BANK OF ISRAEL
Office of the Spokesperson and Economic Information

October 6, 2014

Press Release

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

The discussions took place on September 21 and 22, 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 decision.

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

Data on real economic activity which became available this month bolstered the assessment that activity moderated in the second quarter, and monthly indicators point to further moderation in the third quarter, among other things against the background of Operation Protective Edge. In the second estimate of second quarter National Accounts data, GDP growth was revised downward, from 1.7 percent to 1.5 percent (annual terms, seasonally adjusted), primarily as a result of a contraction of 12.2 percent in goods exports (excluding diamonds and startups) compared with a contraction of 10.1 percent in the first estimate. The current account surplus contracted to $2.2 billion in the second quarter (compared to $3.6 billion in the first quarter) primarily as a result of an increase in the goods account deficit, which was partly offset by an increase in the services account surplus. Preliminary data from the Companies Survey for the third quarter indicate that the net balance continued to decline, encompassing most industries. Goods exports declined in August by 7.5 percent (dollar terms, excluding ships and aircraft and diamonds), and a trend of decline is becoming apparent compared with the second quarter. Services exports were stable in the second quarter compared with the first quarter. In August, there was an increase of 1 percent in goods imports (excluding ships and aircraft, diamonds, and fuels), and stability can be seen in them in July–August compared with the second quarter. In July–August, there was a sharp decline of 35.5 percent in the number of tourist entries relative to the second quarter (seasonally adjusted). The Composite State of the Economy Index remained unchanged in August, and was negatively impacted primarily by declines in indices of goods and services (including tourism) exports for August, and by declines in the indices of trade revenue and industrial production for July. In July, credit card purchases declined by 5.6 percent. This month as well, no decline was seen in the various consumer confidence indices, despite the fighting in the South. The Purchasing Managers Index continued to decline this month, to only 42.6 points. The Climate Index, based on the Business Tendency Survey of the Central Bureau of Statistics, was compiled at the height of Operation Protective Edge, and reflects a low rate of growth of 0.13 percent, after reflecting a range of 0.19 percent to 0.28 percent in recent months.

The labor market

Labor Force Survey data for August indicate that among the principal working ages (25–64) there has been a slight increase in the participation rate (79.3 percent compared to 79.1 percent in July) and the employment rate remained unchanged (at 75.1 percent). Over the year to date, there has been stability in these indicators. The unemployment rate for those ages increased in August (to 5.2 percent, compared with 5.0 percent in July), and the overall unemployment rate increased by a similar rate, to 6.4 percent. There was no increase in the number of employee posts from the beginning of the year, but there was a slight decline in the number of employee posts in the business sector. As opposed to these, other indicators point to continued stability in the labor market: Health tax receipts, which provide an indication of total wage payments in the economy, were 4.8 percent higher in July–August, on a nominal basis, than in the corresponding period of the previous year. Nominal wages increased by 0.72 percent, and real wages increased by 0.66 percent, in the second quarter, compared with the first quarter (seasonally adjusted data). There has been no marked change in the number of unemployment benefit claims and in the job vacancy rate since the end of 2013.

Budget data

In January–August, the deficit in the government's domestic activity (excluding net credit) was about NIS 6.1 billion, which is about NIS 3.9 billion smaller than the deficit in the seasonal path consistent with meeting the deficit target for 2014. This is because since the beginning of the year, domestic expenditure (excluding credit) is about NIS 5.4 billion below the seasonal path. With that, over the remainder of the year an acceleration in expenditure is expected due to the addition that will be provided to the defense budget in respect of the costs of Operation Protective Edge, and for the costs of agreements that the government arranged with entities that encountered difficulties due to the fighting, or with entities that are implementing reforms. Domestic revenues from the beginning of the year are about NIS 1.5 billion lower than the seasonal path. Tax revenues in August increased by about 14.6 percent in real terms, compared with August 2013, and include tax payments by businesses in the South—totaling about NIS 400 million—that were deferred from July due to Operation Protective Edge; net of the effect of the deferral of taxes from July, total tax revenues increased by 12.4 percent in real terms.

2. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) for August declined by 0.1 percent, in contrast to forecasters' projections for an increase of 0.2 percent, on average. There were significant increases in the fruit and vegetables, housing, and culture and entertainment components, and marked declines in the clothing and footwear and the transport and communication components. The inflation rate over the preceding 12 months was zero percent, compared with 0.3 percent over the 12 months ended in July. The tradable goods components of the CPI declined by 2.0 percent over the past 12 months. In contrast, there was a slight rise in the rate of increase in components consisting of nontradable products, and they increased by 1.2 percent, compared with 1.1 percent in the previous month.

