



Bank of Israel

Report to the public of the Bank of Israel's discussions prior to setting the interest rate for October 2006

The broad-forum discussion took place at the Bank of Israel on September 20, 2006, and the narrow-forum discussion on September 25, 2006.

General

Before the Governor makes the monthly interest-rate decision, discussions are held at two levels. The first takes place in a broad forum, in which the relevant background economic conditions are presented, including real and monetary developments in Israel's economy and developments in the global economy. Participants in this discussion include the Governor, the Deputy Governor, the directors of the various economic departments of the Bank (Research Department, Monetary Department, Foreign Currency Department, Foreign Exchange Activity Department) and economists from different departments who prepare and present the material for discussion.

In the narrow forum, the department heads present their recommendations regarding the interest rate and following a discussion, the Governor makes his decision.

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

1. Developments on the real side

General

In analyzing the state of the economy on the real side, the discussants related to data reflecting both the situation shortly before the fighting in the north began and the situation expected after the fighting. The data on real activity indicate that output recovered swiftly from the shock caused by the fighting.

State of the economy shortly before the eruption of fighting in the north: On the eve of the hostilities, the economy was in the midst of rapid growth. According to National Accounts data, the economy grew at a 5.7 percent pace and the business sector by 7.5 percent in the first half of the year (both rates in annual terms).

The effects of the fighting on the economy: The main long-term economic damage occasioned by the hostilities will be felt in inbound tourism. The GDP growth forecast for 2006 is estimated at 4.6 percent as against 5.4 percent before the fighting; the 2007 forecast is 4 percent. Most of the growth slowdown in 2007 is expected to result from a deceleration in the growth rate of the output of public-services..

Balance-of-payments and foreign trade

The surplus on balance-of-payments current account continued to grow in the first half of 2006, and reached \$3.6 billion (almost 5.5 percent of mid-year GDP). The favorable foreign-trade data for August show that the economy recovered rapidly from the fighting. Total exports (seasonally adjusted and excluding ships, aircraft, and diamonds) grew by 4.2 percent in August relative to July, **[NB PLS CHECK THIS NUMBER – IT’S VERY HIGH]**, which is consistent with the upward trend since the beginning of the year. Imports of goods (seasonally adjusted and excluding ships, aircraft, and diamonds) increased by 17.8 percent in August relative to July, and by 6.8 percent excluding imports of energy products.

Labor market

The unemployment rate was largely unchanged, at 8.9 percent as against 8.8 percent in the previous half-year. The slight increase in unemployment was caused by an upturn in the labor-force participation rate; had the participation rate remained stable, the unemployment rate would have fallen to 8.3 percent.

According to National Insurance data, the average real wage per employee post increased by 1.3 percent in the first half of 2006 relative to the year-earlier period. Unit labor cost declined slightly during the first half of 2006 due to an increase in productivity.

2. Budget

Tax revenues in 2006 are expected to exceed the budget outlook by NIS 10 billion (4.8 percent). Assuming that the budget will be implemented in full, the total deficit is expected to be 1.4 percent of GDP, or 1.7 percent including civil compensation that is not covered by the property tax fund. In the 2007 budget as approved by the government, the deficit target was raised to 2.9 percent of GDP and the limit on expenditure growth was increased by 1.6 percent, temporarily, due to expenses related to the war in the north and by 0.5 percent due to expenses related to the disengagement. The government’s budget proposal must be approved by the Knesset.

3. Developments on the nominal side

Inflation

The August Consumer Price Index was flat, affected mainly by increases in the prices of fuel and recreation and vacation services and a seasonal decrease in clothing prices. Dollar-denominated owned housing prices increased, following upturns in June and July. The total CPI rose by 2.2 percent in the past twelve months and by 1.7 percent since the beginning of the year, which is consistent with keeping inflation within the target range.

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

Inflation expectations for the next twelve months, , as derived from the capital market, have been close to the mid-point of the target range in recent months. In September, expectations stood at 1.9 percent on average, unchanged from the previous month.

After the CPI data for August were released, the forecasters lowered their estimates of inflation for the next twelve months from 1.9 percent to 1.7 percent. The average inflation outlook for 2007 also declined, to 1.8 percent.

