BANK OF ISRAEL
Office of the Spokesperson and Economic Information

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Press Release

Report to the public on the Bank of Israel's discussions prior to deciding on the interest rate for June 2014

The discussions took place on May 25 and 26, 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 discussions.

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

The range of data that became available this month leaves a lack of clarity about the state of real activity. According to the first estimate of National Accounts data for the first quarter (seasonally adjusted, annual terms), GDP grew by 2.1 percent, and business sector product grew by just 0.4 percent. The slowdown in growth was led by a contraction of 2 percent in private consumption, and a contraction of 9.8 percent in fixed capital formation (excluding ships and aircraft). In parallel, the estimated growth rate for the fourth quarter of 2013 was revised downward from 3.2 percent to 2.9 percent. It should be noted that the revision does not derive from a change in original data, but rather from a change in the seasonality coefficients, which are given to considerable subsequent volatility. Foreign trade data for April continue to indicate marked weakness in goods exports, which declined by 11 percent in April compared with March (monthly, seasonally adjusted data, excluding ships, aircraft and diamonds), and the trend of decline in its volume is strengthening. In contrast, services exports remained at an elevated level, and were 6.8 percent higher in the first quarter than in the fourth quarter (seasonally adjusted data, excluding startups). Trend data of goods imports continued to decline, with stability in consumer goods imports and a decline in the import of raw materials and capital goods. The Composite State of the Economy Index remained unchanged in April, with a decline in most of its components, most notably declines in goods exports, the import of manufacturing inputs, and in industrial production. Previous months' index readings were revised downward. In contrast, indices of consumer confidence and expectations of activity indicate a positive picture in April. The Consumer Confidence Index compiled by Bank Hapoalim remained stable, and the index compiled by the Central Bureau of Statistics showed improvement. The Purchasing Managers Index increased to 51.4 points, signaling expectations of an expansion in manufacturing activity, derived mainly from domestic demand. The Climate Index based on the Business Tendency Survey of the Central Bureau of Statistics improved, and reflects a monthly growth rate of 0.29 percent.

The labor market

Labor market data indicate improvement during the first quarter, which is not in line with the first National Accounts estimate indicating a slowdown in activity. Labor Force Survey data indicate a decline in the unemployment rate among the principal working ages (25–64) in the first quarter to 5.1 percent, with an increase in the participation rate (79.7 percent) and in the employment rate (75.7 percent). The overall unemployment rate remained stable at 5.8 percent. The number of employed persons increased by about 38,000 compared with the fourth quarter (1.3 percent, seasonally adjusted). National Insurance data indicate an increase of 28,000 employee posts in January–February. The two sources thus present a consistent picture of the labor market. Over the 12 months ending in February, the number of employee posts increased by 2.8 percent in public services and by 1 percent in the business sector, and the gap between the two sectors continues to narrow. Nominal wages increased by 0.2 percent, and real wages remained unchanged, in December–February, compared to the preceding three months (September–November, seasonally adjusted data). Health tax receipts by the National Insurance Institute, which provide an indication of total wage payments in the economy, were 5.4 percent higher in March–April, on a nominal basis, than in the corresponding two months of the previous year.

Budget data

Since the beginning of 2014, the government's domestic deficit (excluding net credit) was NIS 0.4 billion, which is NIS 1.1 billion below the seasonal path consistent with meeting the deficit target for 2014, mainly due to nonrecurring revenues received in January. Tax revenues increased in April. Direct tax revenues in January–April were 10 percent greater in real terms than in the corresponding period of last year, and indirect taxes received were similar to last year (net of legislative changes and nonrecurring revenues). Gross VAT receipts on domestic production, which serve as an indication of the level of activity in the economy, were 0.8 percent lower in April than the average monthly level in the first quarter, and it remains difficult to determine the extent to which this is a result of a decline in the number of new-home purchase transactions due to the government's expected policy measures. Based on trend data, domestic expenditures (excluding credit) increased by 0.8 percent from January through April, compared with September–December of 2013, a relatively low rate of growth compared with the pace until the middle of last year.

2. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) for April increased by 0.1 percent, markedly lower than forecasters' projections for an increase of 0.6 percent, on average, and previous years' April CPI figures. The increase in most components of the CPI was relatively low. The surprise in the CPI derived primarily from increases in the housing and clothing and footwear components that were more moderate than expected, as well as from an unexpected decline in the food component, for which the rate of increase has slowed in recent months. The inflation rate over the preceding 12 months was 1.0 percent, the lower bound of the inflation target range, compared with 1.3 percent over the 12 months ending in March.

