BANK OF ISRAEL
Office of the Spokesperson and Economic Information

December 10, 2012

Report to the public on the Bank of Israel's discussions prior to setting the interest rate for December 2012

The discussions took place on November 25 and 26, 2012

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 real, monetary and financial developments in Israel's economy, and developments in the global economy. Participants in this discussion include the three members of the Monetary Committee from the Bank—the Governor, the Deputy Governor and the Senior Advisor to the Governor—and the three members of the Monetary Committee from the public. Other participants in the discussion are the Directors of the Research and Market Operations Departments, and economists from various departments 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 Governor) has an additional vote.

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

1. Developments on the real side

General assessment

Most indicators of real economic activity that became available this month support the assessment that the moderate growth of activity continues, and is expected to continue in the coming months. With that, there was a decline in demand, reflected in a decline in goods and services imports. Similarly, the rate of increase in the Composite State-of-the-Economy Index slowed in recent months. Various surveys of current economic activity and of future expectations also indicate a slowdown in recent months. The Research Department forecast of 3.3 percent GDP growth in 2012 was unchanged. The Bank of Israel's preliminary assessment is that Operation "Pillar of Defense" will have little impact on the economy.

Monthly indices of the economic situation

National Accounts data for the third quarter indicate that GDP increased by 2.9 percent and business sector product increased by 2.7 percent (in annual terms). Increases of 3.5 percent in private consumption (excluding durable goods) and of 4.6 percent in exports (excluding start-ups and diamonds) contributed to the growth in GDP. With that, there was a decline in demand for consumer durable goods, investment in machinery and equipment, and investment in transport equipment, reflected in a decline in goods and services imports (excluding defense imports) of 12 percent. Similarly, the rate of increase in the Composite State-of-the-Economy Index slowed in recent months, from an average monthly rate of 0.21 percent in January–July (an annualized rate of 2.5 percent), to an average monthly rate of 0.15 percent in August–October (an annualized rate of 1.8 percent). Various surveys of current economic activity and of future expectations (the Business Tendency Survey of the Central Bureau of Statistics, consumer confidence indices, and the Purchasing Managers Index) also indicate a slowdown in the third quarter of 2012 and assessments are that the slowdown will continue in the fourth quarter of the year. Consumer confidence indices show that in October, the general picture—indicating increased pessimism among consumers with regard to near term developments—did not improve.

The labor market

Labor force survey data which became available this month continue to indicate improvement, at a restrained rate, in employment, continued growth in the participation rate, and a continued decline in unemployment. The participation rate in the third quarter increased by 0.6 percentage points compared with the second quarter, to 64.2 percent, and the unemployment rate declined from 6.9 percent to 6.7 percent. The improvement primarily reflected expanded employment in public services—the number of employee posts in public services increased by 0.9 percent in July–August, while there was a decline of 0.4 percent in the number of employee posts in the business sector. Along with the increase in employment, there was a decline in the number of work hours per employed person, reflected as well in an increase in the share of those who usually work part time out of all employed persons. Nominal wages increased by 1.1 percent, and real wages increased by 1 percent, in June–August compared with the preceding 3 months, based on seasonally adjusted figures. Health tax receipts, which provide an indication of nominal wage payments, were 6.5 percent higher in September–October than in the corresponding period of the previous year, compared with a year over year increase of 7.1 percent in July–August.

Budget data

The deficit in domestic government activity totaled about NIS 17.9 billion in January–October, some NIS 6.1 billion greater than the seasonal path consistent with the Ministry of Finance's deficit forecast (3.4 percent of GDP). The gap primarily reflects a shortfall in tax collection as well as high expenditure. Based on developments to date, the deficit for the full year is projected to reach about 4 percent of GDP, assuming that government expenditure does not surpass the original amount in the budget. An analysis of expected debt repayments by the government for 2013 shows a decline in the repayment amount compared with 2012. Thus, the limitation of expenditure to one-twelfth of the previous year's budget until a new budget for 2013 is passed will have a relatively small effect on other government expenditures. Following Operation "Pillar of Defense", a one-time addition to defense expenditure is expected, but it is too early to assess if it will have an effect on the overall budget.

2. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) for October declined by 0.2 percent. Forecasts projected an increase of 0.2 percent, on average. The main reason for the surprise was a sharper than expected decline in the housing and the fruit and vegetables components. The development of actual prices indicates continued moderation of the inflation environment. The rate of inflation over the previous twelve months was 1.8 percent.

