BANK OF ISRAEL
Office of the Spokesperson and Economic Information

July 8, 2013

Report to the Public on the Bank of Israel's discussions prior to setting the interest rate for July 2013

The discussions took place on June 23 and 24, 2013.

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 real, monetary and financial developments in Israel's economy, and developments in the global economy. Participants in this discussion include the three members of the Monetary Committee from the Bank-the Governor, the Deputy Governor and the Senior Advisor to the Governor-and the three members of the Monetary Committee from the public. Other participants in the discussion are the Directors of the Research and Market Operations Departments, and economists from various departments who prepare and present the material for discussion. The data, estimates and assessments in this report are those that were available at the time of the discussions.

In the narrow forum, which consists of the Monetary Committee and the Directors of the Research and Market Operations Departments, the two Departmental Directors 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 the Bank of Israel Law, 5770-2010, (section 18(c)), 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 BROAD-FORUM DISCUSSION-THE STATE OF THE ECONOMY

1. Developments on the real side

Monthly indices of the economic situation

Indicators of economic activity which became available in the past month point to the possibility that in recent months there has been a slowdown in the growth rate of economic activity. The second estimate of National Accounts data for the first quarter indicates stability in the GDP growth rate, but with a slowdown in the growth rate of business sector product, a worsening contraction of investment and imports, and a virtual standstill in exports excluding diamonds and start-ups. The Climate Index-which is based on the Business Tendency Survey by the Central Bureau of Statistics, and which indicated an increase in the growth rate in the previous month-declined in May to a level lower than that of the previous 4 months. The Composite State of the Economy Index, which increased by 0.1 percent in May, was revised downward for previous months. The Purchasing Managers Index declined to 47.1 points in May-continuing its decline in April-after 3 months in which it was above 50 points, considered the boundary between economic expansion and contraction. Consumer confidence indices declined sharply in May. Foreign trade data indicate an increase in the average level of exports (excluding aircraft, ships and diamonds, seasonally adjusted), although the increase is accompanied by marked volatility and likely derives from transitory factors.

The labor market

Monthly labor force survey data indicate that the unemployment rate increased to 6.9 percent in April, compared with an average level of 6.6 percent in the preceding 3 months. Among 25–64 year olds, the rate increased to 6 percent, from 5.7 percent over the preceding 3 months. The employment rate is at a high level, although it appears that in recent quarters its trend of increase has halted. This month, there was an increase in new claims for unemployment benefits and a moderation in the growth of the number of job vacancies in the private sector. Since the beginning of the year there has been a decline of 0.8 percent in the number of employee posts in the private sector, after a virtual standstill in 2012. Nominal wages declined by 1.6 percent and real wages declined by 2 percent in the first quarter, compared with the fourth quarter of 2012, based on seasonally adjusted data. The growth rate of health tax receipts by the National Insurance Institute, which provide an indication of nominal wage payments, remained at the low level which has characterized it since the beginning of the year-receipts were 5.1 percent higher in April-May than in the corresponding period of the previous year.

Budget data

The proposed 2013–14 budget that was approved by the government reflects a marked increase of 7 percent in domestic public expenditure in 2013, and a moderate increase of 1.1 percent in 2014. In January–May, the government's cumulative domestic deficit was NIS 4.3 billion, about NIS 2 billion below the path consistent with the deficit ceiling for 2013 of 4.65 percent of GDP. Trend data of tax receipts since the beginning of the year indicate stability in direct and indirect tax collection, and total receipts below projections consistent with the seasonal path. With that, VAT collection on domestic manufacturing increased relative to the level in the second half of 2012.

2. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) for May increased by 0.1 percent, similar to the weighted average of the Research Department's Staff Forecast, but well below the average projection of 0.3 percent by private forecasters, The low increase in the CPI surprised the market, and was reflected by a decline in *makam* and bond yields. Rental fees on renewing contracts increased by 0.3 percent (0.1 percent seasonally adjusted). The CPI measured over the past 12 months increased by 0.9 percent, led by housing and food prices. The energy index declined by 1.8 percent.

