Bank of Israel

October 08

Report to the public of the Bank of Israel's discussions prior to setting the interest rate for October 2008

The discussions took place on 21 and 22 September 2008[1]

General

Before the Governor makes the monthly interest rate decision, discussions are held at two levels—the first in a broad forum, and the second in a narrower forum.

In the broad-forum discussion, 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 Research and Market Activity Departments of the Bank 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 Research and Market Activity Departments and other members of Management 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

Israel's economy is still on a path of growth, although the rate of expansion of economic activity since the second quarter of 2008 has been below that of the last few years. The revised Bank of Israel forecast is of 4.7 percent growth in 2008. This assessment is based on an annual growth rate of 2.5 percent in the second half of the year. The average rate of unemployment is expected to be 6.1 percent in 2008.

The composite state-of-the-economy index

The August composite state-of-the-economy index showed a rise of 0.1 percent, following no change in the June and July indices (after an upward adjustment to the data for July). The movement of the index over the last three months is consistent

[1] These were the first discussions to take place under the new departmental structure resulting from the reorganization of the Bank.

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with a slowdown in the rate of growth from the rates in the first quarter of 2008 and in the last four years.

The index of manufacturing production (seasonally adjusted) declined by 0.8 percent in July from its June level. In the three months May–July the index rose at annual rate of 4.4 percent (compared with the previous three months, seasonally adjusted). Over the last year (May–July 2008 compared with May–July 2007) the index of manufacturing production has risen by 10.6 percent.

The trade and services revenue index went up by 1.6 percent in July (seasonally adjusted). Year-on-year this index has risen by 0.6 percent (May–July 2008 compared with May–July 2007).

The labor market

National Insurance Institute data show that the nominal wage per employee post rose by 5.2 percent over last year (April–June 2008 compared with the equivalent period in 2007). As a result of the unexpected acceleration in inflation in the last year, the real wage in the business sector remained similar to that a year earlier.

The number of employee posts declined by 0.5 percent in April–June from the number in January–March (seasonally adjusted, annual rate of change). In April–June the number increased by 2.7 percent compared with the equivalent period in 2007.

The Manpower Survey shows that the rate of unemployment fell in the second quarter to 5.9 percent, from 6.2 percent in the first quarter. The rate of participation in the labor market in the working-age population in the second quarter was 56.4 percent, compared with the record level of 56.6 percent in the first quarter.

Foreign trade and the balance of payments

Goods exports (excluding diamonds) fell by 0.8 percent in August from their July level, whereas in last three months, June–August, they were 43 percent higher, annual rate, than in the previous three months (in dollar terms, seasonally adjusted).

Goods imports (excluding ships, aircraft and diamonds) dropped by 7.6 percent from July to August, while in June–August they were 16.8 percent higher, annual rate, than in the previous three months (in dollar terms, seasonally adjusted).

Balance of payments data (seasonally adjusted) show a surplus of about $1 billion in the current account in the second quarter of 2008, following the surplus of $1.2 billion in the first quarter. According to the Research Departments forecast, the surplus for 2008 is expected to be about $2.7 billion.

2. Budget data

Based on revenues and expenditure till now, the total government deficit in 2008 is expected to be below the ceiling it set of 1.6 percent of GDP.

The trend of the slowdown in tax revenues continued, and in the last few months these have been below the seasonal path consistent with the budget forecast. Tax revenues in January–August 2008 (after deducting the effects of changes in tax rates and non-recurring receipts) fell by a real 0.9 percent compared with the equivalent period in 2007.

Despite the reduction in tax revenues the government's domestic surplus is NIS 3.4 billion higher than the seasonal path consistent with the budget, due to domestic under-spending by the government and also due to non-tax receipts in excess of the budget forecast.

3. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) rose by 0.8 percent in August, higher than the average of the forecasts (most of which had predicted between 0.4 percent and 0.7 percent). The seasonally adjusted index rose in August by 0.6 percent. Most of the rise in the index was due to the housing component, which went up by 3.7 percent, contributing 0.7 percent to the rise in the CPI.

Since the beginning of the year the CPI has risen by 4.4 percent. In the last twelve months it has risen by 5.0 percent.

The CPI excluding energy, food, and fruit and vegetables rose by 2.1 percent in the last twelve months, but in August alone it went up by 1.2 percent.