Expectations and forecasts of inflation and the interest rate

This month, 1-year inflation expectations (seasonally adjusted) derived from the capital market remained at 1.1 percent, near the lower bound of the inflation target range, and 2-year expectations declined slightly to 1.3 percent. Private forecasters' projections for the next 12 CPI readings remained at 1.1 percent. Expectations for the coming 12 CPI readings derived from banks' internal interest rates continued to decline, from 0.8 percent in the previous month to 0.7 percent this month. Expectations for medium and long terms continued to decline this month, by about 6 basis points on average, continuing the extended decline seen since the April CPI was published. After the reduction of the Bank of Israel interest rate last month surprised the markets, an additional reduction in the interest rate in the coming months is not expected by forecasters, nor is it reflected in data from the *makam* and Telbor curves.

Monetary aggregates

In the twelve months ending in August, the M1 monetary aggregate (cash held by the public and demand deposits) increased by 21.8 percent, and the M2 aggregate (M1 plus unindexed deposits of up to one year) increased by 8.0 percent.

The credit market

Total outstanding debt of the business sector declined by about NIS 0.7 billion (0.1 percent) in July, to NIS 772 billion, as a result of the net repayment of debt. The figure is virtually unchanged relative to the end of 2013. In July, the nonfinancial business sector issued about NIS 2.5 billion in bonds, compared with a monthly average of NIS 3.7 billion since the beginning of the year. Since the reduction of the interest rate in August, net new investment in corporate bond mutual funds resumed, although at a lower volume than during the first months of the year. Bond market spreads continued to decline this month, and their level remains low, to an extent that may indicate the underpricing of risk in this market. Outstanding household debt increased by about NIS 2.2 billion (0.5 percent) in July, to about NIS 422 billion. The increase derived from continued growth in housing debt, which increased by 0.8 percent. In August, new mortgages taken out totaled NIS 4.1 billion, compared with a monthly average of about NIS 4.4 billion since the beginning of the year. The Banking Supervision Department published a draft directive this month which instructs the banks to increase their Tier 1 capital buffers in accordance with the volume of housing credit at each bank. The interest rate on new mortgages taken out declined in August on the unindexed variable-rate track (by 0.22 percentage points, similar to the decline in the Bank of Israel interest rate), and remained virtually unchanged on the CPI-indexed tracks.

The housing market

The housing component of the CPI (based on residential rents) increased by 0.5 percent in August. In the 12 months ending in August, this component increased by 2.0 percent, compared with 2.2 percent for that figure in the previous month. Home prices, which are measured in the Central Bureau of Statistics survey of home prices but are not included in the CPI, increased by 0.3 percent in June–July. Over the 12 months ending in July, home prices increased by 6.8 percent, compared with an increase of 7.7 percent in the 12 months ended in June. The number of new homes built by private initiative and that remain for sale increased by 2.1 percent in July compared with the previous month (seasonally adjusted data). In the first half of 2014, there was a 10.8 percent decline in building starts compared to the corresponding half last year. After the number of transactions declined in the second quarter, preliminary indicators point to a continued decline in July.

3. The foreign exchange and capital markets

The foreign exchange market

From the monetary policy discussion on August 24, 2014, through September 19, 2014, the shekel weakened by about 3.5 percent against the dollar and by 0.4 percent against the euro. In terms of the nominal effective exchange rate, the shekel weakened by about 1.6 percent this month. For the year to date, the shekel, in terms of the effective exchange rate, has weakened by about 1.3 percent.

The capital market

From the monetary policy discussion on August 24, 2014, through September 19, 2014, the Tel Aviv 25 Index increased by 5.5 percent, similar to the worldwide trend. Yields in the government bond market declined this month, among other reasons as a result of the Bank of Israel reducing the interest rate last month—yields on the unindexed-bond yield curve declined by up to 23 basis points, with further steepening of the curve; the yield on the 10-year unindexed bond declined by about 16 basis points to 2.47 percent. The yield differential between 10-year Israeli government bonds and corresponding 10-year US Treasury securities reversed, so that the US yield is 10 basis points higher than Israel's. *Makam* yields declined by about 20 basis points along the entire curve, and the 1-year yield is 0.25 percent. Israel's sovereign risk premium as measured by the five-year CDS spread remained virtually unchanged at 88 basis points.

