BANK OF ISRAEL

Office of the Spokesperson and Economic Information

October 10, 2016

Report to the public on the Bank of Israel's discussions prior to deciding on the interest rate for October 2016

The discussions took place on September 25 and 26, 2016

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 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

Indicators that became available this month point to a higher pace of activity than that of previous years. According to the second estimate of National Accounts data for the second quarter, GDP grew by 4.0 percent (compared with 3.7 percent in the first estimate) (seasonally adjusted annual data), and exports (excluding diamonds and startups) grew by 10.9 percent (compared with 5.7 percent in the first estimate). Initial results from the Companies Survey for the third quarter are consistent with the assessment that the growth rate in that quarter will not be lower than in previous years (2–3 percent). According to foreign trade data, goods exports (excluding ships, aircraft and diamonds, in current dollar terms) in July–August were 1.3 percent higher than the monthly average in the second quarter, and imports (excluding ships, aircraft, and fuels) remained unchanged. Following an increase in June, services exports (seasonally adjusted in current dollar terms) declined by 6.4 percent in July. Incoming tourism is having difficulty recovering, and the number of tourist arrivals was about 3 percent lower in January–August than in the corresponding period of last year. The Composite State of the Economy Index increased by 0.2 percent in August, led by increases in job vacancies, in retail trade revenue, and in building starts. The Consumer Confidence Index compiled by the Central Bureau of Statistics declined slightly in August, but remains high. The index compiled by Bank Hapoalim increased again in August. There was a relatively sharp increase in the Purchasing Managers Index in August, to 57 points.

The labor market

The picture conveyed by the labor market remains very positive. Wage increases continue, with an emphasis on business sector industries. Real wages increased by 0.3 percent (seasonally adjusted) in April–June compared with the preceding three months, while nominal wages increased by 0.1 percent. Health tax receipts for June–August were 5.3 percent higher (in nominal terms) than in the corresponding period in the year before, reflecting the continued increase in employment and wages. Labor Force Survey data for August indicate that the unemployment rate among the prime working ages (25–64) (seasonally adjusted) remained at the low level of 4.0 percent, and the employment rate and the labor force participation rate continued to increase. The job vacancy rate increased to a record high of 4.0 percent (seasonally adjusted) in August.

Budget data

The cumulative domestic deficit (excluding net credit) in government activity was NIS 2.8 billion in January–August 2016, compared with a deficit of approximately NIS 0.9 billion in the corresponding period of 2015, and it is about NIS 6.9 billion smaller than the deficit in the seasonal path consistent with achieving the deficit target for 2016. The deviation reflects revenues that were NIS 3.7 billion higher than the path, and expenditures that were NIS 3.2 billion lower than the path. Tax revenues in August were about NIS 22.2 billion, which is about NIS 0.1 billion lower than the seasonal path consistent with the estimate of tax revenue in the budget (NIS 277 billion). Tax revenues in January–August were about 3.7 percent higher in real terms than in the corresponding period of the previous year. In August, gross domestic VAT collection declined by about 5.3 percent in real terms compared with August of 2015 (and it increased by about 0.3 percent net of the effect of legislative changes).

Staff forecast

This month, the Research Department updated its macroeconomic forecast. Compared with the previous quarterly forecast, the current forecast reflects a similar assessment regarding the development of inflation and the interest rate, and more positive assessments regarding the growth rate. The inflation rate is expected to be 1.0 percent over the coming four quarters (compared with 1.1 percent in the previous forecast) and is expected to return to within the target range in the third quarter of 2017. The Bank of Israel interest rate is expected to remain at 0.1 percent during the coming year, and to increase to 0.25 percent toward the end of 2017. GDP is expected to grow by 2.8 percent in 2016 (compared with 2.4 percent in the previous forecast) in view of the upward revision of growth data, and to grow by 3.1 percent in 2017 (compared with 2.9 percent in the previous forecast).