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

Inflation expectations for the next twelve months as derived from the capital markets (break-even inflation) declined in September to an average of 2.5 percent, compared with 2.7 percent in August. At the time of the current interest rate decision (on 22 September) these expectations had fallen to around 1.5 percent. The domestic forecasters predict, on average, that inflation in the next twelve months will be 2.9 percent (compared with their predictions last month of 3.0 percent). They forecast inflation of 5.4 percent in 2008, declining to 2.3 percent in 2009.

Some of the forecasters predict that the Bank of Israel interest rate will be increased by 25 basis points for October, but most expect no change, and on average the forecasters predict that at the end of 2008 the interest rate will be 4.4 percent.

At the time of these discussions of the interest rate for October, the slope of the *makam* yield curve reflects market expectations of no change in the Bank of Israel interest rate in the next twelve months.

The makam and bond markets

The yield on 5-year CPI-indexed bonds rose in September to an average of 2.8 percent from an average of 2.5 percent in August. The yield on unindexed 5-year government bonds fell last month by about 0.1 percentage points, and averaged 5.3 percent in September. The yield on one-year *makam* fell by 0.1 percentage points from the previous month, to reach an average of 4.4 percent in September.

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

Prior to the current decision on the interest rate, the Bank of Israel interest rate was 2.25 percentage points higher than the US federal funds rate, and the same as the ECB rate.

The gap between the unindexed 10-year shekel government bond yield and the 10-year US government bond yield widened from 197 basis points on 25 August to the high level of 266 basis points on 17 September—essentially the result of the decline in the 10-year interest in the US.

The expected real interest rate
The Bank of Israel interest rate *minus* inflation expectations twelve months forward was about 1.7 percent on average in September, about 0.3 percentage points higher than its level in August.

The money supply
The annual rate of increase of the (M1) money supply in the twelve months to September was about 15 percent.

The econometric models[2]
Various scenarios were examined using the Bank of Israel's econometric models, and they yielded contradictory results.

In the quarterly DSGE (dynamic stochastic general equilibrium) model used by the Monetary Department, under the assumption that input prices abroad stabilize, in the scenario in which the exchange rate settles at an average of NIS 3.46 to the dollar in 2009—the Bank of Israel interest rate is cut gradually from the last quarter of 2008 to a level of 2.7 percent in the last quarter of 2009, and inflation returns to the target range in the third quarter of 2009.

In the error correction quarterly model, which gives greater weight to the past because the players' expectations are adaptive, under the same assumption of a stabilization of input prices abroad, in the scenario with the exchange rate rising from NIS 3.58 to the dollar in the last quarter of 2008 to NIS 3.79 to the dollar in the last quarter of 2009, with the derived Bank of Israel interest rate (derived from the *makam* curve) at an average of 4.25 percent throughout 2009—inflation in 2009 would reach 3.7 percent, and would return to the target range in the first half of 2010.

4. The foreign currency market and the share market

The foreign-currency market
During the month between the previous and the current interest rate discussions, the shekel first weakened against the dollar, and then strengthened again—it moved from NIS 3.53 to the dollar on 26 August to NIS 3.62 on 11 September, and then returned to NIS 3.53 to the dollar on 19 September. During the month the shekel strengthened against the euro, from NIS 5.15 to the euro on 26 August to NIS 5.01 on 19 September, an appreciation of about 2.8 percent.

The share market
From the previous interest rate decision to the current one the share market in Israel was very volatile, against the background of shocks and high volatility in markets around the world. The Tel Aviv 25 share price index fell by about 12 percent between the 26 August and 21 September. The high volatility can be seen in the 9.1 percent

[2] 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.

drop in the index between 18 and 21 September, followed by its 8.4 percent surge in one day, on 21 September.

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

Israel's risk premium, as measured by the five-year CDS spread, increased significantly, from 88 basis points in August to 115 basis points in mid-September. The risk premium in most emerging markets also increased significantly this month, in light of the global financial crisis.

6. Global economic developments (see Appendix for further details)

In the month between the last interest rate decision and the current one there was a marked deterioration in the global financial crisis. On 7 September the US government nationalized the leading financial companies in mortgage financing, Fannie Mae and Freddie Mac, following their collapse.

In mid-September, within two days the fourth largest investment bank, Lehman Brothers, filed for bankruptcy, the Bank of America bought the investment bank Merrill Lynch, and the US government bought AIG, the largest insurance company in the world, to preempt its collapse.

