BANK OF ISRAEL
Office of the Spokesperson and Economic Information

March 2009

Report to the public of the Bank of Israel's discussions prior to setting the interest rate for March 2009

The discussions took place on 22 and 23 February 2009

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 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 Governor, the Deputy Governor, the directors of the Research and Market Operations 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 Operations Departments and three 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

The effects of the weakening of the global economy are evident in Israel's economy too. The data of the last few months strengthen the assessment that the economy is experiencing a significant slowdown, and support the Bank of Israel's forecast of a standstill and possibly even a decline in GDP in 2009. In addition, the rate of inflation is expected to fall below the target range (1–3 percent) in the second half of the year.

The National Accounts data

National Accounts data published by the Central Bureau of Statistics show that GDP (at constant prices, seasonally adjusted) rose at an annual rate of 1.1 percent in the second half of 2008 compared with the first half. In the last quarter of 2008 GDP fell by 0.5 percent, after rising by 0.9 percent in the third quarter (annual rate of change, compared with previous quarter, seasonally adjusted). In the last quarter of 2008 per capita expenditure on private consumption dropped by 5.5 percent, and exports of goods and services dropped very rapidly, at an annual rate of about 44 percent (both compared with previous quarter, seasonally adjusted).

The composite state-of-the-economy index

The January composite state-of-the-economy index showed a drop of 1.2 percent, following declines (month-on-month) of 0.8 percent in December, 0.5 percent in November and 0.4 percent in October. The falls in the last few months reflect the increased severity of the slowdown in economic activity in the last few months. The intensification of the slowdown is evident from the fact that all components of the index declined, and the index itself fell steeply. The index of manufacturing production (seasonally adjusted) rose in December by 0.7 percent, after falling by 0.6 percent in November. The trade and services revenue index fell by 6.1 percent in December (seasonally adjusted) compared with its November level, after declining by 1.2 percent from October to November.

The labor market

The nominal wage per employee post in the business sector rose by 0.9 percent in November compared with its October level. The average in the three months September–November declined at an annual rate of 0.1 percent compared with the average in the previous three months.

The number of employee posts (seasonally adjusted) increased in November by 0.9 percent from its October level. National Insurance Institute data indicate that the level of employment rose by 0.5 percent in the three months September–November compared with the level in the previous three months.

Foreign trade

Goods exports (excluding diamonds) fell by about 1.6 percent in January from their December level (in dollar terms, seasonally adjusted). The dollar value of these exports dropped by a steep 29 percent in the three months November–January compared with that in the previous three months (annual rate, seasonally adjusted).

Goods imports (excluding ships, aircraft and diamonds) declined by 4.3 percent from December to January (in dollar terms, seasonally adjusted); in the three months November–January they were about 42 percent lower than in the previous three months (in dollar terms, annual rates, seasonally adjusted).

2. Budget data

The downward trend of government revenue continued in January, with a real 20 percent drop compared with the level in January 2008. Both direct and indirect tax revenues fell, reflecting the economic slowdown. As the budget for 2009 has not yet been approved, the government's monthly expenditure is limited by law to one-twelfth of the 2008 budget.

3. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) declined by 0.5 percent in January, having declined also in November and December, so that in those three months it fell by 1.2 percent, and seasonally adjusted, it fell by 0.5 percent. In the last twelve months the CPI rose by 3.3 percent, above the upper limit of the target range.

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

Inflation expectations for the next twelve months derived from the capital market (break-even inflation) rose from an average of 0.6 percent in January to an average of 0.8 percent in February.

On average, Israeli forecasters predict inflation in the next twelve months of about 0.5 percent. They assess on average that in the months February to April 2009 the CPI will rise by a total of 0.3 percent.

The Israeli forecasters predict on average that the Bank of Israel interest rate will be reduced by 45 basis points for March, and that at the end of 2009 the interest rate will be about 0.9 percent.

The slope of the *makam*[1] curve indicates market expectations of some reduction in the interest rate for March, yet later in the year it is expected to start rising, and to reach 1.4 percent one year from now.

The makam and bond markets

On 16 February the Bank of Israel announced that from the following day it would employ an additional instrument of monetary policy, by starting to purchase government bonds on the secondary market, with the intention of strengthening the Bank's influence on interest rates for longer terms.