2. Developments on the nominal side

Inflation

The Consumer Price Index for August declined by 0.3 percent, while the average of forecasters' predictions was for the CPI to remain unchanged. There was a seasonal decline of 4.9 percent in the clothing and footwear component, and a decline of 1.3 percent in the transport and communication component. The inflation rate as measured by the change in the CPI over the past 12 months was -0.7 percent, compared with -0.6 percent in the 12 months ending in July. Excluding the direct effect of energy prices and administrative price reductions, the CPI increased by 0.6 percent over the past 12 months. Over the past 12 months, prices of tradable goods in the CPI declined by 3.4 percent, and the prices of nontradable items increased by 0.8 percent.

Expectations and forecasts of inflation and the interest rate

One-year inflation expectations derived from the capital market declined to 0.4 percent following the publication of the August CPI reading, from 0.6 percent last month. Expectations for inflation over the coming 12 months derived from banks' internal interest rates declined from 0.3 percent to 0.2 percent, and private forecasters' projections for the next 12 CPI readings are for an increase of 0.7 percent, on average (compared to 0.6 percent in the previous month). Third-year forward expectations remained virtually unchanged (1.0 percent), and 3–5 year expectations remained virtually unchanged, at 1.3 percent. Longer-term expectations (5–10 years) remained without significant change, in the center of the target range, at 2.0 percent. According to the *makam* curve and projections by private forecasters, the Bank of Israel interest rate is not expected to change in the next year. The Telbor curve shows some probability of an increase in the interest rate in a year.

Monetary aggregates

In the 12 months ending in August, the M1 monetary aggregate (cash held by the public and demand deposits) increased by 22.3 percent, and the M2 aggregate (M1 plus unindexed deposits of up to one year) increased by 12.3 percent.

The credit market

In the second quarter, business sector debt increased by about NIS 13.9 billion (1.7 percent), to about NIS 829 billion. The increase was mainly a result of quantitative growth of about NIS 8 billion in tradable bonds in Israel, bank loans and nonbank loans. In August, the business sector (excluding banks, insurance companies and foreign companies) issued bonds totaling just NIS 2.5 billion, after issuances of NIS 5.7 billion in July. The average monthly issuance in the past year was about NIS 3 billion. Funds specializing in corporate bonds in Israel and funds specializing in equities in Israel continued to attract net new investment in August and the beginning of September. Since March, funds specializing in corporate bonds in Israel recorded net new investment of about NIS 3.2 billion, and those specializing in equities in Israel had net new investment of about NIS 1.4 billion. Corporate bond spreads (excluding banks and insurance companies) declined over August in most industries, and were about 3 percentage points, on average, at the beginning of September—the lowest level in the past two years. Outstanding household debt increased by about NIS 9.2 billion (1.9 percent) in the second quarter, to about NIS 489 billion, of which there was an increase of about NIS 7 billion (2.2 percent) in housing debt, to about NIS 331 billion. In August, the total volume of new mortgages taken out was NIS 5.5 billion, slightly higher than the average of the past 12 months (NIS 5.1 billion). The share of mortgages taken out for the purchase of investment homes continues to decline, to 13.7 percent in August, compared with an average of 14.9 percent in the past 12 months. The average interest rate on mortgages continued to increase in August on all tracks: On the fixed-rate CPI-indexed track, rates increased by 0.04 percentage points, while on the variable-rate CPI-indexed track, rates increased by 0.15 percentage points. Rates on the fixed-rate unindexed track increased by 0.09 percentage points, and on the variable-rate unindexed track rates increased by 0.05 percentage points.

The housing market

The housing component of the CPI (based on residential rents) increased by 0.4 percent in August, following an increase of 1.2 percent in July. Home prices increased by 0.1 percent in June–July, and figures for the preceding months were revised upward, including the decline recorded in the May–June figures (to -0.1 percent, compared with -0.3 percent). Over the 12 months ending in June–July, home prices increased by 6 percent, lower than the increase of about 7 percent in the 12 months ending in May-June. Activity in the market remains robust, with about 9,000 transactions carried out in July, similar to the figure for June (9,200 transactions), and higher than the average over the past 12 months (about 8,000 transactions per month). New home sales declined moderately in July, to about 2,240 (seasonally adjusted), and the stock of homes available for sale declined slightly, but remained high at approximately 27,900 homes in July compared with 28,100 in June. The number of building starts increased in by 10.3 percent in the second quarter compared with the first quarter (seasonally adjusted. Notably, the first estimate of building start figures is generally biased to the downside). There were about 48,700 building starts, and 41,100 building completions, in the past year.

