BANK OF ISRAEL

Office of the Spokesperson and Economic Information

August 8, 2016

Report to the public on the Bank of Israel's discussions prior to deciding on the interest rate for August 2016

The discussions took place on July 24 and 25, 2016

General

In the process of making the monthly interest rate decision by the Monetary Committee, discussions are held at two levels—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. The data, estimates and assessments in this document are those that were available at the time of the interest rate decision.

In the narrow forum, which consists of the Monetary Committee and the Director of the Market Operations Department, the Directors of the Research Department and the Market Operations Department present their recommendations regarding the interest rate. An open discussion 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. If the vote is tied, the Chairperson (the Governor) has an additional vote.

A. THE STATE OF THE ECONOMY

1. Developments on the real side

Indicators of the state of the economy

Indicators of activity are in line with the assessment that the economy apparently continues to grow at the rate that has been characteristic of the past few years. The third estimate of GDP growth for the first quarter was also revised upward, to 1.7 percent, as a result of an upward revision of goods and services exports that was partly offset by a downward revision of private consumption and investment. The net balance in the Companies Survey for the second quarter increased compared to the net balance in the first quarter, and is in line with a growth environment of about 2.5–3 percent. According to the survey, the expansion took place mainly in industries with activity focused on domestic demand—trade, construction, and transport and communication—while in the manufacturing, services and hotels industries, the rate of expansion was lower. An analysis of revenue and employment data in the manufacturing industry shows that the lack of expansion in the industry is a result of a retreat in production in the high technology industries, particularly for export, while activity in the low technology industries, which also produce for the domestic market, increased. Goods exports (excluding ships and aircraft and diamonds) declined by 5 percent in the second quarter, while revised data on services exports indicate an upward trend since mid-2015. Goods imports (excluding ships and aircraft, diamonds and energy products) increased by 3.6 percent in the second quarter, with an increase of 14.1 percent in the import of capital goods. The Composite State of the Economy Index increased by 0.1 percent in June. The Consumer Confidence Index compiled by the Central Bureau of Statistics has shown continued improvement since October. The Consumer Confidence Index compiled by Bank Hapoalim has remained more or less constant since the beginning of 2015. The Purchasing Managers Index continued to decline in June, to 48.8 points.

The labor market

The picture conveyed by the labor market remains positive. Wage increases continue in all industries. Real wages increased by 2.5 percent (seasonally adjusted) in February–April compared with the three previous months, while nominal wages increased by 3.1 percent. In June, the minimum wage was raised by about 4 percent. Health tax receipts for April–June were 5.5 percent higher (in nominal terms) than in the corresponding period in the year before, reflecting the increase in employment and wages. The job vacancy rate declined to 3.5 percent (seasonally adjusted) in June, but this level remains high and, combined with the decline in the growth rate of employee posts, it indicates that there is apparently some shortage of workers in certain industries.

Budget data

The cumulative domestic deficit (excluding net credit) in government activity was NIS 1.8 billion in January–June 2016, compared with a deficit of approximately NIS 1.0 billion in the corresponding period of 2015, and it is about NIS 4.9 billion smaller than the deficit in the seasonal path consistent with achieving the deficit target for 2016. The deviation reflects revenues that were NIS 3.2 billion higher than the path, and expenditures that were NIS 1.7 billion lower than the path. Tax revenues in June were NIS 22 billion, which is about NIS 1.4 billion higher than the seasonal path consistent with the estimate of tax revenue (NIS 277 billion). Tax revenues in January–June were about 6.3 percent higher in real terms than in the corresponding period of the previous year. Gross domestic VAT collection declined by about 0.7 percent in real terms compared with June of 2015 (it increased by about 5.1 percent net of the effect of legislative changes).

2. Developments on the nominal side

Inflation

The Consumer Price Index for June increased by 0.3 percent, similar to the average of forecasters' predictions. The fruit and vegetables component declined by 3.5 percent, and the clothing and footwear component increased by 8.3 percent, both against a seasonal background. The inflation rate as measured by the change in the CPI over the past 12 months was -0.8 percent, similar to the 12 months ending in May. Excluding the direct effect of energy prices and administrative price reductions, the CPI increased by 0.6 percent over the past 12 months. Prices of tradable goods in the CPI declined by 2.8 percent over the past 12 months, compared with declines of 3.2 percent in the 12 months ending in May and of 3.6 percent in the 12 months ending in April. The change in trend is a result of the beginning of the exhaustion of the direct negative contribution of energy prices. The prices of nontradable items increased by 0.3 percent.

