



BANK OF ISRAEL

Office of the Spokesperson and Economic Information

April 20, 2017

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

The discussions took place on April 5 and 6, 2017.

General

In the process of making the 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.

In the narrow forum—which consists of the Monetary Committee and the Director of the Market Operations Department—the Research and the Market Operations Departments' recommendations regarding the interest rate are presented. 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 6, 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. The decision was unanimous.

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

Main points of discussion

The Committee members discussed the low inflation environment extensively. They agreed that the current inflation environment is not an indication of weakness in demand, and that it reflects, among other things, the continued appreciation of the shekel. They noted that the dissipation of the transitory effects of the decline in energy prices (and in recent months they even contributed to an increase in annual inflation) and of the administrative price reductions.

The Committee members discussed inflation expectations. They referred to the decline in medium–long term inflation expectations derived from the capital market, saying that a large part of it is related to the shekel appreciation, even though its effect on prices is essentially short term. The Committee assessed that at the current time, there are forces supporting the return of inflation to the target range, chief among them the accommodative monetary policy and the increase in energy prices in the past year. They assessed that the expectations actually overweight forces working in the opposite direction, and that the decline in expectations in recent months partly reflects a correction to their increase after the elections in the US. However, the Committee members noted that it is likely that the inflation environment will remain low for some time, in view of the effect of the appreciation since the beginning of the year, and due to the CPI, net of volatile components and administrative price reductions, remaining essentially unchanged in recent months. The Committee members emphasized that despite the decline in medium term and long term expectations, they remained anchored within the inflation target range.

In their discussion on domestic economic activity, the Committee members focused on the first quarter of 2017. They assessed that in that quarter as well, the economy continued to grow at a solid pace (net of the volatile effect of vehicle purchases), and that it is even likely that there was a step up in the rate of growth. In support of that claim, they noted the preliminary findings of the Companies Survey, which indicate that the net balance is at a relatively high level, and the Purchasing Managers Index. They agreed that the economy is around an environment of full employment, as the unemployment rate is low and wages are increasing consistently. They said that the

broad improvement in the global economy and in world trade made marked contributions to the improvement in activity, and in exports in particular. In contrast, they noted the concern of an adverse impact to exports as a result of the continued appreciation, and concern of a possible slowdown in the rate of expansion of credit from banks, a slowdown that is liable to negatively impact the expansion of private consumption.

Regarding the housing market, the Committee members noted the continuing trend of cooling off in activity, against the background of the continued increase in mortgage interest rates, as seen in the prolonged decline in the scope of transactions and of mortgage volumes. They also noted the high level of building starts. They agreed that it is still too early to determine if there has been a turnaround in this market. Although in the past two months the Home Price Index has been stable, in annual terms they continue to rise by a high rate.

In terms of the global environment, the Committee members discussed the improvement in world trade and in the growth data for most advanced and developing economies. Although in the US, the first quarter was relatively weak, the Committee members assessed that this figure mainly reflects transitory factors and therefore it cannot be concluded from it that there has been a turn to the downside. The Committee members said that based on the assessments, US monetary policy will continue to tighten—the US Federal Reserve recently raised the federal funds rate and markets expect that it will increase it another two times this year—while eurozone policy will remain accommodative. Likewise, the Committee members discussed core inflation in the US being near its target while in the inflation in the Eurozone remains relatively low. As for the exchange rate, the Committee members discussed the sharp appreciation of the shekel in terms of the nominal effective exchange rate, notwithstanding the expansion in the interest rate gap vis-à-vis the US.

The Committee members agreed that the current interest rate level is in line with the low inflation environment and with domestic activity—taking into account the global situation, both in terms of economic activity and in terms of monetary developments in major economies—and that it supports the return of inflation to its target range. Three Committee members were of the opinion that there is room to change the forward guidance provided to the public, and to note that the Monetary Committee intends to maintain the accommodative policy as long as necessary in order to entrench the inflation environment within the target range.

One of the Committee members opposed the proposal to stipulate an increase in the interest rate on the entrenchment of the inflation environment within the target range. In his assessment, prices declined over the past two years because competition in the economy increased, among other reasons as a result of government policy intended to

bring the cost of living in line with that in advanced economies, and this process in itself contributes to an increase in GDP and real income. He claimed that it is difficult to explain the inflation dynamics in Israel at this time, and therefore it would not be correct to link the conduct of monetary policy in the future exclusively to the inflation path.

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. 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

Mr. Itamar Caspi, Economist in the Research Department

Ms. Esti Schwartz, Secretary of the Monetary Committee

Mr. Yoav Soffer, Bank of Israel Spokesperson