The yield on 5-year CPI-indexed bonds declined in February to an average of 1.8 percent (reaching as low as 1.4 percent on 17 February), from an average of 2.3 percent in January. The yield on unindexed 5-year government bonds dropped to an average of 3.3 percent in February (reaching as low as 3 percent on 17 February), compared with 3.6 percent in January. The yield on one-year *makam* fell from an average of 1.6 percent in January to an average of about 1.1 percent in February.

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

Prior to the current interest rate decision, the Bank of Israel interest rate was 0.75–1 percentage point higher than the US federal funds rate, and 1 percentage point lower than the ECB rate.

The gap between the unindexed 10-year shekel government bond yield and the 10-year US government bond yield fell from 233 basis points on 25 January to 167 basis points on 22 February.

1 Short-term bills issued by the Bank of Israel.

The expected real interest rate

The Bank of Israel interest rate *minus* twelve-months-forward inflation expectations as derived from the capital market fell by about 0.9 percentage points in February from its January level, and reached an average of about 0.2 percent.

The econometric models[2]

Various scenarios were examined using the Bank of Israel's econometric models, under the assumptions that business sector product will fall in 2009, interest rates will remain low around the world, energy prices will settle at the low prices to which they have fallen, and world trade will contract.

In the basic quarterly DSGE (dynamic stochastic general equilibrium) model, which places great weight on expectations and which uses the Bank of Israel reaction function based on the smoothing of the interest rate path, in the scenario in which the exchange rate in 2009 is between NIS 3.98 and NIS 4.09 to the dollar—the Bank of Israel interest rate declines gradually to a level of zero percent during 2009 (and even slightly lower, a situation that may be interpreted as reflecting monetary expansion using a variety of instruments), and in 2009 as a whole inflation is minus 0.2 percent.

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 weakened by about 4.1 percent against the dollar, from NIS 3.99 to the dollar (on January 26) to NIS 4.16 (on February 20). In the same period the shekel weakened by about 1 percent against the euro, from NIS 5.19 to NIS 5.24 to the euro.

The nominal effective exchange rate of the shekel, calculated as the average shekel exchange rate against 24 currencies (representing 33 countries) weighted according to the volume of Israel's trade with those countries, showed a shekel depreciation of about 2.1 percent in the period from January 26 to February 20.[3]

The share market

The Tel Aviv 25 share price index rose by less than 1 percent between January 27 and February 22, and the Dow Jones index fell by about 9.3 percent.

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

Israel's risk premium, as measured by the five-year CDS spread, increased by 55 basis points in the month to the current discussion, to 2.4 percent. The risk premium of most emerging market countries also rose, as did that of advanced economies including the US, Japan, Germany and the UK.

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

[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.

[3] The weight of the dollar in the effective exchange rate is about 24 percent, and that of the euro, about 35 percent.

In February the crisis in the world economy persisted and became even more severe.

Uncertainty in the financial markets remained at a high level, and the situation in the banking sector deteriorated. The slowdown in global growth intensified, against the background of the sharp fall in demand. Most of the advanced economies are already in recession, and forecasts are of further deterioration, to be followed by a slower recovery process than previously anticipated. Recovery depends on to a great extent on the adoption of appropriate plans to boost economic activity and a suitable, comprehensive solution to the problems of the financial—particularly the banking—sector.

More and more countries announced rescue plans and a switch to expansionary fiscal policy, in attempts to support aggregate demand in the near future. The rise in budget deficits, with large increases in issues of government bonds, is likely to be met by increases in interest rates on government bonds in some countries.

Against the background of the steep drop in demand and the decline in inflation around the world, many central banks are continuing to pursue expansionary policies. In light of the fact that in some countries the headline interest rate is close to zero, central banks are turning to additional policy instruments.

In February the interest rate was cut in the UK, Sweden, Australia, New Zealand, Chile, the Czech Republic, Poland, and elsewhere. In the US, the investment houses expect, on average, that the Fed interest rate will remain at its current low level (of 0–0.25 percent) until the end of 2009. The ECB interest rate is 2 percent. Last month the Bank of England cut its interest rate to 1 percent.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR FEBRUARY 2009

All the members of management participating in the narrow-forum discussion expressed the view that in light of the deterioration in the economic situation, an expansionary monetary policy was required. This, given the forecasters' assessments, on average, that inflation in 2009 (measured over the previous twelve months) was likely to be below the inflation target, and one-year-forward inflation expectations (derived from the capital market) that inflation would be below the lower limit of the inflation target range. Inflation is expected to return to within the target range in 2010.

