



BANK OF ISRAEL

Office of the Spokesperson and Economic Information

October 22, 2018

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

The discussions took place on October 7 and 8, 2018.

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 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 Research Department—the Research and the Market Operations 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. 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 October 8th, 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. Four Committee members supported the proposal to keep the interest rate unchanged, and two Committee members supported increasing the interest rate to 0.25 percent.

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

Main points of discussion

In their discussion on economic activity, the Committee said that initial indicators of third quarter activity point to continued expansion, and the members assessed that the slowing in the second quarter derived from transitory factors, particularly the volatility in vehicle imports. They noted that the Composite State of the Economy Index and the Purchasing Managers Index point to continued expansion, and that the findings of the Business Tendency Survey and preliminary findings from the Companies Survey strengthen the assessment that the economy continues to grow at a pace close to its potential rate. An analysis of Current Account data indicates that the decline in the surplus was mainly a result of growth in goods imports, which supports the assessment that there is excess demand in the economy, which is being directed toward imports. As for the composition of growth, the Committee members said that the most recent data on goods and services exports indicate some weakness; they also tried to assess if in the third quarter the composition of growth returned to being balanced, but noted that at this stage it is still difficult to assess this. The Committee referred as well to the labor market and noted that the data show that it remains tight—the employment and participation rates are high, the unemployment rate is low, and wages continue to rise at a solid pace.

The Committee assessed that since the previous interest rate decision, there was no major change in the inflation environment. Its members said that in the past three months, the annual inflation rate has been within the target range and that except for the communication component, all the CPI components made a positive contribution. They noted that although the CPI readings for July and August were lower than expected, they assessed that it was more plausible to assume that it was a transitory deviation from the inflation trend than a downturn in the trend. It was noted that in the coming months the annual inflation rate may decline temporarily to below the lower bound of the target, but that 1-year expectations from the various sources remain in the same environment in which they were at the previous interest rate decision, and forward expectations for medium and long terms remain entrenched within the target range. The Committee assessed that the forces supporting an increase in inflation remain in place. These include, among other things, the rising wages in the economy, the vigorous private consumption, inflation abroad and the expansionary fiscal policy. It was noted that in the past year inflation rose to near the lower bound of the target,

but it was a temporary rise, after which inflation again declined. However, the Committee members assessed that the forces mentioned above will support the continued rise, and therefore the probability of a prolonged decline of inflation is relatively low. One member noted that these forces have already been acting for a long time while inflation in Israel continues to rise at a moderate pace. The Committee members agreed that the main risk to the continued entrenchment derives from the possibility of renewed appreciation of the shekel.

The Committee agreed that the global economy continues to present a positive trend, led by the US economy. With that, the members assessed that the risks have grown: the growth rate of world trade is moderating against the background of the developing trade war and apparently also against the background of a change in the structure of China's economy. In addition, there is volatility in emerging economies' financial markets against the background of the rise in US yields and the trade war. The Committee noted that the OECD slightly lowered its global growth forecast, as a result of the lowered forecast for the eurozone and other markets. It also noted that oil prices resumed rising, against the background of supply side effects. The Committee members assessed that monetary policy in Europe and Japan is expected to remain accommodative. In contrast, in the US the monetary contraction is expected to continue against the background of activity data and the convergence of inflation to its target.

In terms of the shekel, the Committee members said that the nominal effective exchange rate has remained relatively stable for more than a year, but at an appreciated level from a historical perspective. The Committee members assessed that the forces for appreciation weakened against the background of the widening interest rate spreads between Israel and the world and the contraction of the Current Account surplus.

The Committee members discussed housing market developments, and data received regarding home prices. They noted, among other things, the low level of investment in residential construction (despite the increase in building starts in the second quarter). In addition, the rise in new mortgage volume was discussed, which has continued despite the interest rate on mortgages remaining stable in recent months.

As noted, four of six Committee members were of the opinion that the interest rate should be kept at its current level. They explained that although annual inflation in the past three months has been within the target range, it is still too early to determine that the inflation environment is sufficiently entrenched, and therefore the monetary interest rate should be kept unchanged. They noted the uncertainty regarding the development of inflation in the coming months, primarily against the background of the assessment that during that period the annual inflation rate is expected to decline temporarily to below the lower bound of the target, which could impact on expectations. They assessed that over the coming months conditions for raising the interest rate may come into place, but that the path of increasing the interest rate will be moderate, so as not to disrupt the entrenchment of the inflation rate within the

target. Two Committee members were of the view that the interest rate should be raised to 0.25 percent. They said that the Committee is in agreement that the low inflation rate in Israel does not reflect weakness in demand. In addition, they noted that after inflation's upward trend for some time, the low level of the monetary interest rate is not appropriate for the economy's parameters. They noted that leaving the interest rate at a low level for a considerable time has negative effects over the long term, and that in the decision on the level of the interest rate, the Committee should give greater weight to those effects. The two members claimed that raising the monetary interest rate by 0.15 percentage points will keep the monetary policy accommodative and in their assessment is consistent with the Committee's forward guidance.

In general, the Committee members differed in their assessments regarding the date when it will be possible to begin raising the interest rate, but agreed that when the interest rate begins to rise, the increases will be gradual and cautious. The Committee emphasized that the beginning of the increase is contingent on the economic indicators that will become available and to the extent that they will support the assessment that the inflation environment has become entrenched within the target range. As such, the Committee assesses that in any one of the coming interest rate decisions it will be possible to raise the interest rate in accordance with the data and the manner in which the Committee members analyze them.

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
Mr. Andrew Abir, Director of the Market Operations Department
Prof. Reuben Gronau
Prof. Moshe Hazan
Prof. Zvi Hercowitz

Other participants in the narrow-forum discussion:

Eddy Azoulay, Chief of Staff to the Governor
Ari Kutai, Economist in the Research Department
Esti Schwartz, Secretary of the Monetary Committee
Yoav Soffer, Bank of Israel Spokesperson
Prof. Michel Strawczynski, Director of the Research Department