Expectations and forecasts of inflation and the interest rate

Following the publication of the April CPI figure, inflation expectations for the coming year, from all sources, declined. Private forecasters' projections for the next 12 CPI readings are 1.3 percent on average. Inflation expectations for the coming year derived from the capital market are 1.5 percent, and expectations for the next 12 CPI readings derived from banks' internal interest rates are 1.4 percent. Inflation expectations for medium and long terms remained slightly above the midpoint of the inflation target range, with a decline of about 10 basis points in the medium ranges. After the publication of the CPI data, there was an increase in the market's assessment of the probability of one interest rate reduction in the next three months, as reflected both in private forecasters' projections as well as the Telbor interest rate and *makam* curves.

Monetary aggregates

In the twelve months ending in April, the M1 monetary aggregate (cash held by the public and demand deposits) increased by 20.5 percent, and the M2 aggregate (M1 plus unindexed deposits of up to one year) increased by 8.3 percent.

The credit market

Total outstanding debt of the business sector declined by about NIS 5 billion (0.7 percent) in March, to NIS 772 billion, primarily as a result of the repayment of tradable bond debt, which was partly offset by loans from banks and institutional investors. Following a decline in bond issuances in March, the nonfinancial business sector issued bonds totaling NIS 2.6 billion in April, similar to the average in the past two years, while the spreads continued to decline to historically low levels. Outstanding household debt increased by about NIS 2.9 billion (0.7 percent) in March, to about NIS 412 billion at the end of the month. The increase derived from net debt raised and the increase in the CPI. In April, new mortgages taken out totaled about NIS 4 billion. The risk characteristics of new mortgages—the loan to value ratio, the payment to income ratio, the share of mortgages considered risky, and the share of mortgages granted at variable rate interest—declined in April, continuing their decline in 2013. In April, the interest rate on new mortgages on all tracks continued to decline, while the spreads between fixed interest rates and the yields on government bonds were maintained.

The housing market

The housing component of the CPI (based on residential rents) increased by only 0.1 percent in April. In the 12 months ending in April, this component increased by 2.3 percent, compared with 3.2 percent over the 12 months ending in March. Home prices, which are measured in the Central Bureau of Statistics survey of home prices but are not included in the CPI, increased by 0.4 percent in February–March. Over the 12 months ending in March, home prices increased by 7.1 percent, compared with an increase of 6.9 percent in the 12 months ended in February. In recent months a moderation in building starts is becoming apparent. In the 12 months ended in February, there were 42,500 building starts and 43,000 completions, marking the first time since 2007 that the annual quantity of building completions was greater than the number of starts.

3. The foreign exchange and capital markets

The foreign exchange market

From the monetary policy discussion on April 27, 2014, through May 23, 2014, the shekel weakened by 0.6 percent against the dollar and appreciated by 1 percent against the euro. In terms of the nominal effective exchange rate, the shekel weakened by about 0.4 percent this month. For the year to date, the effective exchange rate has remained essentially unchanged, and over the past 12 months it has appreciated by 4.4 percent.

The capital market

From the monetary policy discussion on April 27, 2014, through May 23, 2014, the Tel Aviv 25 Index increased by 0.4 percent, similar to the trend on most markets worldwide. Government bond yields declined sharply all along the curves. The yield on 10-year unindexed bonds declined by about 40 basis points, to 2.94 percent. The yield differential between 10-year Israeli government bonds and corresponding 10-year US Treasury securities narrowed to 47 basis points. *Makam* yields declined by about 15 basis points along the entire curve, and the 1-year yield is 0.54 percent. Israel's sovereign risk premium as measured by the five-year CDS spread declined slightly, to around 82 basis points.