Interest-rate expectations as derived from the money market (the *makam* curve) indicate that the markets expect no significant change in the Bank of Israel rate during the coming year.

Makam and bond markets

Nominal and real yields shifted moderately in September. The real curve dipped (by up to 0.1 percentage point) at the short end and rose slightly at the long end, resulting in a term structure that was essentially flat, at 3.9 percent. Nominal yields climbed by up to 0.1 percentage points at almost all maturities, from 5.9 percent at the short end to 6.5 percent at the long end (ten years).

Makam yields remained unchanged and the curve was flat at 5.8 percent.

Interest spread and yield gap between Israel and abroad

The NIS/\$ interest spread stands at 0.25 percentage point. U.S. capital market data indicate a strong probability of no change in the U.S. federal funds target rate in the coming months.

The nominal yield gap between Israeli shekel denominated bonds (Shahar) and the U.S. dollar bonds at the ten year maturity continued to widen during the past month, rising by more than 20 basis points to slightly above 170 basis points (4.79 percent as against 6.52 percent) as against 150 basis points a month earlier and 125 basis points shortly before the fighting erupted. The gap between U.S. bonds and those of other emerging-market economies also widened in the past month.

Expected real interest rate

The expected short-term real interest rate was unchanged in September at 3.7 percent and has hardly changed since the beginning of the year

Money supply

The annual growth rate of the money supply (M1) has been trending downward since the beginning of the year and fell from 14.3 percent in July to 12.2 percent in August. The growth was led by the increasing in deposit component in the money supply, which grew by 15.2 percent, as against the cash component, which expanded by 8.3 percent.

Econometric models¹

The various scenarios that were generated using the Bank of Israel's econometric models show a strong connection between the behavior of the exchange rate and

¹ The Bank of Israel uses econometric models to test various scenarios. Due to their nature, including the fact that their results naturally depend on certain assumptions about relevant variables, the scenarios should be viewed as one input among several in the discussions on the interest rate.

inflation. (The results of the models are referred to in the section of this report on the narrow-forum discussion, below).

4. Capital flows, foreign-currency market, and share market

Capital flows

Activity in all major market segments was rather moderate in the past month. This behavior traces to the strong economic fundamentals that were in place immediately before the fighting began, including the credibility of macroeconomic policy.

Foreign-currency market and share market

The shekel continued to appreciate in the past month—from around NIS 4.40 to the dollar shortly before the fighting began in July to around NIS 4.32 in the days immediately preceding the interest-rate decision. The shekel appreciated by a similar amount against the currency basket.

The share market lost ground during the first days of the fighting but afterwards recovered to pre-hostilities levels.

5. Israel's financial risk, risk premium, and foreign investment house surveys

Israel's risk premium as measured by the five-year CDS spread was unchanged in September at 31 basis points. Other emerging-market economies also showed no change in their risk-premium as measured by this metric.

S&P, Fitch, and Moody's surveyed Israel's fiscal situation in view of the new government budget. Their announcements indicated that they accept the widening of the budget framework and the deficit due to the costs of the fighting, but they noted that this will slow the reduction of Israel's debt/GDP ratio. The ratings companies left their Israel ratings and outlooks unchanged but stressed the need for the government to stay within the new budget limits if the rating is to be maintained.

6. Global economic developments²

Global growth is holding firm and is expected to remain vigorous in 2007. The composition of global growth is becoming more balanced as growth in Europe, Japan, and the developing countries—especially China and India—is expected to increase and offset the current and expected slowdown in U.S. growth.

B. NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR OCTOBER 2006

Inflation over the past twelve months has fallen to 2.2 percent, around the mid-point of the target range. The inflation estimates and expectations for twelve months ahead

² Further details on main developments in the U.S., Europe, Japan, and the emerging-market economies are presented in the Appendix.

and longer are also close to the mid-point of the target range. According to expectations derived from the markets, and to private forecasts, the markets expect no significant change in the Bank of Israel interest rate during the next year.

