



BANK OF ISRAEL

Office of the Spokesperson and Economic Information

April 30, 2018

Report on the Bank of Israel's discussions prior to deciding on the interest rate

The discussions took place on April 15 and 16, 2018.

General

The Monetary Committee sets the interest rate in a process that includes two discussions—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.

In the narrow forum—which consists of the Monetary Committee and the Director of the Research Department—the Research and the Market Operations Departments present their views of the main considerations that should guide the setting of the monetary policy. An open discussion on monetary policy 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 summary view of the economic situation available at the time of the Committee's discussion is presented in the [notice regarding the interest rate decision](#), which was published on April 16, and in the [data file](#) that accompanied the notice.

THE NARROW-FORUM DISCUSSION

The members of the Monetary Committee participating in the discussion decide on the appropriate rate of interest for the economy. After the discussion, it was decided to keep the interest rate unchanged at 0.1 percent. Five Committee members supported the proposal to keep the interest rate unchanged, and one Committee member supported increasing the interest rate to 0.25 percent.

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

Main points of discussion

In their discussion on economic activity, the Committee members discussed National Accounts data for the fourth quarter of 2017, which indicated solid growth of 4.1 percent in annual terms. Several activity indicators, such as the Composite State of the Economy Index and the Companies Survey, show the economy continuing to grow at an adequate pace that is in line with the potential growth rate. The Committee members said that the composition of growth in the past year seems more balanced, but there is variance in exports, with services exports growing more rapidly than goods exports. The Committee referred as well to labor market data that continue to indicate a tight labor market, reflected in record high employment and participation rates, a low in unemployment, and a rapid increase in wages in the past three years, though the rate of increase moderated in recent months.

The Committee noted that the inflation environment remains markedly low, adding that it is on a trend of some growth in recent months: core inflation indices are slightly above actual inflation, and expectations derived from the capital market have been on an upward trend in recent months. The Committee members said that on a seasonally adjusted basis, the recent CPI readings were relatively high, but they noted that certain factors continue to delay the return of inflation at this time, including the government's activities to reduce the cost of living and to enhance competition, and online purchases of consumer goods having expanded markedly in the past decade. They assessed that these factors do not reflect weakness in demand. In contrast, the prolonged increase in wages due to the tight labor market, which in the past year was also translated into an increase in unit labor cost, is expected to support the return of the inflation rate to within the target range.

The Committee members noted that global economic growth continued to improve, and international entities revised their growth forecasts for major economies upward. However, the risks to continued growth increased: monthly global sentiment indices have shown a decline in recent months, concerns of a "trade war" increased (even though the steps taken so far have had limited effect), geopolitical tension increased, and US financial conditions tightened. It was also noted that US legislators are increasing the pressure to impose regulation on Internet companies that use users'

data, and this is liable to negatively impact the sector. As expected, the Federal Reserve increased the federal funds rate by 25 basis points in its most recent decision, and is expected to increase the rate twice more in 2018. The ECB kept the accommodative monetary policy in place.

The Committee members discussed that there was no real change in the nominal effective exchange rate since the previous interest rate decision. Most Committee members were of the opinion that the shekel is still over-appreciated. A discussion was held regarding the forces acting to weaken the shekel, including the continued rise in the US interest rate, and the contraction of the Current Account surplus.

The Committee noted that housing market data continue to show that the increase in home prices has halted, against the background of the increase in supply in recent years, and in the past 5 months prices declined. The Committee members said that investment in residential construction declined in the past three quarters, and the pace of building starts and completions declined in the last months of 2017. However, the number of building permits increased. The Committee members were of the opinion that this increase may reflect a renewed increase in building starts, which will support continued decline in prices.

As noted, five Committee members were of the opinion that the interest rate should be kept at its current level. These members claimed that the inflation environment continues to be markedly low and the interest rate should be kept at its low level to support its return to within the target range. They added that the interest rate increasing before inflation is entrenched within the target range is liable to delay the entrenchment of the inflation environment and ultimately to slow the path of interest rate increase. The Committee members also noted that although the low interest rate creates financial risks, these are not only the outcome of the interest rate set by the Bank of Israel, and are not high to the extent that requires an increase of the interest rate: mortgage volume has been moderating in the past two years, the increase in home prices was halted and there was even a decline in home prices in the past five months, the growth in consumer credit has moderated, and at the same time the increase in labor income continues and the level of savings, even after declining, is high in international comparison. One of the Committee members was of the opinion that the interest rate should be increased to 0.25 percent, claiming that the low inflation rate does not indicate a problem with demand. This Committee member claimed that the weight assigned to the over-appreciated exchange rate should be reduced, as it is expected that exports will become less sensitive to the exchange rate as the economy switches from goods exports to services exports, and because world trade is expanding. It is therefore proper to place greater emphasis on other considerations, including the manner in which the continued low interest rate impacts on asset prices and on savings.

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
Mr. Andrew Abir, Director of the Market Operations Department
Prof. Reuben Gronau
Prof. Moshe Hazan
Prof. Zvi Hercowitz

Other participants in the narrow-forum discussion:

Daniel Hahiasvili, Chief of Staff to the Governor
Daniel Nathan, Economist in the Research Department
Esti Schwartz, Secretary of the Monetary Committee
Yoav Soffer, Bank of Israel Spokesperson
Prof. Michel Strawczynski, Director of the Research Department