In reaction to the plight of the global financial system, following the huge losses/write-offs by leading corporations and the credit squeeze, on 20 September the US administration announced a plan, subject to congressional approval, to buy some $ 700 billion of problem assets, such as problem mortgages and mortgage derivatives, from the private sector, with the intention of aiding American financial institutions. In addition, the major central banks (in the US, Europe and Asia) injected a large amount of liquidity, intended to return liquidity to the markets, and regulatory oversight of the financial markets was tightened by the introduction of exceptional steps such as the prohibition of selling shares short in the financial sector.

On 21 September the Fed announced that the large investment houses that were still independent, Goldman Sachs and Morgan Stanley, would become bank holding companies, and would thus come under the supervision of the Fed and subject to its regulations. As a result, those institutions would be able to access the Fed's credit window.

The bad news that emerged, together with other bad reports from other financial institutions, unsettled the markets again. Share prices fell sharply around the world, various risk indices rose, and financial spreads reached record levels.

The financial crisis occurred against the background of the very rapid expansion of sales of structured products and derivatives, from $ 80 trillion gross in 1998 to almost $ 600 trillion in 2007. In other words, the global derivatives market ballooned from about 269 percent of global GDP in 1998 to about 1,103 of global GDP in 2007.

In light of the developments in the financial sector, concern over the effects of the crisis on the worldwide slowdown in growth deepened, and the question being asked is how long the slowdown will last, and how severe it will be.

With regard to inflation, although in the advanced economies it is still higher than the target and higher than forecast, it is expected to decline due to the fall in commodity prices, particularly oil prices, and the predicted slowdown in economic growth.

Towards the middle of September expectations of a cut in the Fed interest rate (then 2 percent) in its meeting on 16 September firmed, but contrary to expectations as reflected by the capital market the Fed kept the rate unchanged. The ECB interest rate (4.25 percent) and that of the Bank of Japan (0.5 percent), are expected to remain unchanged till the end of the year. The Bank of England is expected to cut its interest rate, currently 5 percent, in the next few months.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR OCTOBER 2008

In the narrow-forum discussion, five members of the management make recommendations to the Governor regarding the appropriate rate of interest for the following month. In the current discussion four of them recommended leaving the interest rate unchanged for October at 4.25 percent, and one recommended reducing the rate by 25 basis points.

The participant recommending the reduction emphasized the effects of the instability in the global financial markets on the world economy, including Israel's economy, as the main reason for his view. The four participants recommending no change stressed the fact that inflation, currently 5 percent measured over the previous twelve months, was significantly above the target range. Although the price index excluding energy, food, and fruit and vegetables rose by 2.1 percent in the last twelve months, in July it rose 1.2 percent. They also noted the rapid 5 percent increase in the nominal wage in the business sector over the last year. The assessment was, however, that inflationary pressures would ease in light of the fall in commodity prices, including energy prices (a decline that continued in September).

In the discussion the point was made that the downward trend in one-year-forward inflation expectations, as derived from the capital market, continued. The participants in the discussion were of the opinion that inflation would return to the target range around mid-2009, with the possibility of some reduction in the interest rate in the course of the year.

It was also stated in the discussion that despite the deviation of inflation from the target, events in the financial markets around the world and in Israel, and the attendant uncertainty, as well as the slowdown in economic growth, served to counter the case for a rise in the interest rate, and justified leaving the rate unchanged for October. The expectation was that the leading central banks in the world would keep their interest rates unchanged, and in some countries they would cut the rate.

Various indicators of the slowdown in growth were quoted, including the stability of the composite state-of-the-economy index in the last three months, and the decline in indirect tax revenues.

Taking all the above into consideration, the Governor decided the leave the interest rate unchanged for October at 4.25 percent.

The bank stresses the following points:

- Inflation is above the target range. The Bank's assessment is that inflation, measured over the previous twelve months, will return to within the range in mid-2009.
- The greater global financial instability and its effects on the economy, together with the slowdown in Israel's economic growth, serve to counter the arguments for raising the interest rate.

The Bank of Israel will continue to monitor economic developments in Israel and world wide closely, and will act as necessary to achieve price stability and to support the stability of the financial system. Subject to this, the Bank will continue to support the attainment of a range of objectives of macroeconomic policy, in particular employment and growth.

The decision was made and published on 22 August 2008.

