



BANK OF ISRAEL

Office of the Spokesperson and Economic Information

December 7, 2015

Report to the public on the Bank of Israel's discussions prior to deciding on the interest rate for December 2015

The discussions took place on November 22 and 23, 2015.

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

The first estimate of third-quarter National Accounts data indicate that GDP grew by 2.5 percent (seasonally adjusted data in annual terms), and business sector product

grew by 2.7 percent. These data indicate a return to the growth rate of the past two years, with no compensation in the third quarter for the near-zero growth in the second quarter. Following two quarters of contraction, exports (goods and services, excluding diamonds and startups) increased by 9.7 percent. Private nondurable-goods consumption continued to grow at an adequate rate (6.4 percent), while durable-goods consumption contracted by 16.5 percent, and the increase in investment (in fixed assets, excluding ships and aircraft) remained low, at 0.9 percent. Thus far, it seems that the effect of the wave of violence on economic activity is only moderate: The number of tourist arrivals in October was 5 percent lower than the seasonally adjusted average over the first nine months of the year. The Consumer Confidence Index compiled by Bank Hapoalim declined moderately in October, while there was a relatively sharp decline in the index compiled by the Central Bureau of Statistics. Foreign trade data indicate a slight decline of 0.2 percent in goods exports in October, following a relatively sharp decline in September. There was an increase of 8.5 percent in goods imports in October, but over time, a standstill is apparent in imports of raw materials and capital goods. The Composite State of the Economy Index increased by 0.3 percent in October, led by imports of consumer goods and of manufacturing inputs. The Purchasing Managers Index increased to 51.4 points in October. The Climate Index based on the Business Tendency Survey conducted in October by the Central Bureau of Statistics indicates a decline in the monthly growth rate to 0.21 percent, after having stabilized around 0.23–0.26 percent since the second quarter of 2015.

The labor market

The Labor Force Survey for the third quarter continues to indicate a low unemployment rate (4.5 percent among the prime working ages (25–64)), and high employment (76.4 percent) and participation (80.0 percent) rates. A similar picture was presented by survey data for October. The number of employee posts increased by 0.4 percent in August over July, and by 2.7 percent compared to August 2014. However, over time, there appears to be a standstill in the number of employee posts in manufacturing. In June–August, nominal and real wages increased by 0.4 percent compared with March–May (seasonally adjusted data), and nominal wages increased by 3 percent compared with the corresponding period of the previous year. Health tax receipts for August–October were approximately 4 percent higher (in nominal terms) than in the corresponding period last year. The job vacancy rate declined slightly in October, to 3.2 percent.

Budget data

In January–October, the domestic deficit (excluding net credit) in government activity was NIS 3.8 billion. Total tax revenues since the beginning of the year are about NIS 4.3 billion higher than the seasonal path consistent with the tax revenue forecast, and about 7.5 percent higher than the same period last year. Gross domestic VAT revenues increased by about 9 percent in real terms since the beginning of the year, compared with the corresponding period in 2014. Domestic government expenditure since the beginning of the year is about 5.6 percent higher (in nominal terms) than in the corresponding period last year. The budget for 2015 and 2016 was approved in the Knesset, and the deficit ceiling was raised to 2.9 percent of GDP.

2. Developments on the nominal side

Inflation

The Consumer Price Index for October increased by 0.1 percent, while forecasters had projected a decline of 0.1 percent, on average. There was a marked increase in the fruit and vegetables component (5 percent), and a seasonal increase in the clothing and footwear component (3.2 percent), while there were declines of 1 percent in transport and communications and of 0.8 percent in home maintenance. An estimate at the Bank of Israel indicates that excluding the reductions in the VAT rate and in electricity rates, the October CPI would have increased by 0.4 percent. The rate of inflation as measured by the change in the CPI over the past 12 months was negative 0.7 percent, compared with an inflation rate of negative 0.5 percent over the 12 months that ended in September. Prices of CPI components representing tradable goods declined by a record 3.1 percent over the past 12 months, while CPI components representing nontradable items increased by 0.6 percent. The CPI excluding energy components and administrative price declines (such as the reductions in water and electricity rates) increased by 0.9 percent over the past 12 months. The VAT reduction and the decline in fuel prices at filling stations are expected to contribute to a decline in the CPI in November.

Expectations and forecasts of inflation and the interest rate

Short-term inflation expectations remained low this month: Private forecasters' projections for the next 12 CPI readings are for an increase of 0.7 percent, and 1-year expectations derived from the capital market and from banks' internal interest rates are for an inflation rate of 0.3 percent. Two-year inflation expectations derived from the capital market are 0.7 percent. Medium-term (3–5 years) forward expectations declined to 1.6 percent, while forward expectations for longer terms (5–10 years) continued to maintain stability, ranging around the midpoint of the inflation target. The Telbor curve does not indicate a significant probability of a change in the Bank of Israel interest rate in the next year. Private forecasters expect the Bank of Israel interest rate to remain at its current level in the next few months, and to increase in about a year.