4. Global economic developments

Data which became available this month indicate that the global economy continues to recover, though apparently at a more moderate rate than previously assessed. This month, the OECD revised its 2014 global growth forecast downward by 0.2 percent, and the world trade forecast by 0.4 percent, with a slight upward revision of its 2015 projections. The US economy grew by only 0.1 percent in the first quarter, compared with the fourth quarter. Industrial production contracted by 0.6 percent in April. Personal consumption expenditure increased by 0.9 percent in March, and indicators from the credit market point to improved household economic security. A positive trend continued in the employment market, with a sharp increase of 288,000 in nonfarm payroll employment, and a decline in the unemployment rate to 6.3 percent. In the real estate market, there was a recovery in housing starts and in home prices, but in contrast there was a decline in demand for mortgages and in indices of contractor activity. Inflation surprised to the upside, but part of that is attributed to a drought in the first quarter which led to higher food prices. The Federal Reserve continues its tapering process as expected, and there is no change in the assessments that the federal funds rate will begin to be increased in the second half of 2015, after the Fed Chair noted that the labor market, despite its improvement, is far from satisfactory. In Europe, as well, GDP growth of 0.2 percent in the first quarter, compared with the fourth quarter, was disappointing. It derived primarily from a lack of growth in France and negative growth in the Netherlands and in Italy, which were offset by growth of 0.8 percent in Germany. In contrast, the purchasing managers index declined in Germany and increased in the other countries, so that the overall index for the eurozone remained unchanged. The credit survey indicates growth in demand for commercial and consumer credit, but actual data, according to which commercial credit contracted by 3.1 percent in the past year, point to a supply constraint on credit, likely affected by banking system stress tests. Inflation remains low, and the ECB announced its preparedness to take additional accommodative steps in June. In Japan, there was relatively high first quarter growth of 1.5 percent (in quarterly terms), against the background of household expenditures brought forward ahead of the VAT increase in April. In the second quarter, growth is expected to be negative. The OECD growth forecast for China in 2014 was reduced by 0.8 percent, to 7.4 percent, against the background of the deterioration in financial conditions and a slowdown in the real estate market. The weakness in emerging markets and in China continues, serving as the main risk to global growth. Oil and metals prices remained unchanged this month, while agricultural commodity prices declined slightly.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR JUNE 2014

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 June 2014, it was decided to keep the interest rate unchanged, at 0.75 percent. The six members of the committee voted in favor of this decision.

The discussion this month focused on two main issues: inflation and economic activity. This was against the background of the CPI for April being particularly low, as well as the contradiction between National Accounts data and much of the most recent data published, which both indicate moderation in the economy's growth rate, and data from the labor market and consumer confidence indices indicating continued recovery. In addition, Monetary Committee members discussed the state of the housing market, the fiscal situation and global developments.

Regarding inflation, the discussion revolved around the question of to what extent the low April CPI reading points to a decline in the rate of price increases or whether it is just a one-time downward movement which will be corrected over the course of the year. The Committee agreed that the fact that the increases in most components of the CPI were relatively low supports the assessment that the low CPI reflects a decline in the level of inflation. This month, the decline in tradable goods prices (imported inflation) continued, affected by the decline in energy prices, other commodity prices, and the appreciation of the shekel in the past year. Additionally, in recent months a decline has also been observed in the rate of increase of prices of nontradable goods, products that domestic demand influences the prices of more than the prices of tradable goods. The assessment that the decline in prices in the past month will not be corrected in coming months is reflected as well in assessments of most private forecasters, who revised downward their projections of inflation in the current year.

It was noted that in the past, the CPI for April was high relative to CPI readings of other months, and impacted on the annual rate of price increases. The low CPI reading is thus expected to affect, throughout the coming year, the annual rate of price increases, and over the course of the summer months it is expected to (as measured over the preceding 12 months) decline to below the lower bound of the target inflation range. Such a decline is consistent with a flexible inflation targeting regime which allows a temporary deviation from the target inflation range.
Inflation expectations and projections for the year ahead, affected by the low CPI, were revised slightly downward (to 1.3–1.5 percent), though they are still in the area of the midpoint of the inflation target range.

In a discussion on the state of economic activity, Committee members agreed that first quarter National Accounts data, especially the figure indicating the decline in current private consumption, are not consistent with most current indicators for the quarter, and in particular with positive labor market data and figures related to the rapid increase in direct tax revenues. With that, the most recent data, including foreign trade, services exports, and industrial production, also point to moderation in the rate of growth, which was reflected as well in the Composite State of the Economy Index which remained unchanged.

In light of the inconsistency in the picture presented by various data, and in view of the fact that the National Accounts data published for the first quarter is a first estimate, which is often revised considerably later on, Committee members emphasized the uncertainty regarding the rate of growth at this time.