3. The foreign exchange and capital markets

The foreign exchange market

From the monetary policy discussion on August 28, 2016, through September 23, 2016, the shekel strengthened by 0.2 percent against the dollar, and by 0.3 percent in terms of the nominal effective exchange rate. Over the preceding 12 months, the shekel appreciated by 4.9 percent in terms of the nominal effective exchange rate.

The capital market

From the monetary policy discussion on August 28, 2016, through September 23, 2016, the Tel Aviv 25 Index declined by about 1 percent. Government bond yields declined by up to 7 basis points along the unindexed curve, and increased by up to 6 basis points in the medium to long terms along the CPI-indexed curve, with a steepening of the curve. The *makam* curve traded at a yield ranging around the Bank of Israel interest rate. Israel's sovereign risk premium, as measured by the five-year CDS spread, declined slightly, to about 70 basis points.

4. Global economic developments

The global economy continues to grow at a slow pace, and the growth rate of world trade continues to decline—growing by less than 1 percent in the past year. The OECD slightly lowered its global growth forecast, by 0.1 percentage point, for 2016 and for 2017. Central banks continue to conduct very accommodative monetary policy, and inflation remains very low, although some of the deflationary factors are beginning to moderate. In the US, the expectation according to the GDPNow index is that there will be growth of 2.9 percent in the third quarter, but this is a rate that will not be sufficient to compensate for the low growth of the first two quarters of the year. Personal consumption expenditure continues to drive the economy, while the weakness in the manufacturing sector continues. Nonfarm payrolls increased by 151,000 in August, a relatively low amount, but it was sufficient to prevent an increase in unemployment, and assessments are that the labor market is nearing full employment. In its meeting this month, the Federal Reserve left the federal funds rate unchanged. According to market assessments, there is still a relatively high probability that the federal funds rate will be increased by 0.25 percentage points this year. Data that became available in Europe continue to indicate a low growth rate, and the ECB forecasts growth of just 1.6 percent in 2017–18. Political developments are the main risk to growth. This month, the ECB left its policy in place. In the UK, the Purchasing Managers Index that declined sharply following the referendum again increased to levels indicating expansion, but most assessments expect a negative impact to activity, the strength of which will depend on agreements that will be formulated. In Japan, growth remains near-zero, and the Bank of Japan announced a “yield curve control” program in which it will strive to maintain the 10-year government bond yield at its current level of around 0 percent; in addition, it undertook to continue its monetary accommodation even after inflation reaches 2 percent. In most emerging economies, there was some improvement in assessments regarding economic activity, and in China most economic data published this month were positive. The Producer Price Index (PPI) in China has been just -0.8 percent since the beginning of the year, and its continued stability may reduce global deflationary pressure. The price of a barrel of Brent Sea crude oil ranged between $45–50 during the month. The index of commodities excluding energy declined at the beginning of the month, but then increased later on, finishing the month with a slight decline.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR OCTOBER 2016

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 2016, 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 global environment and the exchange rate, and (4) the housing market.

Main points of discussion

In their discussion on inflation, the Committee members referred to the CPI for August being markedly lower than the seasonal path. They were of the opinion that the low level of inflation in Israel derives mainly from the low inflation abroad and from the administrative price reductions. The Committee members noted that the rise in wages in the economy is expected to act to increase unit labor cost, and to develop into an increase in the domestic inflation rate—assuming that additional declines will not develop in prices of imported products such as commodities. One of the Committee members noted that this process is likely to develop at a more rapid rate than the rate implied in capital market prices and in the forecasts of private entities.

