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

October 8, 2015

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

The discussions took place on September 21 and 24, 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 Director of the Market Operations Department presents his 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 economic activity that became available this month support the assessment that the economy is growing at a moderate rate, and that the sharp decline in the growth rate in the second quarter was transitory, despite the slight downward revision in the second estimate of National Accounts data for the first quarter. Following a sharp decline in exports in the second quarter, foreign trade data show that the monthly average of goods exports in July–August (in current dollar terms) was 2.8 percent higher than the average for the second quarter, and that goods imports grew by 6 percent during the same period. Business services exports increased by 3 percent in July, after declining in June (seasonally adjusted data in dollar terms), and continues to lag behind the growth rate of world trade in services. The current account ended the second quarter with a surplus of $2.6 billion, similar to its level over the past year. The current account was affected positively by the decline in fuel prices and the increase in export prices, and affected negatively by the decline in exports. The Composite State of the Economy Index increased by 0.3 percent in August, led by imports of consumer goods, imports of manufacturing inputs, and building starts. The growth rate of the Business Climate Index increased to 0.27 percent in August (compared to 0.24 percent in July), and there was improvement in domestic-market oriented industries, compared with a decline in manufacturing. The Consumer Confidence Index compiled by the Central Bureau of Statistics increased this month compared with the previous month, and is at a relatively high level compared with the beginning of the year. The Purchasing Managers Index increased to 48.1 points, still in the area indicating a contraction in activity.

*The labor market*

Labor Force Survey data for August indicated a slight improvement in the employment, labor force participation, and unemployment rates. The number of employee posts held by Israelis increased by 0.3 percent in June, compared with May, and in the second quarter remained unchanged, on average, compared with the first quarter. In the second quarter, nominal wages increased by 0.9 percent, and real wages increased by 1.2 percent, relative to the first quarter (seasonally adjusted data). Health tax receipts for June–August were 5.7 percent higher (in nominal terms) than in the corresponding period last year, signaling that wage increases apparently continued in the third quarter. The increase in wages in the past year encompassed all industries, except for the financial services and insurance industry. The job vacancy rate remained high in August, at 3.2 percent.

*Budget data*

In January–August, the domestic surplus (excluding net credit) in government activity was about NIS 0.7 billion. Total tax revenues since the beginning of the year are about NIS 5.5 billion higher, and in August they were NIS 2.4 billion higher, than the seasonal path consistent with the tax revenue forecast, against the background of high revenue from real estate, vehicle, and capital gains taxes. Net of these items, as well, there was an increase in revenues, which is consistent with continued expansion of activity. Since the beginning of the year, domestic VAT revenues increased by about

5.6 percent in real terms, compared with the corresponding period in 2014. Since the beginning of the year, government domestic expenditure is about 4.8 percent higher (in real terms) than in the corresponding period last year.

**Staff forecast:** This month, the Research Department updated its macroeconomic forecast. According to the forecast, the inflation rate over the next four quarters is expected to be 0.6 percent, and at the end of 2016 is expected to be 1.4 percent. The Bank of Israel interest rate is expected, according to the staff forecast, to remain at 0.1 percent throughout 2015 and to begin to increase on a lower path than in the previous forecast, to 0.5 percent at the end of 2016; that is, the forecast is that the interest rate will remain lower than the US federal funds rate, as projected by the leadership of the Federal Reserve, for some time. GDP is expected to grow in 2015 by 2.6 percent (compared with 3.0 percent in the previous forecast), and in 2016 it is expected to grow by 3.3 percent (3.7 percent in the previous forecast).