Expectations and forecasts of inflation and the interest rate

There was no significant change in inflation expectations for the various ranges. One-year inflation expectations derived from the capital market increased to 0.5 percent (compared with 0.4 percent in the previous month). Expectations for inflation over the coming 12 months derived from banks' internal interest rates remained at 0.3 percent, and private forecasters' projections for the next 12 CPI readings are for an increase of 0.8 percent, on average (similar to the previous month). Third-year forward expectations remained unchanged (1.1 percent). Longer term expectations remained within the target range with medium-term (3–5 years) expectations at 1.45 percent, and longer term (5–10 years) expectations at 2.2 percent. Most indicators show that there is no expectation of an increase in the Bank of Israel interest rate in the next year.

Monetary aggregates

In the 12 months ending in June, the M1 monetary aggregate (cash held by the public and demand deposits) increased by 23.5 percent, and the M2 aggregate (M1 plus unindexed deposits of up to one year) increased by 12.5 percent.

The credit market

In June, the business sector (excluding banks and insurance companies) issued bonds totaling NIS 2 billion, after issuances totaled NIS 2.7 billion in May. The average of monthly issuances in the past year was about NIS 2.7 billion. The volume of net mutual fund withdrawals remained high in June, totaling NIS 2 billion. In contrast, funds specializing in corporate bonds in Israel continued to attract net new investment in June. By the middle of July mutual funds returned to net new investment. Corporate bond spreads continued to decline, over the full month, in most industries, and were about 3.4 percentage points, on average (excluding bonds of financial corporations) at the beginning of July. According to the Companies Survey, in general, there is no evidence of financing constraints in the business sector, despite some increase in financing difficulties reported by small and medium businesses and companies in the construction industry. In June, which typically has a seasonally high level of new mortgages taken out, the total volume of new mortgages taken out was NIS 5.6 billion, slightly higher than the average of the past 12 months (NIS 5.3 billion). The share of mortgages issued for the purchase of investment homes continues to decline, to 13.5 percent in May, compared with an average of 15 percent in the past 12 months. The average interest rate on mortgages continued to increase in June on all tracks: On the fixed-rate CPI-indexed track, rates increased by 0.05 percentage points, while on the variable-rate CPI-indexed track, rates increased by 0.19 percentage points. Rates on the fixed-rate unindexed track increased by 0.07 percentage points, and on the variable-rate unindexed track rates increased by 0.04 percentage points.

The housing market

The housing component of the CPI (based on residential rents) increased by 0.1 percent in June, after remaining unchanged in May. The rate of home prices increases remains high. Home prices increased by 0.3 percent in April–May, and by 7.8 percent in the 12 months ending in May, similar to the increase in the 12 months ending in April. Activity in the market remains robust, with 7,800 transactions carried out in May, slightly lower than the average over the past 12 months (about 8,100 transactions per month). The volume of new home sales continues to increase moderately, reaching about 2,750 in May, and the stock of homes available for sale continued to increase in May, reaching approximately 28,700 homes.

3. The foreign exchange and capital markets

The foreign exchange market

From the monetary policy discussion on June 26, 2016, through July 22, 2016, the shekel strengthened by 1.2 percent against the dollar, and by 1.7 percent in terms of the nominal effective exchange rate. Over the preceding 12 months, the shekel appreciated by 1.8 percent in terms of the nominal effective exchange rate.

The capital market

From the monetary policy discussion on June 26, 2016, through July 21, 2016, the Tel Aviv 25 Index increased by about 6 percent. Government bond yields increased moderately along the unindexed curve, and declined by up to 10 basis points along the indexed curve. The *makam* curve traded at a yield ranging around the Bank of Israel interest rate. Israel's sovereign risk premium, as measured by the five-year CDS spread, declined to 75 basis points.

4. Global economic developments

In the days following the referendum in the UK, financial markets were considerably volatile. However, in the weeks that have elapsed since then, most markets stabilized, after a rapid response by the Bank of England and the ECB, and after the political situation in the UK stabilized. The direct effect of the Brexit decision has thus far been reflected in a depreciation of the pound sterling, declines in bank share prices in Europe, and widespread redemptions from commercial real estate funds in the UK. With that, the economic and political uncertainty remains high. The International Monetary Fund reduced its global growth forecast for 2016 and for 2017 by 0.1 percentage points, and the forecast for growth in world trade in 2016 was lowered by 0.4 percentage points. The forecasts are based on the assumption that there will be no further deterioration in the financial markets, and that the UK and the EU will succeed in preventing a sharp increase in economic barriers. Had it not been for the Brexit decision, the IMF would have slightly increased its growth forecast.

