large unions. Apart from their direct effects, the aforementioned inflationary factors are known to also have an indirect effect through the public's expectations. Thus, expectation that inflation will be above its target (according to analysts' forecasts, the capital market and the Survey of Trends) may already be raising prices, due to the expectations of large wage settlements in the future and the pricing decisions that are being made in the present.

**The main element that is expected to constrain inflation is the appreciation of the effective nominal exchange rate.** During the past year, there has been an appreciation in the effective exchange rate of about 2.5 percent[16]. This works to bring down the price of goods imported into Israel, though the transmission from the exchange rate to prices is not immediate. Therefore, it is reasonable to assume that import prices have not yet been fully adjusted to the new level of the exchange rate, such that their downward adjustment will continue during 2011. Apart from this, the background conditions to the appreciation, both real and nominal, continue to exist, including the surplus in the current account (though it is expected to decline) and the interest rate gap between Israel and abroad. The interest gap is expected to widen, in view of the inflationary environment in Israel and the declining surplus in local productive capacity, while the US and European economies have still not recovered from the crisis and as a result their central bank interest rates are still very low (0.0-0.25 percent in the US; 1.5 percent in Europe). These interest rate levels also work to restrain the rate of increase in the local rate of interest.

**The forecast of inflation is close to that of the previous Monetary Policy Report, though the path of the interest rate is lower.** Figures 20 and 21 present a comparison to the forecasts in the previous Monetary Policy Report (May 2011):

[16] The average of the preceeding three months, compared with the average of the corresponding months in 2010.

The Bank of Israel interest rate is expected to be 3.9 percent in another 12 months, which is lower by about 0.6 percent than the forecast in the previous report (for the second quarter of 2012). The decline of the expected path of the interest rate is due to the increase in risk (since the previous report) to real activity (i.e. risks to the global economy as well as geo-political risks in the local environment). An additional reason is the downward shift in the expected path of global interest rates.

The 12-month forecast of inflation (2.9 percent) is a bit lower than the parallel forecast in the previous report (3.1 percent in the second quarter of 2012). Since the previous report, a number of additional indicators now provide support for decreasing the forecast of inflation:  1) the CPI rose during the second quarter at a lower rate that we forecasted in the previous quarter (and therefore the beginning of the forecasted path of inflation is somewhat lower than in the previous Monetary Policy Report); 2) during the first quarter of 2011, hourly wages rose less than was forecasted in the previous quarter; 3) GDP prices fell during the first quarter in contrast to the forecast that they would rise; and 4) Inflation forecasts abroad were lowered a little. In contrast, there are also some inflationary indicators: 1) the publishing of data that is more positive that our previous assessment of economic growth in the first quarter of 2011; and 2) An increase in energy prices in the second quarter of 2011.Taking into account all of these developments, the forecast of inflation is close to that in the previous report.

**The forecasts of inflation in the markets are similar to those of the Bank of Israel.** The expectations of inflation derived from the capital markets stand at 3.0 percent, which is slightly lower than the expectations of 3.1 percent at the time of the writing of the Monetary Policy Report for the previous quarter. The average forecast from the business tendency survey is similar to the survey from the previous quarter: 3.2. The average forecast of private analysts at the end of the first quarter stood at about 2.9 percent, somewhat lower than their forecasts at the time of the writing of the Monetary Policy Report for the previous quarter (3.1 percent).

**The balance of risks in the forecast.** The basic forecast rests on the following assumptions: 1) stability in Israel’s geo-political situation; and 2) continuation of the global economic recovery without any large-scale fiscal or financial crises. In view of the instability in the Middle East and the fact that the forecast does not take into account possible adverse developments in Israel’s security situation, the balance of risks with respect to real activity tends to point downward. Thus, the realization of any one of two negative scenarios, i.e. a global slowdown or a deterioration in Israel’s security situation, is expected to have an adverse effect on the economy’s growth. With respect to inflation, a global slowdown is expected to moderate inflation to some extent due to the drop in demand while a deterioration in the regional geo-political situation may in fact be accompanied by an increase in inflation in parallel to the slowdown in growth, due to the outflow of capital from the economy that will lead to a depreciation.

In addition to these scenarios, there are additional risk factors with respect to inflation that are related to factors that are difficult to forecast and have a large impact on inflation: 1) A deprecation in the exchange rate due to a deterioration in the geopolitical situation or for some other reason, which is liable to push inflation well above its target range. In contrast, a higher rate of appreciation or stronger transmission from the exchange rate to prices (which in recent years has weakened) can be expected to reduce inflation to below the basic forecast. 2) The forecast assumes a rise in the housing component of the CPI (which is based on rents) similar to that during the previous twelve months and therefore developments that are significantly different from this assumption will have an impact on inflation.

The Bank of Israel will continue to monitor economic developments in Israel, abroad, and in the financial markets. The Bank will adjust the instruments at its disposal, and especially the path of the monetary interest rate, in order to attain its objectives of price stability, the encouragement of employment and growth and support for stability in the financial system.