BANK OF ISRAEL
Office of the Spokesperson and Economic Information

Press Release

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

The discussions took place on October 27 and 28, 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 the real, monetary, financial and prudential developments in Israel's economy, and developments in the global economy. Participants in this discussion include the members of the Monetary Committee, the Directors of the Research and Market Operations Departments, and economists from various departments at the Bank of Israel, 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 Deputy Governor serving as Acting Governor) has an additional vote.

A. THE BROAD-FORUM DISCUSSION—THE STATE OF THE ECONOMY

1. Developments on the real side

General Note

The picture of the state of real economic activity is similar to that of the previous month—continued growth at a rate slightly below 3 percent (excluding the effect of natural gas production), although several indicators point to some slowdown, in the third quarter.

Monthly indices of the state of the economy

The Composite State of the Economy Index for September increased by 0.3 percent, among other things against the background of the increase in imports and the effect of beginning natural gas production from the Tamar reservoir, and despite a prolonged decline in the industrial production index. The Purchasing Managers Index continues a trend of decline, and in September it reached 44.9 points. This, while Bank Hapoalim's Consumer Confidence Index increased for the fourth consecutive month, against the background of gains on the capital market and continued stability in the labor market. According to an index based on Google searches, there was an increase this month in the probability that domestic demand will increase faster than the long term rate.

The labor market

Labor force survey data for August indicate that the unemployment rate declined by 0.1 percent, to 6.1 percent, though among the prime working ages, the rate increased by 0.2 percent, to 5.4 percent. Additionally, there was an increase in the share of those employed on a full time basis. Nominal wages increased by 1.4 percent and real wages increased by 0.6 percent in May–July, based on seasonally adjusted data, compared with February–April. Health tax receipts by the National Insurance Institute, which provide an indication of total wage payments in the economy, were 4.7 percent higher in August–September, on a nominal basis, than in the corresponding two months of the previous year. Over time, a declining trend can be noted in their rate of growth. In July, there was an increase of 0.3 percent in the number of employee posts, though since the beginning of 2013 there has been a virtual standstill in the number of employee posts in the business sector. In September, there was a decline of 7.8 percent in the number of job vacancies, to its lowest level since the beginning of the year.

Foreign Trade

Goods exports (excluding ships, aircraft, and diamonds) remained unchanged in September, and declined by 10 percent in the third quarter, compared with the second quarter, deriving primarily from high technology industries. Similarly, an employment weighted exports index, which gives a higher weight to labor intensive industries, indicates an extended trend of moderation since the middle of 2011. Exports of business services (excluding start-ups) declined by 4 percent in July, compared with June.

Budget data

In January–September, the cumulative deficit in the government's domestic activity was NIS 12.6 billion below the seasonal path consistent with the deficit ceiling for 2013 of 4.65 percent of GDP. The below-path deficit reflects an expenditure level that is NIS 8.7 billion lower than the path consistent with full performance of budget expenditures, and revenues which are NIS 3.9 billion above the path consistent with the revenues estimated in the budget. Assuming that there will be some increase in expenditure levels relative to the budget approved by the Knesset, the deficit in 2013 is expected to be in the range of 3.5–4.0 percent of GDP.

2. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) for September was unchanged, compared with projections for an increase of 0.2 percent, on average. The CPI was primarily influenced by an increase in the food excluding fruit and vegetables component, which was offset by declines in the housing, clothing and footwear, and furniture components. The rate of inflation measured over the preceding 12 months is 1.3 percent, similar to last month.

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

Inflation expectations from various sources declined slightly, compared with the previous month. Private forecasters' inflation expectations for the next 12 CPI readings declined to 1.7 percent, on average. Inflation expectations derived from the capital market remained essentially unchanged, at 1.5 percent, while expectations for the next 12 CPI readings derived from banks' internal interest rates were 1.3 percent. Forward expectations for terms of 2–3 years (monthly averages) increased slightly this month, to 2.8 percent; expectations for medium terms remained stable at 2.4 percent, and for terms of 8–10 years there was a slight decline, to 2.0 percent. Based on projections of most private forecasters, as well as on data inherent in the Telbor interest rate and the *makam* curve, no change is expected in the Bank of Israel interest rate in the coming three months.

The Makam and bond markets

Government bond yields declined along the entire curve, and the yield to maturity on a 10-year unindexed bond declined from 3.84 percent to 3.56 percent. *Makam* yields declined along the entire curve, primarily against the background of the interest rate reduction last month, and the 1-year yield declined during the period to only 0.9 percent.