## 2. Developments on the nominal side

*Inflation*

The Consumer Price Index for August declined by 0.2 percent, below the average of forecasters' projections, which was for it to remain unchanged. There were seasonal declines in the fruit and vegetables component (1.5 percent), and in the clothing and footwear component (3.7 percent). There was also a marked decline in the transport and communication component (1.3 percent). The housing component increased by 0.7 percent, and there was a seasonal increase in education, culture and entertainment (1 percent). The rate of inflation as measured by the change in the CPI over the past 12 months was negative 0.4 percent, compared with an inflation rate of negative 0.3 percent over the 12 months that ended in July. CPI components representing tradable goods declined by 1.6 percent over the past 12 months, and CPI components representing nontradable items increased by 0.4 percent. The CPI excluding energy, food, and fruit and vegetables increased by 0.8 percent. The rate of increase in the CPI in the past few months is consistent with achieving the lower bound of the inflation target, but several one-off factors are expected to act in the coming months to reduce the CPI: the decline in electricity prices, the cancellation of the television fee, and the effect of the VAT reduction are expected to reduce the CPI by 0.7 percent in the next three months.

*Expectations and forecasts of inflation and the interest rate*

The planned price reductions noted above led to a further decline this month in short-term inflation expectations from the various sources. Private forecasters' projections for the next 12 CPI readings declined from 0.7 percent to 0.4 percent, and expectations derived from banks' internal interest rates declined from 0.35 percent to 0.2 percent. Twelve-month ahead inflation expectations derived from the capital market also declined, from 0.6 percent to 0.4 percent, and expectations for 2 years declined from 0.9 percent last month to 0.8 percent. Medium-term (3–5 years) forward expectations remained around 1.4 percent this month, while forward expectations for longer terms (5–10 years) continued to range around the midpoint of the inflation target, reflecting the short-term nature of the factors in the decline in expectations for short ranges. In recent days, there was an increase in the probability derived from the Telbor curve that the Bank of Israel interest rate will be reduced in the coming three months. With that, private forecasters expect the Bank of Israel interest rate to remain at its current level in the next few months, and their average forecast for the interest rate in one year remains 0.29 percent, similar to their projections over the previous two months.

*Monetary aggregates*

In the twelve months ending in August, the M1 monetary aggregate (cash held by the public and demand deposits) increased by 51.4 percent, and the M2 aggregate (M1 plus unindexed deposits of up to one year) increased by 13.8 percent.

*The credit market*

Outstanding debt of the business sector remained unchanged in August, at about NIS 812 billion. Repayments of NIS 2 billion were offset by the net raising of debt and as a result of the effect of the shekel's depreciation on the balance of debt. In August, the nonfinancial business sector issued bonds totaling NIS 1.9 billion, below the average over the past 12 months (about NIS 2.2 billion). Issuances were divided among companies in the manufacturing and real estate industries. Against the background of the volatility in global financial markets, corporate bond market spreads increased in August, but at the beginning of September the start of a downward trend in spreads can be seen. Similarly, mutual funds specializing in shares and corporate bonds saw net withdrawals, followed by net new investment, and overall, at the end of August, the balance of these funds remained virtually unchanged.

Outstanding household debt increased by about NIS 5.4 billion (1.2 percent) in July to about NIS 451 billion, of which outstanding housing debt increased by about NIS 2.9 billion (0.9 percent) to NIS 314 billion. New mortgage volume remained elevated, totaling about NIS 6.2 billion in August, and the monthly average over the past 12 months reached a record of about NIS 5.2 billion. The share of mortgages taken to finance the purchase of an investment home increased by 2 percentage points in July compared with June, to 17.1 percent. This was the sharpest increase since November 2012, against the background of investors bringing purchases forward prior to the increase in purchase tax. Similar to June and July, mortgage interest rates in August increased on all indexation tracks, rising by 0.15 percentage points on the fixed and variable rate CPI-indexed tracks, and by 0.12 percentage points on the fixed-rate unindexed track.

*The housing market*

The housing component of the CPI (based on residential rents) increased by 0.7 percent in August, and has increased by 2.5 percent over the past 12 months. In May–June, home prices increased by 0.9 percent, and in the 12 months ending in June, they increased by 6.0 percent, of which 4.6 percent was over the past half year. Preliminary data indicate that the number of transactions in July was markedly lower than in the preceding two months, against the background of the increase in transactions by investors in those months, due to the increase in purchase tax. The number of new homes sold in July remained high—about 2,400—and the stock of homes available for sale remains relatively high at around 16,500, though it continues to decline. The number of building starts in the past two years indicates that the number of building completions is expected to remain at a high level in the coming period.