In the narrow-forum discussion, five members of management make recommendations to the Governor regarding the appropriate rate of interest for the economy. Four of them recommended reducing the rate by 0.25 percentage points, and the other member recommended a reduction of half a percentage point.

The latter argued that it was important to make such a reduction in order to boost growth, among other things by weakening the shekel against other currencies, and that the risks involved in such a cut were not serious.

The four participants recommending a cut of one-quarter of a percentage point argued that a reduction in the interest rate should be made in order to encourage economic activity and to improve liquidity in the financial markets, but they were of the opinion that at this stage a larger reduction was not appropriate. They stated that at current low interest rates, and at this stage of the economic cycle, it is not clear to what extent further cuts in the interest rate would affect the cost of credit to firms and households, and that the effectiveness of further cuts had to be examined. They explained that as the banks are maintaining the spread between the average interest they charge borrowers on credit granted and the interest they pay depositors (which is lower than the Bank of Israel's published rate), the situation has arisen in which despite the fact that the Bank of Israel's interest rate is still positive, the interest the banks pay depositors is close to zero, and they have little room to reduce it further. In this situation, in order to preserve the interest rate spread (also known as banking spread), the transmission mechanism from a reduction in the Bank of Israel interest rate and the rate charged to borrowers is weakened.

Moreover, in Israel and around the world questions arise regarding the functioning of the financial system when interest paid to depositors is close to zero. In these circumstances, there could be a switch from time deposits to current-account deposits, which would make it more difficult for banks to manage liquidity and to balance deposits and loans to different terms. The public may also switch from bank deposits into other assets, that could create an undesirable increase in risk for savers in the financial system.

In the course of the discussion it was noted that when the interest rate is at an unprecedentedly low level, the Bank should focus on other instruments to bring about monetary expansion. As was announced, on February 17 the Bank started buying government bonds on the Tel Aviv Stock Exchange. Such purchases of medium- and long-term bonds on the secondary market directly supports the lowering of interest in the economy also for longer terms, thereby helping to support economic activity.

Another point made in the discussion was that if necessary the Bank would also consider activating other instruments in its arsenal (such as those used by other central banks) to increase liquidity in the financial system, as part of the policy of credit easing or quantitative easing.

With regard to the decision on the interest rate for March, with the intention of reducing the cost of credit and strengthening the economy's ability to handle the effects of the decline in demand, and given the assessments that a cut in the interest rate was consistent with the rapid reduction in inflation and that inflation was likely to drop below the target range in 2009, the Governor decided to reduce the interest rate for March by 25 basis points to 0.75 percent. It was also decided to narrow the interest rate corridor in the credit window and the commercial banks' deposit window from ±50 basis points to ±25 basis points.

The Bank stressed the following points supporting the reduction in the interest rate for March:

- The marked effects of the global crisis and the fall in domestic demand on economic activity in Israel;
- The Bank’s assessment that inflation is on a steep downward path, and is likely to be below the target range in the second half of 2009;
- The low interest rates set by the major central banks around the world, and the additional policy instruments used by them to bring about monetary expansion.

The Bank of Israel will continue to monitor worldwide economic developments and the situation in Israel closely, and will act to encourage employment and growth and to support the stability of the financial system, and to achieve price stability.

The decision was made and published on 23 February 2009.

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 and Finance Division, Research Department
Mr. Barry Topf, Director of the Market Operations Department
Ms. Irit Mendelson, Head of the Markets Division, Market Operations Department
Mr. Balfour Ozer, Member of Management
Dr Ohad Bar-Efrat, Advisor to the Governor and Head of Information and International Affairs Division
Mr. Eddy Azoulay, Chief of Staff to the Governor
Dr. Yossi Saadon, Bank of Israel Spokesperson

Appendix: Major Global Economic Developments

US

The weakness in the US economy continues to become more severe. In the last quarter of 2008 it contracted by 3.8 percent, annual rate, following a decline of 0.5 percent in the third quarter, against the background of the marked drop in consumers' expenditure. The Purchasing Managers Index continued to fall, and reached 33.3 points, the fourth month in succession below the 50-point mark that indicates deteriorating conditions and a slowdown.

The weakness in the labor market persists, with the position worsening even further, and encompassing all sectors. The January Employment Report showed a rise in unemployment to 7.6 percent, its highest level since 1992, and it is expected to continue to rise even higher. The number of jobs lost in January, at 598,000, was the largest drop in employment in one month since 1974.