As far as the housing market, it was pointed out that despite the decision on zero VAT for eligible buyers on a first home purchase from a contractor, a slowdown in taking out mortgages is not discerned so far. However, there is an apparent slowdown in building starts, though their level remains elevated. The increase in the annual rate of building completions continues, and home prices continued to increase at an annual rate of 7 percent.

Committee members said that in terms of the fiscal situation, based on data so far, it appears that the government will meet its deficit target for this year. It was also noted that meeting the fiscal targets in the 2015 budget will require significant adjustments on the expenditure side and on the revenue side.

In reference to the global economy, Monetary Committee members agreed that assessments strengthened this month of a slowdown in global growth in 2014 and 2015. The US economy grew by only 0.1 percent in the first quarter, compared with the fourth quarter. In Europe, as well, GDP growth in the first quarter, compared with the fourth quarter, was disappointing, at 0.2 percent, deriving primarily from a lack of growth in France and from negative growth in the Netherlands and in Italy, offset by 0.8 percent growth in Germany.

This month the OECD revised its 2014 global growth forecast downward, by 0.2 percent, and revised its 2014 world trade forecast downward by 0.4 percent—this was only due to first quarter weakness, since there was no change in the assessment that the recovery in the world economy continues. In addition, there was a slight upward revision in 2015 projections.

Monetary Committee members noted the relative stability this month of the exchange rate for the year to date, after the major appreciation in 2013.

In conclusion, Committee members were of the opinion that the current level of the interest rate is in line with the economic environment as depicted in most data which became available this month, and with the inflation environment, given the accommodative monetary policy in advanced economies. In their assessment, the low level of the current interest rate supports activity and contributed to halting the real appreciation. Some Committee members noted that the picture of economic activity becoming clearer, in contrast to the especially high uncertainty about it this month, will impact on interest rate decisions in coming months.

Following the discussion, the six members of the Monetary Committee voted on the Bank of Israel interest rate for June 2014. All six of the Committee members supported leaving the interest rate unchanged at 0.75 percent.

The decision to keep the interest rate for June 2014 unchanged at 0.75 percent is consistent with the Bank of Israel's monetary policy, which is intended to entrench the inflation rate 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 CPI increased by only 0.1 percent in April, markedly lower than expectations, and the rate of inflation over the previous 12 months was 1 percent, the lower bound of the target range. This measure of the inflation rate is expected to decline in the coming months, to below the lower bound of the target range, though expectations for 1 year ahead are within the target range.
- Indicators of real economic activity which became available this month point to more moderate growth than assessed in the previous month, though the extent of the moderation is uncertain. The first estimate of first quarter data signals a slowdown in growth, due to a contraction of private consumption and fixed capital formation, while labor market data continue to indicate growth in employment and reduced unemployment, and there was improvement in indices of consumer confidence and of expectations of activity. Signs of moderation are also seen in Composite State of the Economy Index data, including goods exports.
- In the past month, the shekel weakened by 0.4 percent in terms of the nominal effective exchange rate, while since the beginning of 2014 the effective exchange rate has been stable, and it has appreciated by 4.4 percent over the past year.
- Against the background of disappointing first quarter growth data in the US and in Europe, the OECD reduced its 2014 global growth and world trade projections this month. Emerging market weakness continues to weigh on global growth. The probability of further monetary easing in Europe increased, and expectations remain that in the US, the federal funds rate will begin to be increased in the second half of 2015.
- Home prices continued to increase in February–March, and their annual rate of increase remains around 6–7 percent. The rate of mortgages taken out remains elevated, with continued decline in the risk characteristics of new mortgages. The increase in the number of building completions continues, but some slowdown is apparent in the number of building starts. This month, as well, there is continued uncertainty regarding the effect on housing market price levels and activity volume of the policy measures that the government decided upon.

The Bank of Israel will continue to monitor developments in the Israeli and global economies and in financial markets, particularly in view of the continuing uncertainty in the global economy and regarding economic activity in Israel. 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 May 26, 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. Rafi Melnick
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. Eddy Azoulay, Chief of Staff to the Governor
Mr. Yuval Mazar, Economist in the Research Department
Mr. Yoav Soffer, Spokesperson of the Bank of Israel
Mr. Ilan Socianu, Assistant to the Secretary of the Monetary Committee