Bank of Israel

Report to the public of the Bank of Israel's discussions prior to setting the interest rate for November 2007

The discussions took place on October 28 and 29, 2007

November 2007

General

Before the Governor makes the monthly interest rate decision, discussions are held at two levels. The first discussion 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 economic departments of the Bank (the Research, Monetary, Foreign Currency, and Foreign Exchange Activity departments) and economists from various departments who prepare and present the material for discussion. The data, estimates and assessments in these minutes are those that were available at the time of the discussions.

In the narrow forum, the directors of the economic departments 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 assessment

The Bank of Israel's current assessment for 2007 is that growth will reach 5.4 percent. The rapid growth trend of the last few years continued in the first half of 2007, and is expected to continue in the second half too. Some recently published data suggest that the rate of growth might be slowing a little—the composite state-of-the-economy index for September, for example, rose by only 0.3 percent, due mainly to a reduction in the August index of manufacturing production. It is too soon, however, to reach conclusions about the significance of those figures for the growth trend, particularly in light of the information derived from the Bank of Israel's Companies Survey for the third quarter of 2007, which shows that rapid economic growth was maintained. The Bank of Israel expects growth in 2008 to slow to 4.4 percent, mainly because of the contraction of the output gap and the economy's convergence to full employment. A scenario was presented in which the US economy slides into a recession, leading to a sharper global slowdown and hence also a more severe dampening of world trade, which would drag the growth rate down even further, to 3.6 percent.

National Accounts data

The Central Bureau of Statistics (CBS) estimates indicate continued rapid growth, with some deceleration in the second half of the year. The estimate of GDP growth in 2007 published by the CBS was revised upwards last month from 5.1 percent to 5.2 percent. According to the CBS, GDP grew at a rate of 6.1 percent in the first half of the year, so the implied growth rate in the second half is 5.6 percent.[1]

The CBS estimates that private consumption will increase by 6 percent in 2007, and investment in the principal industries by 14.4 percent.

The Bank of Israel's Companies Survey

According to the Companies Survey for the third quarter of 2007, the rapid growth rate was maintained. The rise in activity encompassed all the principal industries, including construction and hotels. Companies participating in the survey expect the upward trend to continue in the fourth quarter.

Composite state-of-the-economy index

The composite state-of-the-economy index rose by 0.3 percent in September, a relatively modest rate compared with growth in the first half of the year. This reflected a fall in the indices of goods and services exports in September, and a moderate fall in the indices of manufacturing production and trade and services revenue in August.

The labor market

National Insurance Institute data show that the average real wage per employee post was 3 percent higher in May–July than in the equivalent period in 2006, while the average nominal wage per employee post was 2.4 percent higher.

As a result of the rise in labor costs and some decline in output per man-hour, there was a modest increase in unit labor costs from 2007:Q3.

The Bank of Israel estimates that unemployment will fall from an average of 7.7 percent in 2007 to an average of 7.3 percent in 2008, together with a continued rise in the rate of participation in the labor market and a rise in employment.

Foreign trade

Goods imports and exports both continued to expand rapidly in the third quarter. Goods exports (excluding diamonds) increased at an annual rate of about 15 percent from the second to the third quarter (in nominal dollar terms, seasonally adjusted). The upward trend of goods exports flattened a little in the last few months, with considerable inter-month volatility. Goods imports (excluding ships, planes, diamonds and energy products) grew at an annual rate of about 25 percent in 2007:Q3 from the previous quarter (in nominal dollar terms, seasonally adjusted).

2. Budget data

[1] The annual rate of growth is calculated from the average for 2007 compared with the average for 2006. The growth rate for each half year is calculated against the previous half year.

Budget performance so far in 2007 is consistent with convergence to a balanced budget in 2007. This is mainly due to tax revenues in excess of the forecast path and government expenditure lower than the level consistent with full performance of the budget. It should be noted that the budget deficit ceiling set by the government for 2007 is 2.9 percent of GDP.