Those participating in 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, Member of Management and Head of the Monetary/Financial Division, Research Department
Mr. Barry Topf, Director of the Market Activity Department
Mr. Balfour Ozer, Member of Management
Dr Ohad Bar-Efrat, Advisor to the Governor and Head of International Affairs
Mr. Gaby Fiszman, Chief of Staff to the Governor
Mr. Eddy Azoulay, Chief of Staff elect to the Governor
Dr. Yossi Saadon, Bank of Israel Spokesperson

Appendix: Major Global Economic Developments

U.S.

In September concern over the effects of the financial crisis on the US economy increased, as described above (see section 6, Global economic developments). The real data published in September in the US (up to the date of the current discussions) were not encouraging, and it should be borne in mind that they reflected the situation as it was prior to the deterioration in the financial crisis in min-September.

On the negative side, manufacturing production declined in August by 1.1 percent from its July level, residential construction fell by 6.2 percent in August to its lowest level for seventeen years, the rate of unemployment rose to 6.1 percent, the number of hours worked weekly declined and the number of dismissals increased. Other indicators, headed by growth in the second quarter, came as a very positive surprise (an increase of 3.3 percent, annual rate, over the first quarter).

The most important data regarding the severity of the crisis and how long it will last relate—the housing market—continue to present a bleak picture, but activity declined at a slightly slower pace.

First signs of the moderating effects of oil prices and the slowdown in economic growth (and the strengthening of the dollar) on inflation were evident in import prices, which fell this month by a steep 3.7 percent. The CPI fell by 0.1 percent in August.

At the meeting of the Federal Open Market Committee (FOMC) on 16 September, it was decided to keep the interest rate at 2 percent (although the markets had anticipated a cut). The press release announcing the decision stated that the downside risks to growth and the upside risks to inflation are both of significant concern to the Committee.

The aggravated slowdown in growth, the easing of inflationary pressures, and the financial crisis support the possibility of a reduction in the interest rate.

Europe

The general view in the eurozone is that the economies of Spain, Ireland and Italy are already in recession, and that others are on the way. An OECD report contains the assessment that the UK economy will contract by 0.3 percent and 0.4 percent in the next two quarters respectively. Pessimism in Europe is reflected among other things by the indices of consumer confidence, most of which reach new record low levels each month. Germany's trade surplus dropped sharply in September, emphasizing the weakness in the eurozone's main engine of growth.

In September the ECB reduced its growth forecast for the eurozone to 1.4 percent in 2008 and 1.2 percent in 2009, and raised its inflation forecast to 3.5 percent in 2008 and 2.6 percent in 2009.

The ECB stresses that inflation remains its major concern. This month the situation of the financial sector in Europe also became a cause of concern, with the ECB's announcement that from February 2009 it will tighten the conditions for lending to European banks. Among other changes, the haircut rate will be increased for a long list of assets offered as collateral, which is likely to make it very difficult for European institutions in tight straits to maintain the required level of liquidity. In this context it should be borne in mind that the degree of leverage in the non-financial sector in Europe (57 percent of GDP) is considerably higher than that in the US and Japan.

In its latest decision the ECB kept the interest rate unchanged at 4.25 percent, and it is not expected to change it before the end of the year. The Bank of England is expected to cut its interest rate, currently 5 percent, by the end of the year.

Japan

The Japanese economy is continuing to slow. In the second quarter of 2008, GDP in Japan contracted by 3 percent, annual rate, its worst performance since 2001. The composite index fell in September to a six-year low, and capital investments fell for the fifth consecutive quarter.

At a meeting with business leaders, the Governor of the Bank of Japan used the word “sluggish” to describe Japan’s economic growth, and said it was likely to remain so for the time being; however, Japan's economy is unlikely to experience a deep adjustment phase, partly as a result of the healthy position of Japanese firms.

Inflation in Japan is showing signs of moderating. At its latest policy meeting it decided to leave the interest rate at 0.5 percent, and it is not expected to change it before the end of the year.

The emerging markets

Growth in China declined to 10.1 percent, annual rate, in the second quarter. The easing of inflationary pressures enabled the People’s Bank of China to announce a program to encourage growth: it cut the interest rate to 7.2 percent and reduced the reserve requirement ratio by one percentage point, to 16.5 percent. In most emerging markets, however, and especially in India and Brazil, inflation continued to rise. The main task facing those countries is to prevent a second wave of price increases and wage claims, and they are likely to hold their interest rates at relatively high levels, and may even raise them to achieve that objective.