The weakness in the labor market emphasizes the need for a comprehensive support plan, and indeed the US is activating several programs: a program for fiscal expansion, a program to rescue the banks, a program to rescue the car industry, and a program to save the mortgage and real estate industry. This month the fiscal stimulus program, amounting to $787 billion, was approved. Its main points are tax cuts and infrastructure investment. The administration's plan to rescue the banks focuses on removing problem assets from the banks' balance sheets. Nonetheless, there is still much uncertainty about the way the programs will be implemented and their effects.

Against this background the investment houses significantly reduced their growth forecasts, and on average they expect negative growth in the first half of 2009, and the beginning of a recovery and a switch to positive growth in the third quarter of the year. On average they predict negative growth of 1.9 percent in 2009 as a whole. The

IMF also adjusted its forecast of US growth downward, to a negative 1.6 percent in 2009, with recovery to positive growth of 1.6 percent in 2010.

At the same time, inflation is declining, in light of the intensification of the recession, the decline in the labor market, and falling commodity and oil prices. Moreover, the risk of deflation is increasing.

Europe

The European economy contracted in the fourth quarter of 2008, the third quarter in succession. The slowdown in growth was widespread, with marked contraction of growth in Germany, France, Spain, Italy, the Netherlands and Portugal, and it resulted from the steep decline in exports and investment, as well as the weakness of consumer demand. In the UK too the recession deepened.

Growth forecasts for the eurozone continued to fall, in light of the more severe weakness in both the global and the European environment. Investment houses on average expect negative growth in the first half of 2009, with the start of recovery not before the third quarter of the year. Overall they expect negative growth of 2.3 percent in 2009 and positive growth of 0.9 percent in 2010. The IMF also revised its forecast downward, and it predicts negative growth of 2 percent in 2009 and positive growth of only 0.2 percent in 2010.

On average, the investment houses expect inflation to decline in the next quarters and to become deflation in the third quarter of 2009.

Japan

Japan's economy is deteriorating rapidly, and it contracted in the fourth quarter of 2009 against the background of the steep drop in global demand.

Japan's problem is particularly acute as both monetary policy and fiscal policy are at an impasse, with the central bank interest rate close to zero, and a parliamentary stalemate that prevents the ruling part from getting approval for its fiscal stimulus plan amounting to ¥10 trillion (about $111 billion).

The investment houses, on average, expect negative growth in the next three quarters, and recovery to positive growth starting only in the third quarter of 2009. On average, the investment houses expect negative growth of 4.1 percent over the whole of 2009, and positive growth of 0.5 percent in 2010. The IMF also revised its forecasts downwards, to negative growth of 2.6 percent in Japan's economy in 2009, and positive growth of 0.6 percent in 2010.

The dive in demand, surplus manufacturing capacity, appreciation of the yen, and the fall in commodity prices add their weight to the deflationary pressures, and give rise to concern over a renewed deflationary spiral. On average, the investment houses expect deflation in 2009.

The emerging markets

The rate of growth of the emerging markets slowed considerably, due largely to the weakness of global demand and world trade, and the significant tightening of financing conditions, in particular for economies with large current account deficits. In addition, the currencies of emerging market countries weakened, adding to the pressure on businesses and households, and hence, on the banks.

The IMF expects a sharp slowdown in growth in the emerging markets, from 6.25 percent in 2008 to 3.25 in 2009.

One of the most serious problems is the continuing shortening of credit lines to private borrowers in the emerging markets. Whereas the primary markets for investment grade bonds in the US and Europe reverted to limited activity, in the emerging markets only high-grade government (or government-guaranteed) bonds and high-grade corporate bonds reflected some revival in activity, with only a few new issues.

At the same time, the rate of inflation slowed also in the emerging markets. The IMF expects inflation to moderate from 9.5 percent in 2008 to 5.75 percent in 2009 and to 5 percent in 2010.

Against this background, some of the central banks in emerging market countries adopted expansionary policies in an attempt to improve the liquidity situation in the markets. Others, on the other hand, including Hungary, Russia and Argentina, that had experienced the flight of capital, adopted tight monetary policies.

Growth in China slowed in the fourth quarter of 2008, mainly due to the slump in exports and in the housing market, and it is expected to slow further. Chinese exports dropped more sharply in January than at any time in the last thirteen years. At the same time inflation fell to its lowest rate since 2006. Nonetheless, other economic indicators suggest a recovery in economic activity, apparently due the plan to boost it, totaling $585 billion.