The proposed budget for 2008 passed its first reading in the Knesset in October, after being approved by the government in August. The budget sets the deficit ceiling at 1.6 percent of GDP, and the real increase in government expenditure at 1.7 percent.

3. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) rose by 0.5 percent in September, in line with forecasters' predictions, and below the seasonal path consistent with the inflation target. In the last twelve months the index rose by a total of 1.4 percent, and in the nine months since the beginning of 2007 the CPI has risen by a cumulative 2.3 percent.

If the elements of the CPI (excluding housing, fuel, and fruit and vegetables) are divided into a domestic and an imported component, it can be seen that domestic prices rose rapidly in 2007:Q3, albeit slightly slower than in the previous two quarters, and import prices also rose.[2]

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

Inflation expectations for the next year as derived from the capital market (break-even inflation) did not change in October and remained at an average of 1.2 percent, after declining by half a percentage point in September.

Predictions of Israeli forecasters for inflation one year forward are on average around 1.9 percent. On average, local forecasters expect the change in the CPI in 2007:Q4 to be close to zero, and inflation for the year to reach 2.3 percent, and 2.2 percent in 2008.

On average, local forecasters expect that the Bank of Israel interest rate will not change before the end of the year, but that it will be 4.5 percent at the end of 2008.

Before the interest rate decision for November, the slope of the *makam* curve also reflected expectations in the financial markets that the Bank of Israel interest rate will rise over the next year by 0.5 percentage points.

The makam and bond markets

The interest on 10-year indexed bonds rose fell from an average of 3.7 percent in September to 3.5 percent in October. The nominal yield on 10-year unindexed government bonds dropped by 0.3 percentage points over the past month, and in October averaged 5.7 percent. The yield on one-year *makam* went down from an average of 4.7 percent in August and September to an average of 4.4 percent in October.

[2] For a fuller discussion of the issue of the domestic and import components of inflation, see the Bank of Israel Annual Report for 2006, pp. 105–107 and Box 3.2 on pp. 128–131, and Box 1 on pp. 35–37 in the Bank's Inflation Report No. 20, January–June 2007.

The interest rate differential and the yield gap between Israel and abroad

Before the current interest rate decision, the Bank of Israel interest rate was 0.75 percentage points lower than the US federal funds rate, and the same as the ECB rate.

The gap between the yields on unindexed shekel bonds and US 10-year bonds widened during the last month from about 114 basis points on September 24 to about 123 basis points on October 25, mainly attributable to the fall in yields in the US..

The expected real interest rate

The expected real interest rate (the Bank of Israel interest rate *minus* inflation expectations) for one year forward was about 2.8 percent in October, similar to its rate in September.

The money supply

The rate of increase of the (M1) money supply is on a rising trend, and in September it reached 20 percent (the increase over the previous twelve months), up from 16.5 percent in July. The rapid increase in the aggregate stemmed mostly from the 25 percent rise in current-account deposits. The cash element rose by a more moderate 14 percent.

The econometric models[3]

Various scenarios were examined using the Bank of Israel's econometric models. According to the Research Department's quarterly model, in which the contraction of the output gap constitutes a dominant inflationary element, under the assumption that the exchange rate remains around NIS 4.05 to the dollar) and that the Bank of Israel's interest rate rises to 4.75 percent, inflation in the next twelve months would be about 2.4 percent, and in 2009 would be close to the upper limit of the target range. According to the Monetary Department's quarterly model, in the scenario with the Bank of Israel interest rate at 4 percent in 2007:IV (and 4.3 percent at the end of 2008) and with an average exchange rate of NIS 4.05 to the dollar in 2007:IV (reaching NIS 4.10 to the dollar in 2008:Q4), inflation would reach 2.6 percent in 2007 and 1.5 percent in 2008. The results of both models are sensitive to changes in the exchange rate.

