



BANK OF ISRAEL
Office of the Spokesperson and Economic Information

September 12, 2016

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

The discussions took place on August 24 and 29, 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

The first estimate of second-quarter growth data surprised to the upside. Additionally, significant retroactive revisions were made to National Accounts data. GDP grew by 3.7 percent in the second quarter, and business sector product grew by 3 percent (seasonally adjusted annual data), higher rates than in previous quarters. Private consumption continues to drive growth, increasing by 9.5 percent, and by 7.1 percent excluding personal vehicles. Investment increased by 11.1 percent (though excluding investment in vehicles it contracted by 1.2 percent), and exports increased by 5.7 percent, following several quarters of near-zero growth. Goods exports (excluding ships and aircraft and diamonds, in current dollar terms) declined by 3.3 percent in July, while manufacturing exports have remained stable at a low level over the past six months. Goods imports (excluding ships and aircraft, diamonds and fuels) remained stable in July, and in recent months an upward trend can be seen in the import of raw materials and capital goods. Business services exports (excluding startups) declined by 4.7 percent in May compared with the January–April average, but there has been a renewed upward trend in the past year. The Composite State of the Economy Index increased by 0.2 percent in July, and data for previous months were revised upward, against the background of the revision in growth data. The Consumer Confidence Indices compiled by Bank Hapoalim and by the Central Bureau of Statistics showed improvement in July, with the index compiled by the Central Bureau of Statistics having been improving for about a year and a half. The Purchasing Managers Index increased slightly in July, and remains around 50 points.

The labor market

The picture conveyed by the labor market remains positive. Wage increases continue in all industries, and particularly in the construction industry. Real wages increased by 1.1 percent (seasonally adjusted) in March–May compared with the preceding three months, while nominal wages increased by 0.8 percent. Health tax receipts for May–July were 5.5 percent higher (in nominal terms) than in the corresponding period in the year before, reflecting the increase in employment and wages. Labor Force Survey data for July indicate that the unemployment rate among the principal working ages (25–64) is 4.0 percent, after declining to a historically low level of 3.9 percent in June. The employment rate and the labor force participation rate continued to increase in July. The job vacancy rate increased to a record high of 3.9 percent (seasonally adjusted) in July.

Budget data

The state budget for 2017–2018 was approved by the government. The approved budget deficit is 2.9 percent of GDP in each of the years, higher than the rule set by the previous budget, which dictated a deficit of 2.5 percent of GDP in 2017 and 2.25 percent in 2018. The cumulative domestic deficit (excluding net credit) in government

activity was NIS 1.2 billion in January–July 2016, compared with a surplus of approximately NIS 0.2 billion in the corresponding period of 2015, and it is about NIS 5.7 billion smaller than the deficit in the seasonal path consistent with achieving the deficit target for 2016. The deviation reflects revenues that were NIS 3.9 billion higher than the path, and expenditures that were NIS 1.8 billion lower than the path. Tax revenues in July were about NIS 26.4 billion, which is about NIS 0.2 billion higher than the seasonal path consistent with the estimate of tax revenue (NIS 277 billion). Tax revenues in January–July were about 5.7 percent higher in real terms than in the corresponding period of the previous year. Gross domestic VAT collection increased by about 1.4 percent in real terms compared with July of 2015 (it increased by about 7.4 percent net of the effect of legislative changes).

2. Developments on the nominal side

Inflation

The Consumer Price Index for July increased by 0.4 percent, higher than the average of forecasters' predictions, which was for an increase of 0.2 percent. The fruit and vegetables component increased by 5.7 percent, and the housing component increased by 1.2 percent, while the clothing and footwear component declined by 8.2 percent. The inflation rate as measured by the change in the CPI over the past 12 months was -0.6 percent, compared with -0.8 percent in the 12 months ending in June. Excluding the direct effect of energy prices and administrative price reductions, the CPI increased by 0.8 percent over the past 12 months. Prices of tradable goods in the CPI declined by 3.2 percent over the past 12 months, and the prices of nontradable items increased by 0.8 percent.

Expectations and forecasts of inflation and the interest rate

There was no significant change over the month in inflation expectations for the various ranges. One-year inflation expectations derived from the capital market declined from 0.5 percent last month to 0.2 percent, but following the publication of the CPI, they increased, and currently stand at 0.6 percent. Expectations for inflation over the coming 12 months derived from banks' internal interest rates remained at 0.3 percent, and private forecasters' projections for the next 12 CPI readings are for an increase of 0.6 percent, on average (compared to 0.8 percent in the previous month). Third-year forward expectations remained virtually unchanged (1.1 percent). Longer term expectations remained within the target range with 3–5 year expectations at 1.4 percent, and 5–10 year expectations at 2.1 percent. Most indicators show that there is no expectation of an increase in the Bank of Israel interest rate in the next year.