4. Global economic developments

An uneven picture is beginning to emerge in the global economy. In the US and the UK, the recovery is becoming established and a path of reduced monetary accommodation is beginning to become apparent, while in China, Europe, Japan and some emerging economies, it appears that accommodation will continue. World trade is growing at a slow annual rate of about 3 percent. In the US, second quarter GDP growth data were revised upward, and various indicators (the trade balance, factory orders, retail sales, and the Purchasing Managers and Consumer Confidence Indices) point to a continuing positive trend in the third quarter as well. Employment data were disappointing this month, as 142,000 jobs were added, compared to expectations for 230,000. The real estate market remains relatively weak in view of the moderation in the rate of price increases and a decline in new home sales. The Federal Reserve repeated its commitment to leave the federal funds target rate at low levels for an extended period of time, and the expected date of the beginning of interest rate increases remains the second half of 2015, although the expected interest rate path for 2015 and 2016 was revised upward. In Europe, weak macro figures were published this month: purchasing managers indices and consumer confidence indices continue to indicate pessimism, while industrial production increased by 1 percent, more than expected. Inflation over the preceding 12 months is 0.3 percent, and facing the loss of momentum and the concern of deflation, the ECB reduced its interest rate by an additional 10 basis points this month, and announced the start of a quantitative easing program. The president of the ECB noted that monetary policy alone cannot stop the continued slowdown. In Japan, second quarter growth data were revised downward, to negative growth of 7.1 percent and, together with other data, they indicate that the slowdown does not derive just from the increase in VAT. The governor of the central bank said that the weakening of the yen will help the economy, and his words were interpreted as notice that further monetary accommodation is likely in 2015. In the UK, macro data were positive, and the concerns of a negative impact to stability receded in view of the results of the referendum in Scotland. In China there were disappointing macro data this month, and the central bank is adopting monetary easing measures totaling about 500 billion yuan in order to maintain the growth rate. In India there is a recovery, while the slowdown in Brazil is worsening and is accompanied by a further rating decline. The decline in commodity prices continues and, in turn, is affecting global inflation. The price of Brent Sea crude oil declined by 5.5 percent this month, and the commodities index excluding energy declined by 6.3 percent.

5. The staff forecast

This month the Research Department updated its macroeconomic forecast. According to the revised forecast, the inflation rate in the coming 4 quarters (until the third quarter of 2015) will be 1.0 percent; the Bank of Israel interest rate is expected, according to the staff forecast, to remain at 0.25 percent, GDP is expected to grow in 2014 by 2.3 percent (2.9 percent in the previous forecast), and in 2015 it is expected to grow by 3.0 percent (similar to the previous forecast).

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR OCTOBER 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 October 2014, it was decided to keep the interest rate unchanged at 0.25 percent. The decision was unanimous.

The discussion focused on several main issues: (1) inflation; (2) economic activity; (3) the global economy; (4) the exchange rate; (5) the housing market; (6) the corporate bond market, and (7) the fiscal situation.

During the course of the discussion on inflation, Committee members referred to inflation, as measured over the preceding 12 months, reaching zero percent. They also noted that inflation expectations for the coming year are very close to the lower bound of the target range (1–3 percent) defined as price stability, and that an extended decline in expectations has been seen since the April CPI was published. In addition, inflation expectations declined for longer terms as well, although they are all entrenched within the range. Committee members agreed that the rate of price increases moderated in recent months, affected by, among other things, a decline in global food and energy prices and by the appreciation that occurred until the beginning of August. They noted that the exchange rate only impacts prices in the economy after some time, and therefore the sharp devaluation that occurred in the past two months has not yet been reflected in increased prices; however, it is expected to be thus reflected in the coming months, even if the transmission from the exchange rate to prices is currently low. Committee members were of the opinion that the low inflation rate also derives from weakness in domestic demand, and they assessed that the low interest rate environment will assist in encouraging it. In concluding the discussion on inflation, Committee members agreed that action should continue to be taken in order return the inflation rate to within the price stability target range over the next 12 months.

In their discussion on economic activity, Committee members agreed that the growth rate of the economy has slowed in the past two quarters. The slowdown in the second quarter derived primarily from the contraction of exports and the virtual standstill in investment, and Committee members said that these developments are affected by, among other things, the continued weakness in world trade. As to the third quarter, Committee members claimed, based on several indicators, that growth continued to moderate, and they attributed a large part of that to the moderating effect of Operation Protective Edge. With regard to the labor market, members said that even though the level of unemployment is low, some indicators signal that the improvement in this market has halted: participation and employment rates stabilized, and the number of employee posts in the business sector declined slightly since the beginning of the year. Members concluded by saying that there is a need to continue monitoring developments in this market.

In terms of the global economy, Committee members mentioned the differences between the positive data on US and UK activity and the disappointing data in Europe, Japan, and to some extent, China as well. Members discussed the question of whether it is likely that there will be a prolonged situation of divergence between these groups—that is, a situation in which the US and UK grow at a rapid rate, while Europe and Japan continue to stagnate. Committee members pointed out that the European economy is still a very important one for Israel, and that weak data there negatively impact Israeli exports—not only directly, through moderation in European demand, but also indirectly, through a weaker euro and the resulting tougher competition with European exporters.