4. The foreign currency market and the share market

The foreign-currency market

The shekel appreciated against the dollar, from NIS 4.04 to the dollar on September 24 (the date of the last interest rate decision) to NIS 4.01 on October 25, a 0.7 percent change. The shekel depreciated a little against the euro, from NIS 5.69 to the euro on September 24 to NIS 5.74 on October 25. In other words, the dollar continued to weaken around the world.

---

[3] 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.

The share market
The TA-25 index rose between the previous interest rate decision and the current one by about 6.5 percent, and since the beginning of the year it has risen by a total of 28 percent.

5. Israel's financial risk, the sovereign risk premium

Israel's risk premium as measured by the five-year CDS spread declined this month from around 30 basis points to 22 basis points. In most emerging markets, too, the CDS spread narrowed.

6. Global economic developments (see Appendix for greater detail)

The crisis in the financial markets that erupted in July eased somewhat in the last month. Nonetheless, the effects of the crisis are still evident, and some markets are still experiencing the pressure it caused.

This month the IMF revised its forecasts of world growth downwards. In those forecasts the crisis in the international financial markets is expected to reduce global growth to 4.8 percent, down from the previous forecast in July 2007 of 5.2 percent.

At the time of the current discussions (October 28 and 29), the Federal Open Market Committee was expected to cut the interest rate twice till the end of the year, with the first reduction expected at the next meeting, on October 31. The ECB and the Bank of Japan were expected to leave their rates of interest unchanged till the end of the year.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR NOVEMBER 2007

In the light of developments since the previous interest rate decision on 24 September 2007, the discussion focused on participants' assessments of inflation developments, economic growth and its effect on inflation, and an analysis of the factors affecting the shekel exchange rate. The participants discussed the effect of the crisis that began in July in the world financial markets on world growth in general and US growth in particular, and the implications of these developments on the Israeli economy.

All the department directors participating in the discussion recommended leaving the interest rate unchanged this month at 4.0 percent. They gave the following as the main reasons for their recommendation:

- Given the current level of interest rate, the weakening of the dollar vis-à-vis the shekel offsets the inflationary pressures. The expected cut in the interest rate by the Fed constitutes a factor supporting the weakening of the dollar worldwide. The inflationary pressures in the economy are expressed in the rise of local prices, against a background of continued rapid growth in the economy and the narrowing of the output gap. In addition, there have also been price rises deriving from the increase in prices worldwide of certain imported goods, such as energy and food.

- The assessment of the Bank of Israel is that the interest rate at its current level is consistent with achieving the target of price stability in the next 12 months, based on, *inter alia*, expectations of the capital market, private forecasters' predictions and judgments regarding various scenarios examined using the Bank of Israel's models. CPI figures for the coming months are expected to be low and the inflation rate for 2007 is expected to be within the inflation target range. Inflation expectations for the coming year, as derived from the capital market, stand on average close to the lower limit of the target range, though this is with the expectation of a rise in the interest rate over the next year.

It was noted in the discussion that if growth in the US did indeed slow down significantly in the last quarter of the year and in the beginning of 2008, then this could have a moderating effect on demand and prices in Israel. For now, the fall in activity in the US housing market is partially offset by the increase in US net exports, supported by the weakening dollar. Most forecasts of US growth predict a deceleration. In the discussion it was noted that the financial effects of the crisis in the US mortgage market are already expressed in the lower interest rates in the US, which in itself supports the weakening of the dollar. The time span required for the possible real effects of the crisis to extend to the Israeli economy is longer and the uncertainty regarding them is very high.

Taking into consideration all of the above, and as currently the effect of the weakening dollar against the shekel offsets the inflationary pressures associated with the closing of the output gap, the Governor decided to leave the interest rate for November 2007 at its current level of 4.0 percent.

The Bank of Israel will continue to monitor economic developments closely with the intention of achieving the price-stability target. Subject to this, the Bank will continue to support the attainment of a range of objectives of macroeconomic policy, in particular the encouragement of employment and growth. In addition, the Bank will continue to support the stability of the financial system.

The decision was made and published on October 29, 2007.