Interest rate and yield gaps between Israel and abroad

The yield differential between 10-year Israeli government bonds and equivalent 10-year US Treasury securities declined slightly, to only 105 basis points. Israel's sovereign risk premium as measured by the five-year CDS spread declined slightly, from 117 basis points to only 108 basis points.

The monetary aggregates

In the twelve months ending in September, the M1 monetary aggregate (cash held by the public and demand deposits) increased by 14.1 percent, and the M2 aggregate (M1 plus unindexed deposits of up to one year) increased by 5.4 percent.

The credit market

The total outstanding debt of the business sector increased by about NIS 4.8 billion in August, to NIS 786 billion, (an increase of 0.6 percent). The increase derived primarily from the depreciation of the shekel against the dollar, which increased the shekel value of foreign currency denominated debt, and from the increase in the CPI, which increased the value of CPI-indexed debt.

Net debt raised totaled only about NIS 0.5 billion—about NIS 1.9 billion raised in tradable bonds was partly offset by approximately NIS 1.5 billion in repayment of bank loans. The private nonfinancial sector issued only about NIS 1 billion in bonds in September, compared with a monthly average of NIS 2.3 billion since the beginning of the year, against the background of seasonality related to the New Year holiday season. Outstanding household debt increased by 1.0 percent in August, to NIS 402.2 billion, with an increase of 0.9 percent in households' housing debt, to NIS 284 billion.

In September, there was a seasonal decline to about NIS 3.5 billion in new mortgages granted by banks, compared with a monthly average of NIS 4.4 billion since the beginning of the year. The average interest rate on new unindexed, variable-rate mortgages remained virtually unchanged in September, while the interest rate on CPI-indexed mortgages increased by about 0.1 percentage points. Guidelines issued by the Supervisor of Banks which limit the payment to income ratio, the share of the loan which may be granted at variable rate interest, and the term until final loan repayment are expected to be reflected in housing credit characteristics in the coming months.

The housing market

The housing component of the CPI (based on residential rents) declined by 0.1 percent in September, following consecutive increases each month since February. In the twelve months ending in September, this component increased by 2.7 percent, similar to the 12 months which ended in August. Home prices, which are published in the Central Bureau of Statistics survey of home prices but are not included in the CPI, increased by 0.2 percent in July–August, and over the 12 months ending in August they increased by 9.3 percent, compared with 9.8 percent in the 12 months ended in July. The number of building starts, on an annualized basis, remains above 41,000. In August, the number of transactions in the housing market declined, in line with a decline in the level of readiness to purchase a home, as reflected in the consumer confidence survey by the Central Bureau of Statistics.

3. The foreign exchange and stock markets

The foreign exchange market

From the monetary policy discussion on September 22, 2013, through October 25, 2013, the shekel weakened by 0.7 percent against the dollar, even as most currencies strengthened against the dollar. The shekel weakened by 2.66 percent against the euro, and by 1.5 percent in terms of the nominal effective exchange rate. Since the beginning of the year, the shekel has appreciated by 5.3 percent in terms of the effective exchange rate.

The capital market

From the monetary policy discussion on September 22, 2013, through October 25, 2013, the Tel Aviv 25 Index increased by 3.3 percent, similar to the global trend. The Tel-Bond 60 Index increased slightly, by about 1 percent. At the same time, spreads in the corporate bond market remained low.

4. Global economic developments

The International Monetary Fund lowered its global growth forecast for 2013 by 0.3 percent, to 2.9 percent, and for 2014 by 0.2 percent, to 3.6 percent. In the IMF's Global Financial Stability Report, there is a change in the mix of risks faced by the global economy. The main risk derives from effects related to the process of monetary policy in the US and other economies becoming less accommodative—should that lead to sharper than expected increases in yields, it could threaten stability, primarily in emerging markets which may face capital outflows. In contrast, the report emphasized the improved financial situation in the eurozone. Over the course of the month, concern of a fiscal crisis in the US increased, against the background of the government shutdown and the lack of an agreement to raise the debt ceiling—an agreement which was reached only at the last minute, and which will need to be discussed again in another three months. Against the background of this lack of clarity, as well as the weak employment data that were published, market assessments are that the start of the tapering process of Federal Reserve bond purchases will be postponed to the end of the first quarter of 2014. Macro data published in the US were for the most part disappointing. In Europe, for the first time in a long while, the ECB increased its growth forecast for 2013—by 0.2 percent, to a projected contraction of 0.4 percent; it also lowered its 2014 forecast by 0.1 percent, to 1 percent. Macro data were mixed; purchasing managers indices indicated slight expansion; the unemployment rate declined slightly, and industrial production and retail sales indicated continued contraction at the annual level and a slight improvement at the monthly level. Stress tests planned for the banking system are expected to indicate the need to strengthen banks' capital, which may make it difficult to expand credit to the business sector and to entrench growth. In Japan, the expansion program is apparently leading to only a slight improvement in macro data. In most emerging markets, the slowdown in economic activity continues, against the background of stability in commodity prices and the tightening of financial conditions. With that, growth in China accelerated in the third quarter to a rate of 7.8 percent, from 7.5 percent in the second quarter; however, the IMF's forecast indicates expected moderation in growth and also warned about risk in the credit market. Oil and metals prices increased slightly this month. Inflation forecasts in advanced economies remained low, while accelerating in emerging markets, mainly in Brazil, India and China.