Expectations and forecasts of inflation and of the Bank of Israel interest rate

Private forecasters' inflation expectations for the next 12 CPI readings increased slightly during the month to 2 percent, on average. Inflation expectations for the coming 12 months derived from banks' internal interest rates were stable at 1.7 percent, and expectations derived from the capital market declined to 1.5 percent. Expectations for terms of 2 years and longer (monthly averages) remained stable, and range from 2.3–2.5 percent. Private forecasters' average projections are for the CPI to increase by 0.7 percent in June, and to increase by 0.3 percent in July. Expectations for the Bank of Israel interest rate 1 year from now, based on various sources, are 1.2 percent on average, with one interest rate reduction in the next 3 months reflected in forecasters' projections.

The monetary aggregates

In the twelve months ending in May, the M1 monetary aggregate (cash held by the public and demand deposits) increased by 10.8 percent, and the M2 aggregate (M1 plus unindexed deposits of up to one year) increased by 8.3 percent.

The credit market

The total outstanding debt of the business sector declined by 0.5 percent in April, to NIS 785 billion, as a result of net bank loan repayments and the appreciation of the shekel, effects which were offset by debt raised abroad. Likewise, in May, there was a recovery in the volume of bond issuances by the private nonfinancial sector, reaching NIS 3.7 billion compared with an average of NIS 1.7 billion in the previous two months. Household debt increased by 0.2 percent in April, to NIS 390 billion, with an increase of 0.6 percent in households' housing debt, to NIS 276 billion.

In May, there was a marked increase in new mortgages taken, to NIS 5.6 billion, compared with the monthly average of around NIS 4 billion in the first four months of the year. It is assessed that the increase derives primarily from new mortgages being brought forward ahead of the VAT increase at the beginning of June. Interest rates on mortgages declined in May on all indexation tracks, and are at low points.

The housing market

The housing component of the CPI (based on housing rents) increased by 0.3 percent in May, following an increase of 0.9 percent in April. In the twelve months ending in May, this component increased by 3 percent, similar to the increase over the twelve months ending in April. Home prices, which are published in the Central Bureau of Statistics survey of home prices but are not included in the CPI, declined by 0.1 percent in March–April, after 9 consecutive months of increases, and the increase in February–March was revised downward, from 0.5 percent to 0.2 percent. As a result, the rate of home price appreciation in the twelve months ending in April declined to 8.9 percent, compared with an increase of 10 percent in the twelve months to March. It is likely that the moderation in home prices derived from sellers wanting to complete transactions before the beginning of May, with the expiration of a temporary order allowing 2 apartments to be sold and be exempt from land betterment tax.

There were 39,873 building starts in the 12 months ending in March, and this is expected to continue to support a high level of stock of homes. At the same time, this is still a lower rate than that in 2011.

3. The foreign exchange and stock markets

The foreign exchange market

From the monetary policy discussion on May 26, 2013, through June 21, 2013, the shekel appreciated by about 1.8 percent against the dollar and depreciated slightly, by 0.1 percent, against the euro. In terms of the nominal effective exchange rate, the shekel appreciated by about 1.7 percent during the period. The shekel's appreciation against the dollar stood out against the global trend, and primarily relative to developing economies, and occurred against the background of sales of domestic companies to foreign investors, a current account surplus in the first quarter, and extensive foreign exchange sales by nonresidents.