Monetary aggregates

In the 12 months ending in July, the M1 monetary aggregate (cash held by the public and demand deposits) increased by 23.3 percent, and the M2 aggregate (M1 plus unindexed deposits of up to one year) increased by 12.5 percent.

The credit market

In July, the business sector (excluding banks, insurance companies and foreign companies) issued bonds totaling NIS 4.9 billion, after issuances of NIS 2 billion in June. 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 July and the beginning of August. Since March, funds specializing in corporate bonds in Israel recorded net new investment of about NIS 3 billion, and those specializing in equities in Israel recorded net new investment of about NIS 1 billion. Corporate bond spreads (excluding banks and insurance companies) continued to decline, over the full month, in most industries, and were about 3 percentage points, on average, at the beginning of August—the lowest level in the past two years. In July, which typically has a seasonally high level of new mortgages taken out, the total volume of new mortgages taken out was NIS 5.4 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 July, compared with an average of 14.7 percent in the past 12 months. The average interest rate on mortgages continued to increase in July on all tracks: On the fixed-rate CPI-indexed track, rates increased by 0.22 percentage points, while on the variable-rate CPI-indexed track, rates increased by 0.11 percentage points. Rates on the fixed-rate unindexed track increased by 0.16 percentage points, and on the variable-rate unindexed track rates increased by 0.07 percentage points.

The housing market

The housing component of the CPI (based on residential rents) increased by 1.2 percent in July, following three months of moderate increases (0–0.2 percent). The increase is, for the most part, seasonal. Home prices declined by 0.3 percent in May–June, following eight consecutive months of increases, while figures on the increases in previous months were revised upward. In the 12 months ending in May–June, home prices increased by 6.9 percent, lower than the increase of about 8 percent in the 12 months ending in May. Activity in the market remains robust, with about 8,900 transactions carried out in June, higher than the average over the past 12 months (about 7,800 transactions per month). New home sales declined moderately in June, to about 2,600 (seasonally adjusted), and the stock of homes available for sale remained high, at approximately 28,300 homes in June.

3. The foreign exchange and capital markets

The foreign exchange market

From the monetary policy discussion on July 24, 2016, through August 26, 2016, the shekel strengthened by 2.2 percent against the dollar, and by 1.1 percent in terms of the nominal effective exchange rate. Over the preceding 12 months, the shekel appreciated by 5.1 percent in terms of the nominal effective exchange rate.

The capital market

From the monetary policy discussion on July 24, 2016, through August 26, 2016, the Tel Aviv 25 Index declined by about 1 percent. Government bond yields increased by up to 5 basis points along the unindexed curve, and by up to 10 basis points along the

CPI-indexed 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, remained at about 75 basis points.

4. Global economic developments

The global economy continues to grow moderately, and investment houses' growth forecasts continue to be revised downward. With that, there are no signs so far that the Brexit decision is impacting on activity. World trade increased at a monthly rate of 0.7 percent in June, after declining in May. Major central banks continue accommodative monetary policy. The Bank of England reduced its interest rate, as expected, to 0.25 percent, and adopted several additional accommodative measures. In Japan, the share purchase program was expanded. The central banks of Australia and New Zealand reduced their interest rates. The probability of the US Federal Reserve raising the federal funds rate in 2016 increased this month, against the background of the Fed Chair's remarks at the end of last week noting that "the case for an increase in the federal funds rate has strengthened in recent months". Prices continued to increase in most stock markets, particularly in emerging markets. In the US, second quarter growth of 1.1 percent was disappointing, against the background of a decline in inventories and in fixed capital formation, while personal consumption expenditure continues to drive the economy. The GDPNow Index indicates that growth is expected to improve in the third quarter. In the labor market, the increase in the number of jobs continues. In the real estate industry, the increases in activity and in prices continue. In Europe, there was growth of 0.3 percent in the second quarter (quarterly data) compared with 0.6 percent in the first quarter. Various indices of sentiment in Europe were positive. In the UK, retail sales surprised to the upside in July, but sentiment indices strengthen the assessment that a significant slowdown is expected following the Brexit decision. In Japan, the economy slowed in the second quarter, with growth of only 0.2 percent in annual terms, compared to 2 percent in the first quarter. In addition to the monetary policy measures noted above, the Japanese government announced a broad fiscal program. There are signs of recovery in some of the emerging markets, among other things against the background of stability in commodity prices and the weakening of the dollar. In China, the signs of moderation in economic activity continue, against the background of the long-term structural change the economy is undergoing. The index of commodities excluding energy was virtually unchanged this month. The price of a barrel of Brent Sea crude oil declined at the beginning of the month, but then resumed its increase, to around \$50.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR SEPTEMBER 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 September 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 increase in prices in recent months—the CPI for July was higher than expectations and assessments for it, and was the third successive CPI reading that increased in line with seasonal path consistent with achieving the inflation target. It was noted that the inflation rate as measured by the change in the CPI over the past 12 months remains below the lower bound of the target range. In the view of the Committee members, a major factor in the low level of inflation in Israel is the low rate of inflation abroad, reflected in prices of the CPI's tradable goods, which declined by 3.2 percent. Likewise, inflation was affected by the administrative price reductions, but their impact is expected to expire in the coming months. It was also noted in the discussion that although prices of nontradable items increased by a rate slightly lower than the lower bound of the inflation target range, it was the Committee's opinion that their increase would gather strength, affected by the wage increase, to the extent it continues. It was noted that while the wage increase acts to raise the unit labor cost, the decline in commodity prices worldwide acts in the opposite direction, so that the rise in wages has not yet turned into an increase in the domestic inflation rate.