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

Forecasts of the inflation rate over the next twelve months based on the average of forecasters' inflation predictions, and inflation expectations based on over-the-counter CPI futures contracts offered by banks, were relatively stable at around the midpoint of the inflation target range. Expectations calculated from the capital markets (break-even inflation) declined this month, from 2.5 percent to 2.2 percent. Inflation expectations for two years and longer declined for shorter terms to 2.3–2.4 percent, and remained stable for longer terms at around 2.5 percent. Expectations for the Bank of Israel interest rate one year from now derived from the Telbor (Tel Aviv Inter-

Bank Offered Rate) market as well as expectations based on the average projection of forecasters are for an interest rate of 1.8 percent. All forecasters who provide projections to the Bank of Israel predict that the Bank will keep the interest rate for December unchanged.

The interest and yield spreads between Israel and abroad

The yield differential between 10-year Israeli government bonds and equivalent 10-year US Treasury securities declined by 7 basis points, to 249 basis points. Israel's sovereign risk premium as measured by the five-year CDS spread declined slightly this month to 145 basis points, displaying volatility during Operation "Pillar of Defense".

The monetary aggregates

In the twelve months ending in October, the M1 monetary aggregate (cash held by the public and demand deposits) increased by 4.4 percent, and the M2 aggregate (M1 plus unindexed deposits of up to one year) increased by 4.8 percent.

The credit market

The outstanding debt of the business sector declined by 0.7 percent in September, after a decline of 0.2 percent in August. In the past 12 months, the debt has increased by 2.1 percent. Total outstanding credit to households increased in September by 0.6 percent, to NIS 383 billion. The total volume of new mortgages granted in October was NIS 3.4 billion, compared with NIS 3.2 billion in September. The balance of housing debt was NIS 274 billion at the end of September, an increase of 6.6 percent since September of 2011. Interest rates on new mortgages granted in October remained essentially unchanged. Last month, the Supervisor of Banks published a draft directive limiting the loan-to-value ratio in housing loans.

The housing market

The housing component of the CPI (representing rents) declined by 0.8 percent in October. In the twelve months ending in October it increased by 2.2 percent, compared with an increase of 2.8 percent in the twelve months to September. Home prices, which are published in the Central Bureau of Statistics survey of home prices but are not included in the CPI, increased in August–September by 0.5 percent, after increasing by 0.6 percent in July–August. In the twelve months ending in September, home prices increased by 2.2 percent, compared with an increase of 1.4 percent in the twelve months to August.

Activity in the construction industry is strong compared with its levels in the past decade. The number of building starts remains high and is expected to continue to be reflected in an increased stock of homes. At the same time, the level of building starts remains below the record level of mid–2011, and there is a decline in the rate of properties marketed by the Israel Land Administration.

The Bank of Israel Research Department assessment (staff forecast)

The Bank of Israel Research Department's macroeconomic forecast for 2012 and 2013 was published in September. The forecast (which was published as a separate press release together with the interest rate notice for October) projected GDP growth of 3.3 percent in 2012 and 3 percent in 2013. According to the forecast, the inflation rate in 2013 is expected to be 2.2 percent. Some decline in the inflation environment over recent months is likely to support a downward revision of the inflation forecast for the coming year, within the framework of the forecast which will be published with the interest rate notice for January.

3. The foreign currency and stock markets

The foreign exchange market

From the previous monetary policy discussion held on October 28, 2012, through November 23, 2012, the shekel was unchanged against the dollar—with volatility during Operation "Pillar of Defense"—in contrast with most major currencies, which weakened against the dollar. The shekel weakened by 0.2 percent against the euro. In terms of the nominal effective exchange rate the shekel appreciated by about 0.2 percent.

The capital market

From the previous monetary policy discussion held on October 28, 2012, through November 23, 2012, the Tel Aviv 25 Index increased by about 0.2 percent, in contrast to the declines in most stock markets worldwide, and against the background of Operation "Pillar of Defense". The Tel-Bond 20 Index and the Tel-Bond 40 Index each increased by 0.7 percent.

4. Global economic developments

The main factor affecting global financial markets during the past month was the increased concern over budget problems (the "fiscal cliff") in the US. Economic indicators point to moderate improvement in the US and Chinese economies, in contrast to continued recession in Europe, and a deterioration in the economic situation in Japan. In Europe, it appears that the recession is reaching the core eurozone economies; in Germany there was a slowdown in real economic activity. The European Commission's updated growth forecasts for eurozone countries strengthen the pessimistic assessments in terms of a continuing slowdown in those economies next year as well. Concern over the debt crisis in Greece rose again, with the IMF and EU authorities yet to approve the next tranche of the aid package to

Greece. Stock market indices world wide recorded losses for the most part this month. Yields fell on major government bond markets. Inflation rates in leading economies continued to moderate. Commodity prices remained virtually unchanged and oil prices increased slightly.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR DECEMBER 2012

Main points of discussion

The six 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 December 2012, Committee members voted unanimously in favor of leaving the interest rate unchanged at 2 percent.