## 3. The foreign exchange and capital markets

*The foreign exchange market*

From the monetary policy discussion on August 23, 2015, through September 21, 2015, the shekel weakened by about 1.3 percent against the dollar, and by about 1.35 percent against the euro. The shekel weakened by about 1.1 percent in terms of the nominal effective exchange rate.

*The capital market*

From the monetary policy discussion on August 23, 2015, through September 21, 2015, the Tel Aviv 25 Index declined by 2.9 percent. Yields in the government bond market increased for nearly all terms to maturity, with steepening curves. Nominal yields increased by up to 10 basis points for medium-long terms, while yields on the CPI-indexed curve declined slightly for terms of up to 3 years, and increased by up to 12 basis points for terms up to 10 years. There were declines along the *makam* yield curve, and it was trading slightly below the Bank of Israel interest rate. Israel's sovereign risk premium, as measured by the five-year CDS spread, declined slightly, from 73 basis points to 67 basis points.

**4. Global economic developments**

Advanced economies continued to grow at a moderate rate, while developing economies continue to slow. Global equity markets declined, with considerable volatility. The recovery in the US continues, reflected in the upward revision of GDP growth data for the second quarter, from 2.3 percent to 3.7 percent. Exports were negatively impacted by the strengthening of the dollar, and growth in private consumption was lower than forecast, against the background of only a moderate increase in wages. Weakness can be seen in the manufacturing sector, but the services sector—the main part of the US economy—continues to grow. The federal funds rate was left unchanged, but most members of the Federal Open Market Committee believe that it will increase this year, and the probability derived from markets for such an occurrence is about 40 percent. In the eurozone as well, second quarter growth data was revised upward, from 0.3 percent to 0.4 percent. The slow decline in unemployment continues—reaching 10.9 percent—and retail sales were higher than expected. The ECB lowered the inflation and growth forecasts for the next three years, and increased the ceiling for government bond purchases from 25 percent to 33 percent of each series. The risk from the crisis in Greece has apparently declined. In Japan, there were mixed data, and a further decrease in corporate tax was announced. Developments in China were the focus of most of the attention this month. Macroeconomic data were considered negative in the short term, but are also considered as reflecting a long-term structural change in the Chinese economy. The declines in the Chinese stock market became more severe, and led to many policy measures being taken with the aim of moderating them. Real activity in other developing economies continued to moderate, particularly among commodity exporters and among countries that maintain extensive trade ties with China. Inflation is slowing in many economies, and energy and commodity prices indicate a high likelihood that inflation will continue to decline in the short term. After declines in the price of oil during the previous two months, the price stabilized this month, at $48 per barrel at the end of the period, compared with $46 in the previous month. Industrial metals prices increased slightly, and agricultural commodities prices declined slightly.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR OCTOBER 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 October 2015, it was decided to keep the interest rate at 0.1 percent. The decision was unanimous.

**Main points of discussion**

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

The annual rate of inflation has been negative for several months. Although the CPI’s rate of increase in recent months has been consistent with achieving the lower bound of the inflation target range, against the background of additional structural steps approved by the government, further declines in the CPI are expected in the coming months. The Committee assesses that a considerable part of the price declines derives from changes in commodity prices abroad and from structural changes that are of a one-off nature, and does not reflect weakness of domestic demand. The assessment was raised that the increase in real and nominal wage is expected to have a positive impact in the near term on the rate of inflation, through its effect on demand.

The Committee discussed the data in the second estimate of second quarter data, which indicate a marked slowdown in economic activity, and in particular, a notable decline in exports and a low level of investment. Committee members noted the transitory nature of some of the factors that led to the low second-quarter growth data. The relatively high level of domestic demand was noted, as was the labor market’s elevated employment level alongside an increase in the job vacancy rate and an increase in nominal and real wages. In contrast, it appears that weakness of activity abroad will continue to weigh on exports, and the low level of investment is expected to have a prolonged effect.

