BANK OF ISRAEL
Office of the Spokesperson and Economic Information

January 12, 2015

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

The discussions took place on December 28 and 29, 2014.

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 of 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 that became available this month continue to point to a recovery in economic activity after Operation Protective Edge, though the conflict's negative impact on the economy and on growth has not yet been fully compensated for. Foreign trade data declined this month (in dollar terms; due to the strengthening of the dollar worldwide it may be assumed that the quantitative decline was smaller). Goods exports (excluding ships and aircraft and diamonds) declined by 3.0 percent in November, compared with October, after increasing in the previous two months. Goods imports (excluding ships and aircraft, diamonds and fuels) declined by 1.5 percent, further to the marked decline in October. Exports of other business services (excluding start-ups) remained unchanged at the peak levels they reached at the beginning of the year. Data on tourist arrivals and overnight stays indicate some recovery in the tourism industry, and it is occurring at a relatively rapid rate compared with that following previous security incidents. However, tourism service exports, and with them agricultural exports, to Russia constitute a marked share of overall tourism service and agricultural exports—even though total exports to Russia are only a small share of Israel's total exports—so these industries are therefore liable to be negatively impacted by the crisis there. The Composite State of the Economy Index increased by 0.1 percent in November, similar to its pace of increase since the beginning of the year. Preliminary data from the Bank of Israel's Companies Survey for the fourth quarter point to improvement in the state of companies and a return of activity to its level at the beginning of 2014. The business sector Climate Index, based on the Business Tendency Survey conducted by the Central Bureau of Statistics for November, continues to indicate a relatively low monthly growth rate, of 0.17 percent. The Consumer Confidence Index compiled by Bank Hapoalim continued to decline this month, returning to its level at the beginning of 2014. The Consumer Confidence Index compiled by the Central Bureau of Statistics has remained virtually unchanged since July. Bank Hapoalim's Purchasing Managers Index increased slightly in November, to 48.7 points, and remains below the level that distinguishes between contraction and expansion.

The labor market

Labor market data that became available this month bolster the positive picture emerging from that market. The Labor Force Survey for November indicates an increase in both the employment and participation rates among the primary working ages (25–64) by 0.6 percentage points, with the unemployment rate remaining low at 4.8 percent. The overall unemployment rate declined by 0.1 percentage points to 5.6 percent. In parallel, the number of those employed full-time increased in August–November by 4.2 percent, and the number of those employed on a part-time basis declined by 1.4 percent. The number of employee posts rose by 0.7 percent in September, compared to August, with the increase occurring in both the business sector and in the public services. Nominal wages increased in July–September by 1.0 percent, and real wages increased by 0.9 percent, compared to April–June (seasonally adjusted data). Health tax receipts continued to increase at a stable rate, and were 5.4 percent higher (in nominal terms) in October–November than the corresponding period last year.

Budget data

In January–November, the deficit in the government's domestic activity (excluding net credit) was about NIS 9.6 billion. This is about NIS 4.9 billion smaller than the deficit in the seasonal path consistent with meeting the 2014 deficit target, as expenditure has been lower than the seasonal path consistent with full budget performance. Total domestic expenditures (excluding credit) were NIS 6.6 billion lower in January–November than the expenditure consistent with the seasonal path. With that, expenditure is expected to accelerate in December and reach full budget performance for 2014, due to, among other things, the defense supplement. Domestic revenues from the beginning of the year are about NIS 1.7 billion lower than the seasonal path consistent with the budget forecast. Based on trend data, tax revenue in November, excluding one-time effects, remained without significant change compared to previous months. The transition to a 1/12 budget will not restrict budget performance in most months during 2015 compared with the budget proposal that was approved by the government, since the redemption of debts expected in 2015 is smaller than in 2014. With that, there will be a limitation on expenditures for new programs.

2. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) for November declined by 0.2 percent, in line with forecasters' projections. The clothing and footwear component increased markedly, while the fruit and vegetables, and transport and communication components declined notably. The inflation rate over the past 12 months was negative 0.1 percent, compared with negative 0.3 percent over the 12 months ended in October. The tradable goods components of the CPI declined by 0.4 percent this month, and their rate of decline over the past 12 months remained unchanged from the previous month, at 1.8 percent. The CPI components representing nontradable items declined by 0.1 percent this month; their rate of increase over the previous 12 months increased to 0.9 percent, compared with 0.6 percent in the 12 months ending in October. Over the past 12 months, there have been marked declines in the food, fruit and vegetables, and furniture and household equipment components, with only the housing component increasing significantly.

Expectations and forecasts of inflation and the interest rate

The declines in water and electricity prices that are planned for the beginning of the year are expected to reduce the inflation rate by about 0.4 percent, in a one-off effect. Against this background, inflation expectations derived from various sources remain low. Inflation expectations derived from the capital market were volatile during the month, due to fluctuations in government bond yields, and at the end of the period, one-year inflation expectations (seasonally adjusted) were 0.45 percent, and expectations for two years were 0.8 percent. Private forecasters' projections for the next 12 CPI readings declined from 0.7 percent to 0.6 percent, on average. Expectations for the coming 12 CPI readings derived from banks' internal interest rates declined from 0.4 percent to 0.3 percent. Expectations for medium and long terms were also volatile during the month, and showed slight increases at the end of the period. Based on private forecasters' projections, and data derived from the *makam* and Telbor curves, no change is expected in the Bank of Israel interest rate in the next three months.

Monetary aggregates

In the twelve months ending in November, the M1 monetary aggregate (cash held by the public and demand deposits) increased by 32.8 percent, and the M2 aggregate (M1 plus unindexed deposits of up to one year) increased by 8.4 percent.

The credit market

Total outstanding debt of the business sector declined by about NIS 0.7 billion (0.1 percent) in October, to NIS 817 billion, primarily as a result of net repayment of bank loans which was partly offset by the depreciation of the shekel. In November, the nonfinancial business sector only issued about NIS 0.9 billion in bonds, compared with a monthly average of NIS 2.7 billion since the beginning of the year. After negative net new investment by the public in corporate bond mutual funds in recent months, there were extensive withdrawals from such funds as well as from general bond funds in December, with a slight increase in corporate bond market spreads, primarily in the investment and holding companies sector. Outstanding household debt increased by about NIS 3.1 billion (0.7 percent) in October, to about NIS 431 billion. Of that, outstanding housing debt increased by about NIS 1 billion. In November, about NIS 4 billion in new mortgages were taken out, compared with a monthly average of about NIS 4.2 billion since the beginning of the year. The interest rate on new mortgages taken out declined in November on all tracks, with the decline most notable in the unindexed, fixed-rate, track.

The housing market

The housing component of the CPI (based on residential rents) increased by 0.2 percent in November, similar to the previous month. In the 12 months that ended in November, this component increased by 2.7 percent. After declines in home prices reported in the previous two months' data, in September-October, still before the announcement of the cancellation of the zero-VAT plan, they increased sharply, by 1.4 percent. The trend of decline in the annual rate of increase in home prices halted, with prices increasing by 6.5 percent over the 12 months ending in October, compared with an increase of 4.6 percent in the 12 months ended in September. The increase in the number of new home sales continued in October, after a sharp increase in September. There was no change in the number of new homes available for sale. The first tenders in the target-pricing program commenced this month. In the third quarter, there were sharp increases in building starts and building completions, and in the past 12 months they totaled 44,200 and 42,100, respectively.

3. The foreign exchange and capital markets

The foreign exchange market

From the monetary policy discussion on November 23, 2014, through December 26, 2014, the shekel weakened by 2 percent against the dollar, and strengthened by 0.7 percent against the euro. In terms of the nominal effective exchange rate, the shekel appreciated by about 0.2 percent. For the year to date, the shekel has weakened by about 3.7 percent in terms of the effective exchange rate.

The capital market

From the monetary policy discussion on November 23, 2014, through December 26, 2014, the Tel Aviv 25 Index increased by about 1.3 percent. Government bond yields increased, as yields on the unindexed curve increased by about 25 basis points for most terms and yields on the CPI-indexed curve increased by an average of about 15 basis points. The yield on unindexed 10-year bonds increased by around 30 basis points, to about 2.45 percent, and the yield differential between 10-year Israeli government bonds and corresponding 10-year US Treasury securities returned to a positive value and increased to about 20 basis points. *Makam* yields increased by about 7 basis points along the entire curve. Israel's sovereign risk premium as measured by the five-year CDS spread declined slightly, to about 77 basis points.