Those present at the narrow-forum discussion:
Prof. Stanley Fischer, Governor of the Bank of Israel
Prof. Zvi Eckstein, Deputy Governor of the Bank of Israel
Dr. Karnit Flug, Director of the Research Department
Dr. Edward Offenbacher, Director of the Monetary Department
Mr. Barry Topf, Director of the Foreign Currency Department
Mr. Balfour Ozer, Director of the Foreign Exchange Activity Department
Dr. Ohad Bar-Efrat, Advisor to the Governor and Head of International Affairs
Mr. Gaby Fiszman, Chief of Staff to the Governor
Mr. Yossi Saadon, Bank of Israel Spokesperson

Appendix: Major Global Economic Developments

U.S.

Recently published economic data show that the immediate negative impact of the latest credit crisis has remained limited. The labor market remained strong, despite signs of isolated weaknesses, and moderated the concern of a significant slowdown in the US. Employment increased in September, and real wages continued to rise.

However, the slowdown in the US housing market is more serious than originally expected. Housing starts dropped by more than 10 percent in September (the lowest figure in 14 years), house sales, and house prices fell, and stocks of new housing for sale grew.

At the same time as these risks to growth became evident, the US Federal Reserve remained concerned too about inflation risks, particularly against the background of high prices of energy, raw materials and food, and the fall in the dollar exchange rate which brought about a rise in import prices. This against a background of pressures from increased pressure in the labor market.

The consumer price index in the US increased in the 12 months to September by 2.8 percent. The deceleration in growth is expected to help in moderating the inflationary pressures.

The probability of the Fed's reducing its federal funds rate at its meeting at the end of October (a few days after the Bank of Israel discussion on the November interest rate) rose considerably in the past month and futures contracts currently factor in an almost certain cut of 25 basis points at the October meeting, and a further 25 basis point cut by the end of the year with a high probability.

Europe

Europe’s economy accelerated in the third quarter of the year and it seems that the effect of the latest crisis in the financial markets on European growth is expected to remain limited. However the strengthening of the euro, the rise in oil prices, and the tightening of credit conditions are expected to impact growth, which has been fueled up till now mostly by investments and exports. According to the IMF forecast published this month, growth in Europe is expected to reach 2.5 percent in 2007 and 2.1 percent in 2008.

The IMF also expects inflation in the euro area to remain at the level of 2 percent in both 2007 and 2008.

The ECB left its key interest rate unchanged this month at 4.0 percent, though it maintained a bias to tightening monetary policy. Investment houses and futures contracts on ECB rates expected that the interest rate in Europe will remain unchanged for at least until the end of the first quarter of 2008.

Japan

Growth in Japan recovered in the third quarter after slowing down considerably in the second. Increases were registered in both exports and industrial output in August. However, consumer spending which remained low, global economic deceleration and a rise in prices of energy and commodities, are expected to slow the rate of growth. In addition, a change recently introduced in building standards, caused a delay in building permits and brought about a drop of more than 43 percent in building starts in August, a fact that is expected to amplify the impact on growth. The IMF lowered its growth forecast for Japan to 2 percent for 2007 and 1.7 percent in 2008, against a background of greater deceleration than expected in the global economy.

At the same time, inflation is expected to remain around zero this year and to become positive only in 2008, according to the IMF forecast.

As expected, the central bank left its interest rate unchanged this month at 0.5 percent. The investment houses and futures contracts on the Bank of Japan's interest rate expect on average that interest rates will rise only in 2008.

The emerging markets

The emerging markets continued to enjoy underlying positive economic data, low political risk, attractive stock markets, as well as positive technical data. The emerging markets also were affected by the latest crisis in the global financial markets although the effect on these markets remained limited and was less than in previous crises.

The IMF noted in its review the emerging markets' great contribution to world growth, particularly the rapid growth in China, India and Russia.

Inflationary pressures in many emerging markets rose, against a background of strong growth and rises in food prices. This increased the need for, and the probability of, a rise in interest rates in these markets.