Committee members agreed that the steps decided upon this month by the government, alongside additional planned proposals will lead to fiscal policy being more expansionary than what had appeared beforehand, and the steps contribute, from this perspective, to acceleration of growth.

The growth rate of the global economy remains moderate, and forecasts of growth and of trade were revised downward. Despite some probability derived from the markets for an increase in the US federal funds rate in September, the Federal Reserve decided, in the meantime, to leave the rate unchanged, and uncertainty remained about the date of liftoff. The level of volatility in the markets seems to have declined slightly after sales across various equity markets. Committee members reiterated that the nominal effective exchange rate is appreciated, which weighs on the growth of exports.

Committee members discussed the acceleration in price increases in the housing market and the risks attributed to continued rapid growth in mortgage volumes. It was noted that the atypical increase in demand in previous months is explained by one-off factors and a correction was seen in the past month. The scope of building completions remains elevated, and in view of the high volume of building starts there is an expectation for continued growth of housing supply in the future. The acceleration in growth of supply is apt to contribute to stabilization of housing prices, and likely to a moderate decline, as well, in them.

In conclusion, Committee members noted that the data that became available this month, the moderation in the rate of price increases, the acceleration in housing price rises, developments abroad, and particularly the verification of the low second quarter growth and exports data, and the downward revision in growth forecasts, reflect a complex picture. However, Committee members assessed that the slowdown in the rate of price increases is based mainly on one-off factors, and similarly, the decline in the economy's growth environment is moderate and derives mainly from transitory factors and that domestic demand and the labor market remain stable, so that the current interest rate level is in line with, at this stage, the overall picture of the situation.

Following the discussion, the five members of the Monetary Committee voted on the Bank of Israel interest rate for October 2015. All members supported keeping the interest rate at 0.1 percent.

**The main considerations behind the decision**

The decision to keep the interest rate for October 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. The path of the interest rate in the future depends on developments in the inflation environment, growth in Israel and in the global economy, and the exchange rate of the shekel, as well as on monetary policies of major central banks.

The following are the main considerations underlying the decision:

- The rate of increase in the CPI in recent months has been consistent with achieving the inflation target, although it is expected that in the coming months several one-off factors will act to reduce the CPI, and against this background there was an additional decline in short-term inflation expectations this month. To date, there is no evidence that the decline in the inflation environment is a result of moderation in domestic demand. Medium and long-term (forward) expectations remained entrenched near the midpoint of the target range.
- Indicators of real economic activity that became available this month support the assessment that the economy is growing at a moderate rate, and that the sharp decline of the growth rate in the second-quarter derived mainly from transitory factors. Foreign trade data indicate some recovery in the third quarter, but over time the trend of lack of growth in exports, as well as in investment, is worrying. The elevated employment level and low unemployment are consistent with the increase seen in wages. The Research Department's staff forecast for growth in 2015 was reduced by 0.4 percentage points, to 2.6 percent, and was reduced by 0.4 percentage points for 2016, to 3.3 percent.
- There are increasing signs of a slowdown in the growth rate of the global economy, with an emphasis on China and other emerging economies. In the US and Europe, moderate recovery continues. Global equity markets declined, with considerable volatility. Inflation in many countries continues to moderate. Monetary policy in

major economies remains highly accommodative, and uncertainly continues regarding the date of an initial increase in the US federal funds rate.

- From the monetary policy discussion on August 23, 2015, through September 21, 2015, the shekel weakened by about 1.1 percent in terms of the nominal effective exchange rate. However, since the beginning of the year there has been an effective appreciation of 4.8 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.
- Robust activity in the housing market continued this month, and was reflected in an especially elevated level of new home sales, and in an acceleration of the rate of price increases, which have risen by 6 percent over the past 12 months. Likewise, the rate of new mortgages taken out remains high. The elevated level of building starts in the past two years supports an increase in housing supply.

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 September 24, 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
Prof. Alex Cukierman
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 Hahiashvili, Chief of Staff to the Governor
Ms. Ana Sasi-Brodesky, Economist in the Research Department
Ms. Esti Schwartz, Secretary of the Monetary Committee
Mr. Yoav Soffer, Spokesperson of the Bank of Israel