4. Global economic developments

The divergent trends in the global economy continued this month, with strong growth in the US and weakness in Europe, Japan, and emerging economies. The decline in fuel prices is expected to support the global economy. However, as occurred in Russia, it is liable to negatively impact the economic stability of oil exporters. In the US, third quarter growth was again revised upward. In the labor market, US nonfarm payrolls increased by around 320,000 in November, and industrial production reached its highest level since 2010. In contrast, weakness is apparent in the real estate industry, and purchasing managers indices were mostly disappointing. There is some moderation in inflation, in light of the decline in energy prices, and financial markets are pricing in a first increase in the federal funds rate in the third quarter of 2015. In Europe, the fragile and uneven recovery continues, with the unemployment rate remaining above 11 percent. In France and Italy, weak data were published this month, while in Germany slightly better data were published. The eurozone's Current Account surprised to the upside, against the background of the weakening of the euro, and there is an increasing probability that the ECB will launch a significant quantitative easing program in 2015. In Switzerland, a negative interest rate was set for deposits at the central bank, against the background of strengthening appreciation pressures, and in Norway the interest rate was reduced due to the expected negative impact on the economy of the decline in oil prices. In Japan, a reduction in corporate taxes and a deferral of an increase in the VAT rate following election results are expected to support recovery, but in contrast they will increase fiscal risk. Disappointing macro data were published in China this month, and inflation there is moderating against the background of the decline in oil prices. In Brazil, the virtual standstill continues, and nonetheless the interest rate was increased due to high inflation. In India, positive trends continue, and the recovery is expected to continue. In recent days, it appears that the policy measures in Russia stabilized the situation there for now. There was a mixed trend on global financial markets this month, with an increase in volatility. Oil prices declined by more than 20 percent this month, and the price of a barrel of Brent Sea crude oil reached $60.

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

Main points of discussion

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 January 2015, it was decided to keep the interest rate unchanged at 0.25 percent. The decision was unanimous.

The discussion focused on several main issues: (1) inflation; (2) economic activity; (3) the global economy; (4) the exchange rate; (5) the housing market; (6) the corporate bond market.

The Committee discussed recent changes that occurred in the area of prices, agreeing that the decline in prices derives in part from external developments (declines in fuel prices and in European prices). Some Committee members felt that the decline in prices is not evidence of a weakening of domestic demand. Members discussed the question of whether a halt to the decline in the inflation environment is indicated by recent data—the CPI's annual rate of increase rose slightly, although it remains negative, and there was a halt in the decline seen in recent months in inflation expectations for various terms. Committee members agreed that the announced declines in water and electricity rates are expected to reduce the level of prices, in a one-time occurrence, and will bring down the January CPI by 0.4 percent. Net of this one-time effect, one-year inflation expectations from the various sources are near the lower bound of the inflation target range. According to the Research Department's staff forecast, inflation in 2015 is expected to be 1.1 percent, and net of the effect of the electricity and water price reductions, is expected to be 1.5 percent.

In their discussion on the real economy, Committee members noted the improvement in macro data in the past month: indicators point to a recovery from the effect of Operation Protective Edge and a return to the growth rates that characterized the economy during the year, even though there has not been a full correction from the negative impact of the operation. Partial data from the fourth quarter Companies Survey, the fact that the Composite State of the Economy Index continues to increase at the moderate rate that characterized its development from the beginning of the year, and the fact that labor market data signal marked improvement in all indices, support the conclusion that there is a trend of improvement.

The Committee discussed the mixed data arriving from the global economy—the accelerated rate of US growth, while that the same time the continued weakness in data from Europe, Japan, and China. Committee members noted that the US economy is a generally closed economy, and if personal consumption expenditure and employment there continue to improve, that will support further recovery in the US even if weakness in European economies continues. The Committee discussed the crisis in Russia, reflected in volatility in global financial markets; members agreed that the crisis does not have a marked impact on Israel's economy overall. The Committee also dealt with oil prices declining by more than 20 percent in the past month and the effect of this development on global inflation and activity.