In the US, the estimate of first quarter growth was revised upward, and growth in the second quarter is expected to be about 2.4 percent. Indicators of activity in the manufacturing sector were positive this month, and personal consumption data remain strong, although consumer confidence weakened following the Brexit vote. The probability of increase in the interest rate by the end of the year—as derived from the markets—declined following the Brexit vote, but increased again following the publication of labor market data for June, which surprised to the upside in a number of parameters. In Europe, there was growth of just 0.5 percent in the manufacturing sector (relative to the same period last year), with contraction in Germany and Italy and low growth of retail sales. The purchasing managers indices, which were sampled after the Brexit vote, do not show a significant negative impact as a result of the decision. Inflation increased slightly and returned to positive territory. The ECB did not change its monetary policy at its most recent meeting. The handling of the problems in the banking system, primarily in Italy, is a source of risk to the eurozone's economy. In the UK, real economic data for the period preceding the referendum have not yet been published. The Bank of England surprised markets when it did not reduce its interest rate, but it is expected to do so in August. In Japan, activity data continue to indicate weakness, and estimations are that further accommodative measures will be taken there following the electoral victory of the ruling party. In China, official growth data indicate relatively high second quarter growth, based on broad government investment. The price of a barrel of oil declined this month from around \$50 to about \$46, and the index of commodities excluding energy also resumed its decline, falling by about 4 percent from its level in the previous month.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR AUGUST 2016

The members of the Monetary Committee participating in the discussion decide on the appropriate rate of interest for the economy. After the discussion on the interest rate for August 2016, it was decided to keep the interest rate unchanged at 0.1 percent. The decision was unanimous.

The discussion focused on several main issues: (1) inflation; (2) real economic activity; (3) the global environment, and (4) the housing market.

Main points of discussion

The Committee members discussed the low inflation environment extensively. They noted that in the past 12 months, the CPI declined by 0.8 percent, but that excluding the direct effect of energy prices and excluding administrative price reductions, the CPI increased during that period by 0.6 percent. In the discussion on inflation expectations, the Committee members examined capital market-derived expectations for all terms. They noted that short term expectations increased slightly and are rising toward the lower bound of the inflation target range, while forward expectations for medium terms remain stable at a level above the lower bound. The Committee emphasized that medium and long term inflation expectations remained anchored within the target range. The Committee members agreed that wage increases have not yet been reflected in an increase in unit labor cost, primarily due to the decline in energy prices. However, looking forward, the wage increase in the economy is expected to be reflected in a rise in unit labor cost and therefore in an increase in the inflation level as well. Some Committee members noted that the main risk to inflation returning to within the target range derives from the possibility that energy prices will again decline.

In their discussions on economic activity, the Committee members focused on the revised growth data. They referred to the Central Bureau of Statistics updating the first quarter's growth rate to 1.7 percent in annual terms, and noted that this figure is higher than the figure in the previous revision, but lower than the rate of growth that characterized the economy in previous years. However, the updated indicators point to growth in the second quarter having returned to the rate that characterized the previous two years. The Committee members emphasized the labor market's robustness: in their assessment, it is near full employment, seen in the high and stable level of employment, the increase in the number of job vacancies, and the accelerated increase in nominal and real wages. The Committee members noted that the prolonged weakness in exports is being led by a decline in exports of high technology and medium-low technology manufacturing companies. They agreed that while the decline in exports and in posts in high technology is impacted by, among other things, unique factors—some of which are perhaps transitory—the decline in exports of medium-low technology manufacturing companies was affected by the exchange rate. In contrast, the Committee members emphasized the trend of increase in services exports and the increase in revenue and in the number of posts in low technology companies, an increase that was supported by strong domestic demand.

Regarding the global environment, the Committee members noted that there was a decline in the high volatility that characterized financial markets due to Brexit, though the IMF slightly reduced its global growth forecast, and there is still some uncertainty about the effect of the Brexit process in the medium-long term. The Committee members emphasized that the monetary policy of central banks worldwide remained very accommodative, and may even become more accommodative in some advanced economies. In contrast, they noted that in the US, markets are pricing in a high probability of the federal funds rate being raised at least once by the end of 2017, possibly even during the current year. Regarding the exchange rate, the Committee members agreed that the intervention in the foreign exchange market in recent years contributed to a moderation in the appreciation of the effective exchange rate, and thus allowed companies to carry out necessary adjustments and prevented a long term adverse impact on the economy as a result of the unusual situation that was created—that is, the very accommodative monetary policy worldwide.