Monetary aggregates

In the twelve months ending in October, the M1 monetary aggregate (cash held by the public and demand deposits) increased by 45.3 percent, and the M2 aggregate (M1 plus unindexed deposits of up to one year) increased by 14.7 percent.

The credit market

In October, the nonfinancial business sector issued bonds totaling NIS 3.3 billion, higher than the average over the past 12 months (about NIS 2.1 billion). There were particularly high issuances by companies in the investments sector and in the trade and services industry. Corporate bond market spreads were stable, and withdrawals from mutual funds continued. The volume of new mortgages taken out in October was NIS 4.6 billion—an increase compared with September. However, activity in the market in those two months was relatively low due to the holidays. In October, mortgage interest rates continued to increase, by 0.13 percentage points on the CPI-indexed fixed rate

track, and by 0.07 percentage points on the CPI-indexed variable rate track. Interest rates remained unchanged on the fixed and variable rate unindexed tracks.

The housing market

The housing component of the CPI (based on residential rents) declined by 0.4 percent in October, and it has increased by 2.0 percent over the past 12 months—lower than the average for that range over the past three years. In August–September, home prices declined by 0.1 percent, and in the 12 months ending in September, they increased by 6.6 percent. Preliminary data for September indicate a sharp decline in the number of transactions, among investors, first-time home buyers, and buyers upgrading their dwellings. With that, the decline in the volume of transactions derives from strong seasonality in September and from the continued effect on investors of the purchase tax increase in June. The volume of new homes sold in September (seasonally adjusted) remained virtually unchanged compared with the previous month. The stock of homes for sale remained stable in September, at approximately 27,000 homes, about 60 percent of which are by private initiative and about two-thirds of which are in the Tel Aviv, Gush Dan and Jerusalem regions. The high rate of building starts in the past year is expected to continue being reflected in the high level of building completions in the coming period.

3. The foreign exchange and capital markets

The foreign exchange market

From the monetary policy discussion on October 25, 2015, through November 20, 2015, the shekel was virtually unchanged against the dollar, and strengthened by about 3.7 percent against the euro. The shekel strengthened by about 1.6 percent in terms of the nominal effective exchange rate.

The capital market

From the monetary policy discussion on October 25, 2015, through November 20, 2015, the Tel Aviv 25 Index declined by about 0.4 percent. Yields in the government bond market increased for nearly all terms to maturity. Nominal yields increased by up to 25 basis points for short-medium terms, with a flattening of the curve, while yields on the CPI-indexed curve increased by up to 17 basis points along the entire curve. The *makam* yield curve traded slightly above the Bank of Israel interest rate. Israel's sovereign risk premium, as measured by the five-year CDS spread, increased from 72 basis points to 80 basis points.

4. Global economic developments

This month, the OECD again reduced its global growth forecast, against the background of weakness in world trade and the slowdown in developing economies. The US economy grew by only 1.5 percent in the third quarter (annual terms), but is expected to grow at a more rapid rate in the following quarter. The employment report for October was surprisingly strong, with nonfarm payrolls increasing by about 270,000 and the unemployment rate declining to 5 percent, as data from various sources indicated increases in wages. The publication of the report, together with

various indicators provided by the US Federal Reserve, led to a sharp increase in the probability reflected in the markets that an initial increase in the federal funds rate will occur in December. However, the subsequent path of the increase in the federal funds rate is expected to be moderate. In the eurozone, third quarter growth is estimated at 0.3 percent (quarterly terms), and reflects an acceleration in France and some slowdown in Germany and most other countries. Unemployment continues to decline, and reached 10.8 percent. Although the rate of inflation increased, it remains far from the target, and the ECB signaled that it is possible it will take additional accommodative steps—capital markets ascribe a high probability to the option that the interest rate in the eurozone will be reduced. In Japan, growth has been negative for two consecutive quarters, despite expansionary policy by the government and central bank. The Bank of Japan pushed off the expected date for achieving the inflation target and reduced the growth forecast, so that chances increased that additional accommodative steps will be taken. Data in China indicated stability, and concern of a sharp deterioration lessened. In other emerging markets as well there were generally signs of calming, but many are exposed to risks as a result of the decline in demand in China and the expected federal funds rate increase in the US. Commodity prices resumed a decline this month, and the price of a barrel of Brent crude oil fell to \$44, compared with \$48 the previous month.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR DECEMBER 2015

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 December 2015, 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) real economic activity; (2) inflation; (3) the global environment and the exchange rate; and (4) the housing market.