With regard to the exchange rate, while the trend of depreciation has in fact weakened (this month the shekel depreciated slightly against the dollar, but this was offset by appreciation against other currencies), there are already initial signs that the depreciation is impacting on exports.

In the discussion on the housing market, Committee members referred to the release of the market's virtual standstill: there was a sharp increase in home prices and in new home purchases, and with that an increase in new mortgage volume. At the same time, building starts and building completions increased. These changes occurred even before notification of the cancellation of the zero-VAT plan, and they are a correction to the extended period of deferral of purchases. The Committee expressed concern over the renewal of the trend of price increases, but in contrast noted that the high level of inventory of unsold homes is likely to halt that trend.

In referring to the capital market, the Committee noted positively the halt to the trend of decline in corporate bond spreads, and added that this month there was even a slight increase. This development points to some internalization of the risks in this market.

In conclusion, Committee members were of the opinion that the current interest rate level is consistent with a flexible inflation target regime—a regime that allows, by law, a temporary deviation from the target range defined as price stability. This interest rate supports real activity and the return of the inflation rate to within the target range, among other things through its effect on the exchange rate.

Following the discussion, the five members of the Monetary Committee voted on the Bank of Israel interest rate for January 2015. All five members supported keeping the interest rate at 0.25 percent.

The main considerations behind the decision

The decision to keep the interest rate for January 2015 unchanged at 0.25 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 over the next twelve months, 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, the monetary policies of major central banks, and developments in the exchange rate of the shekel.

The following are the main considerations underlying the decision:

- The rate of inflation as measured over the previous 12 months was negative 0.1 percent, compared with negative 0.3 percent over the 12 months ending in October. Excluding the expected effect of a reduction in electricity and water prices, inflation expectations for the coming year from the various sources are near the lower bound of the inflation target range. According to the Research Department's staff forecast, the inflation rate in 2015 is expected to be 1.1 percent, and net of the effect of the electricity and water price reductions it is expected to be 1.5 percent.
- Indicators which became available this month point to a recovery in activity after Operation Protective Edge, with the economy's expected return to its path of growth from before the operation expressed in a relatively high growth rate in the coming quarters. Partial data from the fourth quarter Companies Survey support this assessment, and the Composite State of the Economy Index continues to increase at the moderate rate that has characterized it since the beginning of the year. All labor market indicators also signal continued improvement. According to the Research Department's staff forecast, growth in 2015 is expected to be 3.2 percent.
- There was considerable volatility in the foreign exchange market this month. Over the course of the month, the shekel appreciated by 0.2 percent in terms of the nominal effective exchange rate, and weakened by 2 percent against the dollar. Since the beginning of August, when the trend of depreciation in the effective exchange rate began, the shekel has weakened by 6.9 percent, and it has depreciated by about 3.7 percent since the beginning of the year. Continued depreciation will support a recovery in exports and in the tradable sector as a whole, and is expected to contribute to returning the inflation rate to within the target range.

- There are increasing signs that the US recovery is solidifying, while weakness continues in Europe, Japan and most emerging markets. The crisis in Russia was expressed in increased volatility in global financial markets. The decline in energy prices is expected to continue to reduce global inflation and to support the economic recovery. Financial markets are pricing in an initial increase in the US federal funds rate in the third quarter of 2015; in Europe and in other economies, monetary easing continues.
- Home prices increased sharply in September-October, even before the announcement of the cancellation of the zero-VAT plan, and it appears that there is an increase in the rate of mortgages being taken out and in new home sales. There were sharp increases in the number of building starts and building completions in the third quarter.
- This month, there was a slight increase in corporate bond market spreads, and extensive negative net new investment in bond funds.

The Monetary Committee is of the opinion that the current level of the interest rate supports the continuation of the recovery in economic activity, and the return of inflation to within the target range.

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 December 29, 2014.

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 the Market Operations Department
Ms. Dana Orfaig, Economist in the Research 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