In terms of the housing market, the Committee members noted that home prices continued to increase by a high rate in recent months. They also noted the high level of activity in the market, reflected in the large number of transactions, and the high volume of new mortgages taken out, even despite the continued trend of increase in the interest rate on mortgages. The Committee members assessed that the number of building starts currently is near the level consistent with the current housing needs in the State of Israel, but added that in order to fill the accumulated shortage in homes—a shortage created in years when building starts were lower than the economy's needs—the high rate of building starts must be maintained over time. The Committee members agreed that the risks from the housing market remain high.

In conclusion, the Committee members agreed that the current interest rate level is in line with the low inflation environment and with domestic activity, taking into account the global situation—both in terms of economic activity and monetary developments in major economies—and that it supports the return of inflation to its target range. They were of the opinion that in view of the risks to growth and to attaining the inflation target in Israel, primarily against the background of the continued decline in exports and the assessments regarding world trade, and in view of the time it will take until the inflation rate returns to within the target range, it may be assessed that monetary policy in Israel will remain accommodative for a considerable time.

Following the discussion, the four members of the Monetary Committee voted on the Bank of Israel interest rate for August 2016. All members supported keeping the interest rate unchanged at 0.1 percent.

The main considerations behind the decision

The decision to keep the interest rate for August 2016 unchanged at 0.1 percent is consistent with the Bank of Israel's monetary policy, which is intended to return the inflation rate to within the price stability target range of 1–3 percent a year, and to support growth while maintaining financial stability. The Monetary Committee continues to assess that in view of the inflation environment, and of developments in growth in Israel and in the global economy, in the exchange rate, as well as in monetary policies of major central banks, monetary policy will remain accommodative for a considerable time.

The following are the main considerations underlying the decision:

- The inflation environment continues to increase moderately. The Consumer Price Index increased in the past three months, and short-term inflation expectations remained stable this month after increasing in previous months, but they are still below the lower bound of the inflation target range. Medium and long-term expectations remain anchored within the target range.
- Indicators of activity are in line with the assessment that the economy continues to grow at the rate that characterized recent years, led by private consumption and by industries focused on domestic activity. The slowdown in manufacturing is concentrated at high-technology industries, and a trend of increase in services exports is becoming apparent. The picture conveyed by labor market data continues to be positive, and there are signs that the economy is nearing full employment.
- In the weeks since the referendum in the UK, most financial markets stabilized. However, the uncertainty regarding the ramifications of the Brexit process is expected to remain high, and due to the Brexit decision, the IMF reduced its global growth forecast. In Europe, weakness is becoming apparent and risks to the economy are increasing, while in the US, indicators of activity, primarily labor market data, were strong. The monetary policy of major central banks is expected to remain very accommodative.
- From the monetary policy discussion on June 26, 2016, through July 22, 2016, the shekel strengthened by 1.2 percent against the dollar. In terms of the effective exchange rate, the shekel appreciated by 1.7 percent, similar to the rate of appreciation over the past 12 months. The level of the effective exchange rate continues to weigh on the growth of exports and of the tradable sector.
- The rate of increase in home prices remains elevated, and both the level of transactions and the volume of mortgages remain high. The stock of homes for sale continues to increase.

The Monetary Committee is of the opinion that the risks to achieving the inflation target and to growth remain high. The Bank of Israel will continue to monitor developments in the Israeli and global economies and in financial markets. The Bank will use the tools available to it and will examine the need to use various tools to achieve its objectives of price stability, the encouragement of employment and growth, and support for the stability of the financial system, and in this regard will continue to keep a close watch on developments in the asset markets, including the housing market.

The decision was reached and published on July 25, 2016.

Participants in the narrow-forum discussion:

Members of the Monetary Committee
Dr. Karnit Flug, Governor of the Bank and Chairperson
Dr. Nadine Baudot-Trajtenberg, Deputy Governor
Prof. Reuben Gronau
Prof. Nathan Sussman, Director of the Research Department

Other participants in the narrow-forum discussion:
Mr. Andrew Abir, Director of the Market Operations Department
Mr. Daniel Hahiashvili, Chief of Staff to the Governor
Ms. Esti Schwartz, Secretary of the Monetary Committee
Mr. Yoav Soffer, Spokesperson of the Bank of Israel
Mr. Nadav Steinberg, Economist in Research Department