The discussion focused on the following main issues: (1) the level of activity in the economy and the labor market; (2) the effects of Operation "Pillar of Defense"; (3) the inflation environment and the housing market; and (4) the credit market.

In terms of real economic activity, some Committee members assessed that indicators which became available this month and in particular the picture depicted by various surveys continue to point to a slight decline in the rate of expansion of activity, while other Committee members assessed that the rate of GDP growth has remained at the same level since the second quarter of 2011. Labor market indicators show a mixed picture; although there is continued improvement in employment, this improvement is seen mostly in the public sector, while employment in the business sector has not increased. In addition, there appears to have been a decline in the utilization of production inputs, along with a decline in the level of productivity (which is in line with an increase in the participation rate). Committee members agreed that apparently marked fiscal restraint is not expected from the postponement of approving the budget until after elections, and a switch to administration under the limitation of monthly expenditure of 1/12 of the 2012 budget until then, as debt repayment expenses are expected to be lower in 2013 than in 2012.

Committee members were in agreement that the recent military operation in the Gaza Strip did not have marked effects on the present and future growth rates of the economy, and that there were only moderate effects on the foreign exchange and capital markets. Committee members project a one-time addition to defense expenditures in order to replenish inventories, but it is too early to assess if this will have an effect on the overall budget.

The Committee discussed the moderate inflation environment, as reflected in the low CPI figures in recent months, including the decline in the housing index in October. Some Committee members noted that this is consistent with the assessment that there is some slowdown in growth. With regard to the homes market, Committee members were of the opinion that it is too early to assess the effect of the step taken last month by the Supervisor of Banks limiting the LTV in housing loans.

The discussion also focused on the issue of credit in the economy: Committee members noted the widening gap between interest on credit and the Bank of Israel interest rate, and the continued standstill in the balance of credit to the business sector. With that, Business Tendency Survey data, which do not show an increase in the severity of the credit constraint, are consistent with the estimation that this derives primarily from a decline in demand for credit, as well as an increase in the risk premium, and not from a supply constraint.

Against the background of the reduction of the interest rate last month, Committee members agreed that leaving the interest rate unchanged is consistent with the level of economic activity and the inflation environment as depicted by indicators which became available this month

Following the discussion, the six members of the Monetary Committee voted on the Bank of Israel's interest rate for December 2012. The six Committee members unanimously agreed to leave the interest rate unchanged.

In its announcement, the Bank highlighted the following main considerations underlying the decision to leave the interest rate for December unchanged at 2 percent:

- The rate of inflation over the previous twelve months is at the midpoint of the inflation target range, and inflationary pressures are not visible. Various measures of inflation expectations for the coming twelve months are also around the midpoint of the target range.
- Most economic indicators which became available this month support the assessment that moderate growth in activity has continued, and is expected to continue in the coming months. These indicators are consistent with the Research Department forecast of 3.3 percent GDP growth in 2012 and 3 percent growth in 2013. Various surveys of economic activity continue to indicate pessimism and projections for moderation in activity.
- The level of economic risk from around the world remains high, and with it the concerns over negative effects on the local economy. Economic indicators point to moderate improvement in the US and Chinese economies, in contrast to continued recession in Europe and a deterioration in the economic situation in Japan. Inflation worldwide continues to be low, and commodity prices, which remained stable this month, are expected to continue to support the current level of inflation.
- During the month, most economies did not see a change in monetary policy, and interest rates in major economies remained low. In addition, markets are not pricing in an interest rate increase this year by any of the central banks of the large advanced economies. The quantitative easing policies of the Federal Reserve, the Bank of England, and the Bank of Japan continue.

The Bank of Israel will continue to monitor developments in the Israeli and global economies and in financial markets, particularly in light 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 announced on November 26, 2012.

Participants in the narrow-forum discussion:

Members of the Monetary Committee
Prof. Stanley Fischer, Governor of the Bank of Israel, Chairperson
Prof. Alex Cukierman
Dr. Karnit Flug, Deputy Governor of the Bank of Israel
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
Prof. Nathan Sussman, Director of the Research Department
Mr. Eddy Azoulay, Chief of Staff to the Governor
Dr. Yossi Saadon, Advisor to the Governor and Bank of Israel Spokesperson
Ms. Ana Sasi-Brodesky, Economist in the Research Department
Ms. Esti Schwartz, Monetary Committee Secretary