In the discussion on the exchange rate, Committee members referred to the shekel's depreciation in the past two months, and assessed that continued depreciation will support exports, will improve the competitiveness of domestic tradable goods, and will support economic growth. Committee members noted that in the past month some foreign currency demand also derived from domestic entities, which reduced the hedging of their investments abroad. The Committee assessed that continued depreciation is likely to strengthen this trend and thus to contribute to continued depreciation in the shekel.

With regard to the housing market, Committee members noted that home prices continue to increase, and the pace of new mortgages taken out remains high, notwithstanding that the number of transactions declined, among other reasons due to uncertainty about the plan to reduce the VAT on new homes for eligible buyers to zero. They also expressed their concern that the number of building starts had declined since the beginning of the year. Committee members discussed the risks deriving from the housing market in a low interest rate environment, and assessed that the steps taken by the Banking Supervision Department—including its most recent one, related to increasing capital buffers—are helping to reduce the risks inherent in mortgages and to strengthen the banks' ability to absorb in a case of the risks materializing.

Committee members referred to a decline in corporate bond spreads and their low level. They reiterated their concern that these spreads apparently do not reflect full pricing of the credit risks in this market, particularly in the case of low rated bonds.

With regard to the fiscal situation, Committee members extensively discussed the fiscal expansion expected, based on budget negotiations taking place at this time, in 2015. They assessed that a moderate fiscal expansion could strengthen economic activity, to the extent that it focuses on encouraging growth and domestic demand. Committee members expressed concern that a sharp increase in public expenditure, without an increase in taxes and cancellation of exemptions, would markedly increase the government debt and deficit. They noted that the continued decline in the debt to GDP ratio strengthened the credibility and stability of Israel's economy, and a turnaround in this trend is liable to lead to negative consequences from those perspectives.

In conclusion, Committee members were of the opinion that after the Bank of Israel reduced the interest rate in the past two months by a cumulative 0.5 percentage points, and as the low interest rate is supporting the economy at this time, the current level of the interest rate is in line with the economic environment.

Following the discussion, the six members of the Monetary Committee voted on the Bank of Israel interest rate for October 2014. All six members supported keeping the interest rate at 0.25 percent.

The decision to keep the interest rate for October 2014 unchanged at 0.25 percentage points is consistent with the Bank of Israel's monetary policy, which is intended to return the inflation rate to 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 main considerations behind the decision

The following are the main considerations underlying the decision:

- ❖ The inflation environment remained low this month. The inflation rate measured over the preceding 12 months was zero percent, and inflation expectations remain low, with some of them showing a further slight decline.
- ❖ The assessment that activity had already begun to moderate in the second quarter was bolstered this month. Partial data from the Companies Survey, as well as the Composite State of the Economy Index, tourist entries, and additional indicators point to the moderation continuing in the third quarter, most of which is attributed to the effects of Operation Protective Edge. Labor Force Survey data indicate that the improvement in the labor market has halted, though health tax receipts point to continued expansion, at the rate of recent months.
- ❖ The shekel weakened by 1.6 percent this month in terms of the nominal effective exchange rate. Continued depreciation will support a recovery in exports and in the tradable sector. The shekel has depreciated by about 1.3 percent since the beginning of the year.
- ❖ The global economic situation is uneven: recoveries are becoming established in the US and the UK, but slowdowns continue in Europe and Japan, and data in China were disappointing. World trade is growing at a slow rate. The Fed is still expected to increase the federal funds rate in the US in the second half of 2015, while in Europe and Japan, monetary easing is apparently being enhanced.
- ❖ Home prices increased by 6.8 percent in the previous 12 months, and the increase in the balance of housing credit continues. The Supervisor of Banks published a draft directive which instructs banks to increase their Tier 1 capital buffers in accordance with the volume of housing credit. The number of transactions continues to decline, against the background of the uncertainty in the market, among other things regarding the plan for a zero VAT rate on new homes.
- ❖ Corporate bond funds are again showing net new investment, although at relatively low volumes. Spreads in that market continue to apparently indicate underpricing of risks.

  In light of the interest rate reduction in the past two months, by a cumulative 0.5 percentage points, and the support that the low interest rate level is providing the economy at this time, the Monetary Committee decided to keep the interest rate unchanged this month.

The Bank of Israel will continue to monitor developments in the Israeli and global economies and in financial markets. 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 September 22, 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. Daniel Hahiashvili, Chief of Staff to the Governor
Mr. Muly San, Economist in the Research Department
Ms. Esti Schwartz, Secretary of the Monetary Committee
Mr. Yoav Soffer, Spokesperson of the Bank of Israel