BANK OF ISRAEL
Office of the Spokesperson and Economic Information

November 5, 2020

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

The discussions took place on October 21 and 22, 2020.

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 Markets), who prepare and present the material for discussion.

In the narrow forum—which consists of the Monetary Committee and a representative of the Markets Department—the Research and the Markets 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.

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 October 22, 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. 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 the proposal to reduce it to 0 percent. In addition, the Monetary Committee members unanimously decided to expand the government-bond purchase program and the new pillar in the plan to ease credit terms for small businesses.

The discussion focused on the path of recovery of economic activity and of inflation after the second lockdown, and the focused policy required to deal with the adverse impacts of the crisis, the policy necessary for maintaining the stability of the financial markets and on the continued efficient functioning of the credit market, on exchange rate developments, and on the fiscal uncertainty.

Main points of discussion

The data and indicators presented to the Monetary Committee described the recovery experienced by the Israeli economy during the summer months, but also the sharp adverse impact on activity as a result of the imposing of the second lockdown. Before the second lockdown was imposed, the broad unemployment rate had stabilized at approximately 11–12 percent, but it soared to 19 percent in the second half of September. The number of unemployed people in the first half of September was around 470,000, and it increased by around 300,000 people due to the imposing of the lockdown. The data also indicated that a sharp decline in activity could be seen during the second lockdown, though its intensity was more moderate than during the first lockdown. The recovery after the first lockdown, which was more rapid than expected, points to a successful adjustment process for the economy. In contrast, the concern arose that the recovery in the process of exiting the second lockdown will be slower due to the deterioration in the financial state of small businesses in comparison with their situation upon exiting the first lockdown. It was noted that the characteristics of the crisis lead to its impacts not being uniform, and the adverse impact is focused on industries that are affected directly by the limitations on activity and the social distancing requirements. The risk for those industries and for the households whose livelihood depends on them is particularly big, and the gaps in the risk among the various sectors are liable to increase the longer the crisis lasts. The Committee members noted that this feature of the crisis highlights the important role of fiscal policy.

Against the background of the improvement in the global economy in the third quarter, the IMF revised upward its forecast for the global economy. Based on the updated forecast, the IMF expects that the global economy will contract by 4.4 percent in 2020 and will grow by 5.2 percent in 2021. It also noted the sharp contraction in world trade. Inflation worldwide remained low, except for the US where it increased to a rate of about 1.5 percent. The recovery in commodity prices continues, and signs of it may be seen in some increase in the inflation rate in Israel in the coming months. However, the price of crude oil—a force that weighs on the return of inflation to its range in Israel as well—continues to be low relative to 2019. The monetary policy in various countries remained very accommodative and central banks continued to signal their readiness to take unconventional steps to ease financing terms, beyond those that they are already taking today. Equity indices in global capital markets recovered in recent months but their volatility remains high.

The Committee discussed the Research Department's forecast, which describes 2 possible scenarios. In the scenario in which there is control over the pandemic, GDP is expected to contract by 5 percent in 2020 and to grow by 6.5 percent in 2021. In the more severe scenario, negative growth of 6.5 percent is expected in 2020, and growth of only 1 percent is expected in 2021. The debt to GDP ratio in 2021 is expected to be 76 percent under the optimistic scenario, and 83 percent under the pessimistic scenario. In addition, the downside risks to the forecast were discussed—most of them depend on epidemiological developments: the effectiveness of the current lockdown and the date of fully ending it, the morbidity rate in the coming winter, and the date of completing the development and distribution of a coronavirus vaccine, but there are also other economic risks, such as further weakness in activity abroad, government measures, and the political and budget uncertainty.

In a discussion on fiscal policy, the Committee members expressed worry about the uncertainty continuing, in view of the economy operating without a 2020 budget and a 2021 budget not having been submitted for government approval yet. In September, the deficit reached 9.1 percent of GDP, and at the end of the year the deficit is expected to be approximately 13–14 percent of GDP. About three-quarters of the deficit are related to the ramifications of the coronavirus pandemic—about half due to the increase in expenditures, and about a quarter due to a decline in tax revenues as the GDP response to the crisis.