The GDP loss occasioned by the fighting is believed to be temporary and is not expected to have a long-lasting effect on future growth and inflation. In other words, the GDP gap is expected to continue narrowing and the unemployment rate to decline gradually. Continued long-term capital inflows and the large surplus on balance-of-payments current account is expected to continue to subject the shekel to appreciation pressure, thereby dampening inflation.

A considerable part of the discussion this month was devoted to consideration of the effects of the hostilities in the north on domestic economic activity. The data on real activity point to a rapid recovery of activity after the fighting, with the negative impact of the fighting on economic activity expected to be concentrated in the third quarter of the year. On the eve of the hostilities, the economy had been on a rapid growth trajectory accompanied by a narrowing of the GDP gap. In the first half of the year, GDP grew at a 5.7 percent rate and the business sector by 7.5 percent (both rates annualized). The adjusted growth outlook for 2006 stands at 4.6 percent as against 5.4 percent before the fighting, and the growth rate expected for 2007 is 4 percent. Generally speaking, the fighting is not expected to cause significant damage to demand because some of the decline in private-sector demand will be offset by an increase in government expenditure. The belief that aggregate demand will not change significantly, coupled with the temporary and limited nature of the supply-side damage, leads to the conclusion that the fighting is unlikely to have a material effect on price developments.

The unemployment rate stood at 8.9 percent in the second quarter of 2006. The unemployment rate failed to decline due to an upturn in the labor-force participation rate. Discussants saw no significant inflation pressures arising from the labor market, after a slight decline in unit labor cost in the first half of 2006 due to the rapid increase in productivity.

In September, as in August, estimates of the fiscal cost of the fighting and its implications for the state budget were discussed. In view of the costs of the fighting and the attendant economic damage, the government decided to increase its spending. Real government expenditure is projected to grow by nearly 3 percent in 2006. (The increase is composed of a 1 percent real increase in the state budget plus an expected increase in the rate of fulfillment of budget spending plans.) For 2007, it was decided to raise the spending limit by an extra 1.6 percent (beyond the 1.7 percent increase already agreed upon) due to war-related expenditures and 0.5 percent for the costs in 2007 of the 2005 disengagement.³ The spending increase is expected to raise the government deficit to 1.7–1.8 percent of GDP this year and 2.8–2.9 percent in 2007. Political pressures to increase budget spending both to improve defense preparedness

³ For technical reasons this will be added to the *increase* in government spending, even though disengagement spending will be lower in 2007 than it was in 2006.

and to tackle welfare-related issues increased uncertainty about the government's budget decision before it was approved in September. . This uncertainty may persist for the next few months, until the Knesset approves the budget. Referring to the budget pressures, the discussants noted the importance of staying within the budget limits in order to help maintain economic stability and bolster the confidence of domestic and foreign investors in the performance of the Israeli economy, especially in view of Israel's heavy debt burden.

The strength of Israel's financial markets continued to stand out in September. . This stability reflects the strong fundamentals prior to the fighting, the belief that the basic macroeconomic framework would be maintained, and the belief that the economic effects of the fighting will be relatively minor. During the hostilities (except for the first few days) and afterwards, the financial markets displayed robustness. After the fighting, the risk premium as measured by the five-year CDS spread reverted to pre-fighting levels and remained stable in the past month. However, the yield gap between ten-year *Shahar* bonds and U.S. government bonds to the same term widened to 170 basis points as against 125 basis points shortly before the fighting began. In the past month, the shekel continued to appreciate in the foreign-currency market and was stronger than before the fighting began. The NIS/\$ central bank interest spread remained steady at 0.25 percentage point.

The discussants also noted that after rising oil prices contributed to an acceleration of inflation at the beginning of the year, the downward trend in global energy prices in recent months is expected to mitigate price increases in the short term.

The participants referred to scenarios that were run using the Bank of Israel's econometric models. In scenarios that envisaged the continuation of current exchange and interest rates, inflation was projected to fall to the lower part of the target range by year's end.

The discussants noted that the appreciation of the shekel against the dollar has eased inflation pressures and this effect will continue as long as these developments do.

Overall, the receding of inflation to the mid-point of the target range, the appreciation of the shekel in the foreign-currency market, and the decline in global energy prices are important factors that are acting to strengthen price stability, against budget uncertainty originating in demands and pressures for more government spending.