The capital market

From the monetary policy discussion on May 26, 2013, through June 21, 2013, the Tel Aviv 25 Index declined by 1.3 percent. Yields on government bonds increased sharply, by about 40 basis points for most maturities-except for short-term unindexed securities which posted a decline in yields. The yield differential between 10-year Israeli government bonds and equivalent 10-year US Treasury securities contracted by about 20 basis points, to 133 basis points, primarily due to a sharper increase in yields in the US. *Makam* yields declined along the entire curve by 5–10 basis points, against the background of the interest rate reduction in the previous month. One-year yields declined to 1.22 percent during the period. Israel's sovereign risk premium, as measured by the five-year CDS spread, increased by 9 basis points to 131 basis points, in contrast to the trend in global emerging markets which increased sharply. The Tel-Bond 60 Index declined by about 1.4 percent. In contrast, spreads in the corporate bond market narrowed, primarily for debt issued by companies with lower ratings.

4. Global economic developments

Growth forecasts continue to be revised downward. In its survey this month, the World Bank reduced its global growth forecast by 0.2 percentage points (to 2.2 percent) for 2013 and by 0.1 percentage points (to 3 percent) for 2014, due primarily to weakening momentum in emerging markets, even as it increased the growth forecast for Japan and the US. Some optimism about the US economy has also been reflected recently in remarks by the Chairman of the Federal Reserve. In contrast, the OECD reduced its 2013 growth forecast for the US by 0.1 percentage points (to 1.9 percent) and for Europe by 0.2 percentage points (to –0.6 percent), though it increased its 2013 and 2014 growth forecasts for Japan. The IMF also revised downward its US growth forecast for 2014, from 3 percent two months ago to 2.7 percent. Macro data published in the US this month were mixed, though Consumer Confidence indices were appreciably positive, reaching a nearly 6-year high. In Europe, macro data continue to indicate a recessionary environment. Macro data in Japan and the UK were relatively positive, while in China the growth rate continued to moderate. According to surveys published this month, the global economic recovery is expected to stabilize this year and strengthen in 2014, with some variation expected among the different economies. These surveys indicate that the main risks, even if somewhat weakened, remained-renewed fiscal and/or banking system deterioration in Europe, a sharper than expected slowdown in China, and recently, increasing risk in the markets following a possible withdrawal from accommodative policy programs, as that is liable to threaten the financial stability of some economies and possibly the continuation of the global economic recovery. The global inflation environment continued to moderate, primarily in emerging markets. It is generally assessed that at present inflation risks tend to the downside. Against the background of the economic picture, many central banks continued their accommodative monetary policy. The Fed announced a future tapering of its quantitative easing programs, subject to improved macroeconomic conditions in the US.

B. THE NARROW-FORUM DISCUSSION-THE INTEREST RATE DECISION FOR JULY 2013

Main points of discussion

The six 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 July 2013, a unanimous decision was made to leave the interest rate at 1.25 percent.

The discussion focused on the following main issues: (1) the inflation environment; (2) the level of activity in the economy; (3) the fiscal situation; (4) the housing market; and (5) the global markets and their effect on the exchange rate.

The Committee members discussed the inflation environment. Inflation during the past 12 months is near the lower bound of the inflation target, but is expected to rise to the center of the target range in the next month. In addition, inflation expectations for the coming 12 months from various sources are slightly below the center of the target range.

The Committee members agreed that according to data that has become available this month, there has been a further slowdown in the growth rate of the economy. They relied on a number of indicators, including the second estimation of the National Accounts data for the first quarter, survey results for May (the Climate Indices and the Composite Index), and the Consumer Confidence Indices. At the same time, the Committee members agreed that the recent interest rate reductions decided upon in the previous month, before obtaining the most recent data, provide a response to the developments shown by these data.

A further issue that was raised is the developments in fiscal policy and their effects. The budget decision reached by the government, which is intended to reinstate budgetary control, is expected to moderate the expansion of demand. At the same time, some Committee members noted that it is important to track the changes that will be inserted into the budget during the legislative process, and to make sure that they will remain within the budget and deficit target frameworks that have been set.

The Committee members noted the most recent data on housing prices-published by the Central Bureau of Statistics for March–April-which indicate a reduction of 0.1 percent, following 9 months of consecutive increases. At the same time, some of the Committee members commented that the annual rate of increase is still high, and that it is still early to determine that this indicates a turnaround since this figure may have been affected by temporary factors.