The discussion on real economic activity focused on the revised growth data and on the labor market. Committee members were of the opinion that the growth rate in the first half of 2016—near to 3 percent, according to the revised data—reflects a growth rate that is consistent with the robust labor market. Similar to previous quarters, growth was driven by the increase in private consumption (and particularly durable goods consumption), but as opposed to those quarters, second quarter data show an improvement in exports as well, though their level is not markedly different from the level in 2012. The Committee noted the strong employment data and low unemployment data accompanied by a continued increase in the number of job vacancies. Against this background, the Committee referred to the increasing difficulty in filling job vacancies, and not only in high tech industries. This difficulty, if it continues to increase, is liable to serve as a limitation on the growth rate in the future. Looking forward, the Committee members assessed that the current interest rate environment supports a continued trend of growth and employment, while the main risks to continued growth are liable to derive mainly from negative developments in the world.

In terms of the global environment, the issues noted in the discussion were low US growth data despite good employment data; continued slow growth in the eurozone, led by Germany and Spain, and expectations of relatively high growth in emerging markets. Against this background, the Committee members referred to an increase in the probability that the US Federal Reserve will increase the federal funds rate in 2016. In terms of the exchange rate, the Committee members again noted that against the

background of the appreciation this month, the level of the exchange rate is expected to continue weighing on the development of exports.

Regarding the housing market, the Committee members referred to the negative home-price index reading that was published in the past month, and said that it is not enough to indicate a change in trend, primarily against the background of the high level of activity. Although the rate of price increases in the past 12 months moderated slightly, it remains high.

In conclusion, the Committee members 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. They 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 September 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 September 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, the developments in growth in Israel and 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:

- The Consumer Price Index for July increased more than expected, following three successive positive CPI rates of change. Short-term inflation expectations remained low this month, and are still below the lower bound of the inflation target range. Medium and long-term expectations remain anchored within the target range.
- In the first half of 2016, the economy grew by 2.9 percent, similar to the average growth rate of recent years. In the second quarter, based on the first estimate of National Accounts data, growth was higher than expected, at 3.7 percent. However, it is too early to establish if this rate, which is higher than the recent years' average, will be sustained. Private consumption continues to drive growth, supported by the increase in wages and by accommodative monetary policy. Exports increased at an

adequate rate, although it still lags world trade growth. The picture conveyed by labor market data remains positive, and there are signs that the economy is nearing full employment.

- The global economy continues to grow at a moderate rate. Second quarter growth data for major economies were low, and weakness continues in world trade. Monetary policy is very accommodative in Europe, Japan, and the UK, and additional central banks reduced interest rates this month. In the US, there was an increase in the probability that the federal funds rate will be raised this year, though the uncertainty surrounding it is still high.
- From the monetary policy discussion on July 24, 2016, through August 26, 2016, the shekel strengthened by 2.2 percent against the dollar. In terms of the effective exchange rate, the shekel appreciated by 1.1 percent, and has appreciated by 5.1 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.
- Although the most recent observation indicated a decline in prices, the rate of increase in home prices remains elevated, and the levels of transactions and mortgage volumes remain high. The stock of homes for sale continues to be high.

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 August 29, 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. Ynon Gamrasni, Economist in Research Department

Mr. Daniel Hahiashvili, Chief of Staff to the Governor

Mr. Daniel Natan, Economist in Research Department

Ms. Esti Schwartz, Secretary of the Monetary Committee

Mr. Yoav Soffer, Spokesperson of the Bank of Israel