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

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 November 2013, a decision was made to leave the interest rate unchanged at 1 percent. The decision was unanimous.

The discussion focused on the following main issues: (1) the global environment and its effect on activity in Israel; (2) the development of the exchange rate and its effects on exports, and; (3) the housing market.

Concerning **the global environment**, the Committee members expressed concern that the delay in tapering in the US reflects the Federal Reserve's estimation that the recovery observed in the US economy is moderate and fragile. Furthermore, concern was expressed regarding the decline in growth rates in emerging economies in particular, and in the global economy in general. The fragility of global growth may harm the growth of the Israeli economy and may, in particular, make it difficult to expand exports. With that, it was noted that the expected easing of fiscal restraint in the US and Europe during 2014 will contribute to an improvement in the global growth rate, and may lead to an improvement in Israeli exports.

The Committee members discussed **the development of the exchange rate and its effect on exports**. Even though the trend of appreciation of the shekel was halted in the past month, the Committee members discussed the effects of the continuing appreciation of the shekel on Israeli exports, since over time, a decline has been noted in most export industries. It was noted that in the past year, there has been a standstill in exports from the traditional industries, which are labor-intensive industries that are relatively sensitive to the exchange rate, but it was also noted that in recent months, the weakness has been in the high technology industries which, by their very nature, are less sensitive to the exchange rate.

In **the housing market**, the trend of increase in housing prices continued this month as well. The Committee members emphasized the need for measures on the part of the government in order to expand the supply of homes. The Committee members also discussed the effects of the macroprudential measures taken thus far on mortgages.

The main argument for leaving the interest rate unchanged is that the current interest rate environment following the reductions made since May seems appropriate both to the inflation level, which is within the target range but in the lower part of it, and to the somewhat weak level of activity observed in recent months. The importance of the low interest rate level is brought into sharper relief in view of the weakness of exports and the delay in tapering in the US to the end of the first quarter of 2014.

Following the discussion, the five members of the Monetary Committee voted on the Bank of Israel interest rate for November 2013. All of the Committee members supported leaving the interest rate unchanged at 1 percent.

In its announcement of the decision, the Bank emphasized that the decision to leave the interest rate for November unchanged at 1 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.

- Inflation over the past 12 months, and inflation forecasts and expectations for the year ahead, remain within the inflation target range, and below the midpoint of the target range.
- The picture of the state of real economic activity indicates continued growth at a rate slightly below 3 percent (excluding the effect of natural gas production), although several indicators point to some slowdown, primarily a decline in exports and industrial production, in the third quarter.
- The interest rate was reduced by a cumulative 0.75 percentage points since May, including a 25 basis point reduction last month. Both interest rate and yield gaps with advanced economies have narrowed.
- Last month the appreciation trend of the shekel halted, and the shekel weakened by 1.5 percent in terms of the effective exchange rate. The shekel weakened by 0.7 percent against the dollar, while most currencies strengthened against the dollar.
- The IMF reduced its global growth projections for 2013 and 2014. Market assessments are that the Federal Reserve will delay the beginning of the tapering process of its bond purchases until the end of the first quarter of 2014.
- A decline in the number of housing transactions continues, alongside the continued increase in home prices, and the high volume of new mortgages taken out. Guidelines published by the Supervisor of Banks, which limit the share of repayment out of income, the share of the loan which may be granted at variable rate interest, and the term until final loan repayment, are expected to reduce the risk to mortgage borrowers and the banking system.

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 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 October 28, 2013.

Participants in the narrow-forum discussion:

Members of the Monetary Committee

Dr. Karnit Flug, Deputy Governor, under whose authority as Acting Governor of the Bank of Israel serves as Chairperson of the Monetary Committee
Prof. Alex Cukierman
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. Eddy Azoulay, Chief of Staff to the Governor
Dr. Ziv Naor, Economist in the Research Department
Ms. Esti Schwartz, Secretary of the Monetary Committee
Mr. Yoav Soffer, Deputy Spokesperson of the Bank of Israel
Prof. Nathan Sussman, Director of the Research Department