Main points of discussion

In their discussion on economic activity, the Committee members agreed that the economy continues to grow at a moderate rate. The Committee members related to the continued weakening of exports—although exports strengthened in the third quarter, this followed two quarters of contraction and the most recent data do not indicate improvement. The Committee members assessed that as long as world trade shows weakness, it will continue to weigh on exports. The increase in investment in the third quarter also remains low. In contrast, the Committee emphasized that the growth rate of private consumption of nondurable goods is high and supports continued moderate growth. There is also resilience in the labor market, which is reflected in the low unemployment rate, the high level of employment, in wage increases, and the high job vacancy rate. The Committee members noted that to date it appears that the current wave of violence has a moderate impact on economic activity.

Regarding inflation, the Committee members noted that the negative rate of inflation over the preceding 12 months derives mainly from the decline in energy prices and

from administrative measures approved by the government. They assessed that the increase in wages is expected to have a positive impact on the inflation rate and to support its return to its target path, while in contrast, the decline in commodity prices that was renewed this month may have a negative impact on the inflation rate in the short term.

Regarding the global environment, the Committee members claimed that the growth rate of the global economy and the inflation environment remained moderate, and growth and trade forecasts were revised downward this month as well. The Committee noted that global financial market expectations are for a path of divergence in monetary policy—according to market forecasts, there is a high probability that the Fed will raise the interest rate in December 2015, while in Europe and other major economies there will be enhanced monetary accommodation. At this stage it is difficult to assess the effect of these opposing processes on Israeli markets.

Regarding the housing market, it was noted that the annual rate of price increases remains high despite home prices remaining essentially unchanged in the past two months. The public continues to take out new mortgages at a high rate, and the pace of building starts continues to be relatively high. The risks inherent in this market remain elevated.

In conclusion, the Committee members agreed that the current interest rate level is in line with the low inflation environment, the prolonged slowdown in the global economy and the moderation in the volume of exports, and that it supports the return of inflation to its target range. The Committee members were of the opinion that in view of the assessments provided in the discussion regarding world trade and the risks to growth in Israel, and in view of the time it will take to return the inflation rate 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 December 2015. 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 December 2015 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 of 1–3 percent a year, and to support growth while maintaining financial stability. In view of developments in the inflation environment, in growth in Israel and in the global economy, in the exchange rate, as well as in monetary policies of major central banks, the Monetary Committee assesses that monetary policy will remain accommodative for a considerable time.

The following are the main considerations underlying the decision:

- The inflation environment in the short term is affected by factors of a one-off nature. Short-term inflation expectations remained low this month, and are affected by these factors and by the recent renewed decline in commodity prices. Medium-term (forward) expectations declined slightly after increasing in the previous month, and long-term (forward) expectations remained entrenched near the midpoint of the target range.
- The first estimate of third quarter growth data indicates a return to the rate of growth that prevailed in the past two years, without compensation for the near-zero growth in the second quarter. The rate of growth in nondurable goods consumption was maintained, there was an acceleration in public consumption, and after a prolonged period of time there was a recovery in exports. However, the most recent data indicate that the improvement in exports may have been transitory. The picture presented by labor market data continues to be positive. To date, the effect of the wave of violence on economic activity is moderate.
- This month, the OECD again reduced its global growth forecast, against the background of the weakness in world trade and the slowdown in developing economies. Global financial market expectations are that the US Federal Reserve will begin to increase the federal funds rate soon, but that in Europe and other major economies, monetary accommodation will be enhanced.
- From the monetary policy discussion on October 25, 2015, through November 20, 2015, the shekel strengthened by about 1.6 percent in terms of the nominal effective exchange rate, as the shekel was stable against the dollar and appreciated relatively sharply against the euro. Since the beginning of the year there has been an effective appreciation of 7.5 percent. The development of the exchange rate since the beginning of year is weighing on growth of exports and the tradable sector, and is delaying the return of inflation to within the target range.
- The volume of new mortgages taken out remains elevated, as do new home sales and the stock of homes available for sale. Home prices have increased by 6.6 percent over the past 12 months. However, prices have been stable over the past two months.

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 November 23, 2015.

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 (in discussions held on November 22, 2015)

Prof. Reuben Gronau

Prof. Nathan Sussman, Director of the Research Department

Other participants in the narrow-forum discussion:

Mr. Andrew Abir, Director of Market Operations Department

Mr. Daniel Hahashvili, Chief of Staff to the Governor

Dr. Ran Shahrabani, Economist in the Research Department

Mr. Ilan Socianu, Deputy Secretary of the Monetary Committee

Mr. Yoav Soffer, Spokesperson of the Bank of Israel