The Committee members discussed the high volatility that has recently been prevalent in the global markets, particularly the increase in yields in the government bond market in the US, against the background of the Federal Reserve's announcement of the expected tapering of its quantitative easing program subject to improved macroeconomic conditions in the US. The Committee members believed that the increase in yields abroad, should it continue, together with the interest rate reductions in the previous month and the foreign exchange purchases that are intended to offset the effects of natural gas production, may moderate the forces supporting appreciation of the shekel.

Following the discussion, the six members of the Monetary Committee voted on the Bank of Israel interest rate for July 2013. All six Committee members voted to leave the interest rate unchanged at 1.25 percent.

In its announcement, the Bank highlighted the following main considerations underlying the decision to leave the interest rate for July unchanged at 1.25 percent:

- Inflation expectations for the coming year, based on various sources, are near the midpoint of the inflation target, ranging from 1.7 percent to 2 percent. The actual increase in prices over the past 12 months is near the lower bound of the target range, but is expected to rise to the center of the target by July, primarily due to the VAT rate increase.
- Indicators which became available in the past month point to the possibility that there has been a slowdown in the growth rate of economic activity in recent months. The two reductions in the interest rate in the past month provide, at this point, a response to the developments derived from those indicators. The Research Department's updated growth forecast for 2013 remained unchanged, while the forecast for 2014 was revised downward primarily due to the fiscal program which was approved to deal with the budget deficit.
- The Federal Reserve recently announced an expected removal of policy accommodation in the future, subject to the continued improvement in macroeconomic conditions in the US. Against this background, bond yields rose in the US. This increase, should it continue, is likely to moderate the forces for appreciation of the shekel. The expansionary policy of major central banks, reflected in low interest rates and quantitative easing programs, continues for now.
- Macroeconomic data that were published this month indicate a mixed picture for the US, a recessionary environment in Europe, weakness in emerging markets, and, in contrast, recovery in Japan and the UK. Global growth forecasts and projections for major economies were mostly revised downward.
- Home prices, which are published in the Central Bureau of Statistics survey of home prices but are not included in the CPI, declined by 0.1 percent in March–April, after 9 consecutive months of increases. As a result, the rate of home price appreciation in the twelve months ending in April moderated to 8.9 percent, compared with an increase of 10 percent in the twelve months to March. With that, this is a single piece of data. Implementation of the taxation measures in the

housing sector, which were approved by the government, is expected to moderate demand in the housing market.

Against the background of these considerations, the Monetary Committee decided to keep the interest rate unchanged this month, and to allow its recent steps to take effect. The Monetary Committee will continue to examine the impact on the economy of the steps it recently took and will act as necessary in the future.

The Bank of Israel will continue to monitor developments in the Israeli and global economies and in financial markets, particularly in light of the continuing high level of uncertainty in the global economy. The Bank will use the tools available to it 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 keep a close watch on developments in the asset markets, including the housing market.

The decision was reached and published on June 24, 2013.

Participants in the narrow-forum discussion:

Members of the Monetary Committee
Prof. Stanley Fischer, Governor of the Bank of Israel, Chairperson
Prof. Alex Cukierman
Dr. Karnit Flug, Deputy Governor of the Bank of Israel
Prof. Reuben Gronau
Prof. Rafi Melnick
Mr. Barry Topf, Senior Advisor to the Governor on Monetary Policy Issues

Other participants in the narrow-forum discussion:
Mr. Andrew Abir, Director of the Market Operations Department
Mr. Daniel Nathan, Economist in the Research Department
Dr. Yossi Saadon, Advisor to the Governor and Bank of Israel Spokesperson
Ms. Esti Schwartz, Secretary of the Monetary Committee
Mr. Yoav Soffer, Bank of Israel Assistant Spokesperson
Prof. Nathan Sussman, Director of the Research Department