In view of these various considerations, all the department directors who took part in the discussion recommended that the interest rate for October be left unchanged. The Governor decided to leave the rate for October at 5.50 percent.

The decision was made and published on September 25, 2006.

Those present at the discussion:

Prof. Stanley Fischer, Governor of the Bank of Israel

Prof. Zvi Eckstein, Deputy Governor of the Bank of Israel

Dr. Edward Offenbacher, Director of the Monetary Department
Barry Topf, Director of the Foreign Currency Department
Balfour Ozer, Director of the Foreign Exchange Activity Department
Dr. Karnit Flug, Director of the Research Department
Dr. Ohad Bar-Efrat, Head of International Affairs and Advisor to the Governor
Gaby Fiszman, Chief of Staff to the Governor
Amnon Yaacoby, Advisor to the Governor

Appendix: Major Global Economic Developments

U.S.

The main questions on today's agenda are the intensity of the American economic slowdown and the extent of its effect on the global economy. Will the pace of inflation in the coming months correspond to the Fed's estimate, with inflation expectations abating over time in view of the growth slowdown, or will U.S. inflation maintain and even gather strength? The main scenario speaks of a "soft landing." Under this scenario, which is expected by the Fed, the growth rate will slow as the housing market cools gradually and earlier interest rate increases have a lagged effect, but the new growth rate will be only slightly lower than the potential long-term growth rate of around 3 percent. This scenario is shared by the IMF, which expects the U.S. growth rate to slow from 3.4 percent this year to 2.9 percent in 2007, and is supported by data from the labor market, consumer spending, retail sales, and consumer confidence indices, which have remained stable. The business sector is also displaying stability at a high level of activity. Even in the construction industry, the leading sector in the activity slowdown, the major slump in the housing market is not matched by any such development in the business real-estate market. One factor does favor an upturn in inflation: the sizable increase in unit labor cost in recent quarters (9 percent in the first quarter of 2006 and 5 percent in the second quarter).

Market data imply only a 16 percent probability of another rate hike by year's end and a 25 basis-point decline in the first half of 2007.

Europe

Growth in Europe is gathering strength and expanding in breadth. Domestic demand is firm in view of strong corporate profits and an improvement in the labor market, accompanied by increases in employment and wages. The business-confidence and consumer-confidence indices are continuing to trend upward, supporting the belief that growth in 2006 will slightly surpass the potential growth rate, which the ECB estimates at 2 percent. The IMF raised its 2006 growth outlook by half a percentage point, to 2.5 percent, but left its 2007 outlook at 2 percent. The slowdown in 2007 is expected to originate mainly in a slowdown in global growth, appreciation of the euro against the dollar, and monetary and fiscal restraint.

The ECB expects inflation to remain above its 2 percent target in the second half of 2006 and in 2007. This outlook carries an upward-biased risk due to concern about unexpectedly strong transmission of previous increases in oil prices to consumer prices, the raising of indirect taxes in Europe, and unexpectedly large wage increases.

As expected, the ECB left its key rate for October unchanged at 3.00 percent, explaining that this rate is still low and that liquidity in the euro area remains strong. The markets and the investment houses expect the rate to climb to 3.5 percent by year's end with near certainty and express the probability of another increase in the first half of 2007 at 70 percent.

Japan

Japan's growth rate slowed to only 1 percent in the second quarter as against 2.7 percent in the first quarter. Still, domestic demand remained firm, the labor market continued to improve, and the unemployment rate is falling. The investment houses predict an average annualized growth rate of 3.3 percent in the second half of the year.

The Consumer Price Index was the focal point of interest in September as its base year was changed from 2000 to 2005. The new base implied much lower inflation data than those previously recorded. For example, in July the total CPI climbed by 0.3 percent and the core index by 0.2 percent, as against 0.8 percent and 0.6 percent, respectively, under the previous reckoning. But even according to the adjusted series, the pace of inflation has picked up and has been positive for the past two months. However, the significant decline in the inflation rate led to a change in investors' assessments. Thus, ten-year yields fell by almost 20 basis points and expectations of another rate hike in Japan receded into the more distant future.

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