The discussion on real economic activity focused on the updated growth data and on the labor market. The second estimate of second quarter growth was revised upward and indicated strong growth. In the second quarter, similar to previous quarters, growth was driven by an increase in private consumption, but in contrast to those quarters, there was also a marked improvement in exports. The Committee members assessed that the high growth rate of private consumption is based mostly on labor income and not on excess leverage or on a notable share from savings. The Committee asserted that recent growth data and the updated data on economic activity, including the Companies Survey, indicate that the economy is growing by a rate similar to the rate of recent years. The Committee members referred as well to the strong employment data, and the low unemployment accompanied by a prolonged increase in the number of job vacancies in many industries, and a continued increase in wages.

In terms of the global environment, it was noted that monetary policy worldwide remains very accommodative in view of the low growth rates and the forecast for the future. Against this background, the Committee members noted that the Federal Reserve did not increase the federal funds rate in September, but they added that there is a high probability that it will increase the rate by the end of 2016. In terms of the exchange rate, in view of the appreciation of recent months, the Committee members again said that the level of the exchange rate is expected to continue to weigh on developments of exports.

Regarding the housing market, the Committee members referred to home prices and mortgage volumes and noted that these have stabilized in recent months, but that it is too early to determine that there has been a change in their trend. The Committee members added that the continued increase in mortgage interest rates together with the increase in the number of building starts are expected to moderate the continued increase in home prices.

In conclusion, the Committee 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. The Committee members were of the opinion that in view of the risks to attaining the inflation target in Israel, and in view of the time it will take until the inflation rate returns to within the target range, it may be assessed that monetary policy in Israel will remain accommodative for a considerable time.

Following the discussion, the four members of the Monetary Committee voted on the Bank of Israel interest rate for October 2016. All members supported keeping the interest rate unchanged at 0.1 percent.

The main considerations behind the decision

The decision to keep the interest rate for October 2016 unchanged at 0.1 percent is consistent with the Bank of Israel's monetary policy, which is intended to return the inflation rate to within the price stability target range of 1–3 percent a year, and to support growth while maintaining financial stability. The Monetary Committee continues to assess that in view of the inflation environment, and of developments in the global economy, in the exchange rate, as well as in monetary policies of major central banks, monetary policy will remain accommodative for a considerable time.

Following are the main considerations underlying the decision:

- After the months of May through July, when the Consumer Price Index increased by a rate consistent with the seasonal path of the inflation target, the CPI for August was markedly lower than the path. Inflation as measured by the change in the CPI over the past 12 months continues to be negative, and short-term inflation expectations are still below the lower bound of the inflation target range. Medium-term and long-term expectations remain anchored within the target range.
- The second estimate of National Accounts data for the second quarter was revised upward, and indicators that have become available to date point to the assessment that in the third quarter the economy continued to grow by a rate not less than that of recent years. The picture conveyed by labor market data remains positive, with growth in employment and in wages; a shortage of workers is becoming apparent in various industries.
- The global economy continues to grow by a slow rate, and the growth rate of world trade continues to decline. Central banks continue to conduct very accommodative monetary policy. Assessments are that there is a relatively high probability that the US federal funds rate will be increased by the end of the year, though the path of the expected interest rate increase for the coming years is lower than previously assessed.
- From the monetary policy discussion on August 28, 2016, through September 23, 2016, the shekel strengthened by 0.2 percent against the dollar. In terms of the nominal effective exchange rate, the shekel appreciated by 0.3 percent, and has appreciated by 4.9 percent over the past 12 months. The level of the effective exchange rate continues to weigh on the growth of exports and of the tradable sector.
- In the past two months home prices have stabilized. In the second quarter there was an increase in the number of building starts. Monthly mortgage volume is stabilizing, with a continued increase in mortgage interest rates.

The Monetary Committee is of the opinion that the risks to achieving the inflation target remain high. 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 and will examine the need to use various tools 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 continue to keep a close watch on developments in the asset markets, including the housing market.

The decision was reached and published on September 26, 2016.

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. Daniel Hahiashvili, Chief of Staff to the Governor
Mr. Daniel Nathan, Economist in Research Department
Ms. Esti Schwartz, Secretary of the Monetary Committee
Mr. Yoav Soffer, Spokesperson of the Bank of Israel