The inflation environment remains low, with the year over year inflation rate at -0.7 percent, and 1-year expectations from all sources remaining below the lower bound of the target. Forward inflation expectations for short and medium terms declined slightly since the previous interest rate decision, while expectations for longer terms remained anchored within the target range. The Committee assessed that the unconventional policy steps that it is currently taking, as well as the low interest rate level in the market—its lowest level ever—will assist in increasing the inflation rate, both directly as well as indirectly via improvement in economic activity.

The Committee discussed the developments in the foreign exchange market. Since the previous interest rate decision, the shekel strengthened by 0.4 percent in terms of the effective exchange rate. During that period, the shekel appreciated by 0.5 percent against the dollar and the euro. The development over the course of the period was uneven—the shekel weakened in September and strengthened again in October. Over the course of several months the effective exchange rate moved in a relatively narrow range, and the Bank of Israel continues to follow the foreign exchange market and to intervene in it as necessary, as it has done until now.

The data from recent months indicate relative stability and the orderly functioning of the financial markets, against the background of the policy steps taken. The Committee discussed that it is preferable to promote and initiate policy measures that may prevent possible future difficulties in the markets, and decided that out of its commitment to the markets' stability and orderly functioning to increase the government-bond purchase program. In this regard, the Committee discussed the high real rate of interest in Israel, compared with the rest of the world, including the recent widening gap vis-à-vis the US, and agreed that the increase in the scope of purchases as decided upon could moderate the forces for an increase in the real and nominal yields, and thus support an increase in the expected inflation rate. It was noted that the government-bond purchase program had a considerable effect on the price of credit in the economy and on the ability of companies to issue debt in the capital market, and that the credit needs are expected to remain significant in view of the continuation of the crisis.

The Committee discussed the increase in the risk premium inherent in the providing of loans to small businesses, which derives from the uncertainty regarding their activity and survival in view of the limitations imposed by the government in order to prevent the spread of the pandemic. This increase in risk is liable to adversely impact the orderly functioning of the credit market and the passthrough of monetary policy to the interest rate in this market segment. Therefore, the need arose in the Committee to operate an unconventional tool focused on the goal of making it easier, as much as possible, for small businesses, through the recognition of their importance in the recovery of employment and activity in the economy. Within the framework of the program, the Bank of Israel will provide the banking system with loans for a term of 4 years at a fixed interest rate of -0.1 percent, against loans that the banks will extend to small and micro businesses, on condition that the interest rate on the loans to small and micro businesses does not exceed Prime + 1.3 percent.

The Committee members voted unanimously in favor of increasing the government-bond purchase program and in favor of the new pillar in the plan to ease credit terms for small businesses—though the approach that the support that monetary policy can provide during a crisis such as this should be increased—whether to ensure the orderly functioning of the financial markets or to ease the terms of credit, to support the recovery of demand in the economy, and to moderate the appreciation forces.

Five Committee members were of the opinion that the interest rate should be kept at its current level of 0.1 percent. They were of the opinion that this low interest rate level supports the recovery of economic activity and the gradual return of the inflation rate to within the target range, and particularly in view of the Bank of Israel operating additional tools in the credit market. One Committee member voted in favor of reducing the interest rate to 0 percent. He was of the opinion that an interest rate lower than 0.1 percent is more appropriate due to the magnitude of the crisis and the adverse impact, anomalous in its magnitude, on the employment level.

Participants in the narrow-forum discussion:

Members of the Monetary Committee:
Prof. Amir Yaron, Governor of the Bank and Chairperson
Mr. Andrew Abir, Deputy Governor of the Bank of Israel
Prof. Reuben Gronau
Prof. Moshe Hazan
Prof. Zvi Hercowitz
Prof. Michel Strawczynski, Director of the Research Department

Other participants in the narrow-forum discussion:
Mr. Tal Biber, Head of the Markets Division, Markets Department
Dr. Golan Benita, Chief of Staff to the Governor
Mr. Uri Barazani, Spokesperson of the Bank
Mr. Arad May, Secretariat of the Monetary Committee
Mr. Yoav Soffer, Advisor to the Governor
Mr. Yair Avidan, Supervisor of Banks
Ms. Tida Shamir, General Counsel
Ms. Dana Orfaig, Research Department