BANK OF ISRAEL
Office of the Spokesperson and Economic Information

10 August 2009

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

The discussions took place on 26 and 27 July 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 two other participating 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

In the month since the previous interest rate discussions, additional information became available that supported the assessment that the decline in economic activity moderated and possibly even halted in the second quarter of 2009. Some indicators suggested the start of a turnaround in some industries.

The National Accounts

According to the updated estimates of the Central Bureau of Statistics (CBS) published on 16 July, GDP declined by 3.7 percent in the first quarter of 2009 (annual rate, compared with the previous quarter), whereas the original estimate (of 16 June) was a contraction of 3.9 percent. The revised assessment reflects reductions in all uses, in particular a fall of 3.5 percent in private consumption (compared with a decline of 3.4 percent in the previous estimate), and a drop of 29.4 percent in exports (compared with a 37 percent in the previous estimate). Imports shrank by more than 40 percent in the first quarter

The composite state-of-the-economy index

The Bank of Israel's composite state-of-the-economy index for June increased by 0.2 percent from its May level, its first increase since July 2008. The rise in the index reflects increases in goods imports and exports, while the other components of the index declined. The May index was revised upwards to –0.3 percent from –0.5 percent, due to revisions by the CBS.

The index of manufacturing production fell in May by 1.5 percent, further to its 0.9 percent drop in April (month-on-month changes, seasonally adjusted). The index of trade and services revenue fell by about 0.6 percent in May, after declining by 3.1 percent in April.

The labor market

The number of employee posts (seasonally adjusted) fell by 0.8 percent in April from the March level. In the three months February to April the number of employee posts fell by one percent compared with the level in the previous three months. The nominal wage per employee post dropped by 0.9 percent in April, with a 1.7 percent fall in the business sector wage. In the three months February to April the nominal wage in the business sector fell by 1.4 percent compared with the level in the previous three months.

According to CBS trend data, the rate of unemployment reached 8.4 percent in May, up from 8.2 percent in April and 7.2 percent in January 2009. The Ministry of Industry, Trade and Labor employers survey shows a further decline in the demand for workers in the second quarter, but somewhat more moderate than that in the first quarter.

The Companies Survey

Data derived from the reports of companies participating in the Bank of Israel's Companies Survey indicate that the decline in activity persisted in the second quarter of 2009, but at a more moderate pace. The net balance of total activity was still negative, but a significant improvement compared with the first quarter: –11 in the second quarter, compared with –41 in the first. The moderation of the decline was evident in most industries: in construction and communications the survey actually indicates a slight increase in activity. Companies in most industries reported some easing of demand side constraints on expanding their activity. The leading index in the Companies Survey expresses expectations of a further decline in activity in the third quarter, but a far more moderate decline than that expected in the previous quarter: the probability of a slowdown in the third quarter is 58 percent, compared with a probability of 98 percent in the previous quarter.

Foreign trade

Goods exports increased by 2.6 percent in June from their May level, and in the whole of the second quarter (all changes in this section are in dollar terms, seasonally adjusted, and exclude ships, aircraft and diamonds) they increased by 1.2 percent, compared with the level in the first quarter. The increase reflects an expansion of high-tech exports and a reduction in exports of medium-high-tech, medium-low-tech and low-tech industries. The slowing of the reduction in exports is consistent with the moderation of the contraction of world trade in the last few months.

Goods imports (in dollar terms, seasonally adjusted, excluding ships, aircraft and diamonds) increased by 3.9 percent from May to June, and in the whole of the second quarter they declined by 4.9 percent. The increase in June occurred in all categories—investment goods, raw materials and consumer goods.

2. Budget data

The budget deficit in the first half of 2009, excluding credit, totaled NIS 17.7 billion, compared with large surpluses in the first halves of the years 2006–08. The large deficit reflects the steep drop in tax revenues that started in September 2008, and underspending in the first quarter of 2009. After adjusting for the effects of changes in tax rates and non-recurring revenues, tax revenues dropped by about 12 percent in real terms in the first half of 2009 compared with their level in the first half of 2008. That said, in June there was a continuation of the trend of moderation in the decline in direct and indirect tax revenues that started in March.

As part of the economic program, tax on cigarettes and excise duty on fuel were increased in May, VAT was increased in July by one percentage point to 16.5 percent, in the middle of July a water surcharge went into effect, and in August the reform introducing a "green" anti-pollution tax on cars becomes effective.

3. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) rose by 0.9 percent in June, significantly more than the forecasters' expectations of an increase of between 0.3 percent and 0.5 percent. Since the beginning of 2009 the CPI has risen by 2.1 percent, driven mainly by two components—energy prices, that increased by 8.1 percent, and housing prices, that increased by 2.8 percent. The index excluding energy and housing increased by 1.3 percent since the beginning of the year. In the last twelve months the CPI increased by 3.6 percent, above the upper limit of the inflation target range.

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

One-year-forward inflation expectations derived from the capital market ("break-even inflation") reached 2.6 percent on 26 July; the average level of expectations following the publication of the June CPI (on 16 July) was 2.6 percent, and the average from 1 July to 26 July was 2.2 percent, similar to the June average. The rise in average inflation expectations reflects among other things the surprising June index and the price increases expected in the next few months following the government decision to increase VAT and to impose a tax on water prices.

Inflation expectations for the second and third year forward remained stable at 2.9 percent, those for four to five years forward declined slightly to 2.4 percent, and expectations for the long term (eight to ten years forward) rose in July to 2.6 percent, from 2.3 percent in June. The forecasters predict that inflation one year ahead will be 2.8 percent, compared with expectations of 2.3 percent at the time of the previous month's discussions on the interest rate, and 2.6 percent before the publication of the June index. On average they expect that the July index will increase by 0.8 percent and the August index by 0.5 percent.

With regard to the interest rate, the Israeli forecasters expect on average that the Bank of Israel rate will remain unchanged for the next three months, and that twelve months hence it will be 1.75 percent.

An analysis of the slope of the *makam* yield curve shows that capital market traders expect the interest rate to remain unchanged for the next two months, and expect it to be 1.9 percent in twelve month's time.

The makam and bond markets

The yield on unindexed and CPI-indexed medium- and long-term government bonds fell in July (up to 26 July) from their levels in June, and were similar to their May levels. The real yield on 5-year CPI-indexed government bonds fell by 0.7 percentage points to an average of 1.5 percent. The yield on 5-year unindexed government bonds declined to 4 percent until the publication of the June CPI, and then increased again to an average of 4.2 percent after 16 July.

The slope of the *makam* yield curve moderated in the first half of July, with a decline in terms close to a year and an increase in short-term yields. From the publication of the June CPI (on 16 July) until 26 July the yield curve became steeper, with a rise in short-term yields and a steeper rise in yields to one year. The yield to maturity on one-year *makam* averaged 1.1 percent until 15 July, compared with 1.3 percent in June, and increased to 1.5 percent on 26 July.

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 0.25 to 0.5 percentage points higher than the US federal funds rate, and 0.5 percentage points lower than the ECB rate.

The gap between the unindexed 10-year shekel government bond yield and the 10-year US government bond yield continued to contract last month, to 171 basis points in June, and to 166 basis points on 23 July.

The expected real interest rate

The Bank of Israel interest rate *minus* twelve-months-forward inflation expectations derived from the capital markets declined in July from its June level as a result of the increase in inflation expectations, and in July (until 26 July) averaged a negative 1.8 percent.

The monetary aggregates

In the twelve months to June 2009 the M1 monetary aggregate (cash held by the public and demand deposits) grew by 56 percent, and the M2 aggregate (M1 plus unindexed deposits of up to one year) by 18 percent. The rapid increase in M1 was partly due to the public's switching from deposits to current accounts in light of the low level of interest on the deposits.

The econometric models[1]

Various scenarios of the development of inflation and other variables in the next year were examined using the Bank of Israel's econometric models. As in the previous month, the underlying assumptions were that real economic activity would decline in 2009 and that there would be a moderate increase in 2010 in line with the Bank of Israel macroeconomic forecast, that interest rates around the world would rise gradually, starting in 2010, that world trade would slump in 2009 and increase slowly in 2010, and that prices of inputs start rising from the second quarter of 2009

In the basic quarterly DSGE (dynamic stochastic general equilibrium) model, which places significant weight on expectations and which uses the Bank of Israel reaction function based on the smoothing of the interest rate path, inflation in the next year (from the third quarter of 2009 to the second quarter of 2010) would be 1.6 percent. A major contributing factor to this result was the transitory effect of the increases in taxes (VAT and water) by the government. According to this model, the rate of inflation is expected to slow as this effect diminishes, and to reach 0.9 percent at the end of 2010. An alternative model that gives greater weight to the inertia in the inflation process yields higher rates of inflation in the next four quarters and in 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 strengthened by about 2.2 percent against the dollar, and on 26 July was NIS 3.87 to the dollar. In the same period the shekel strengthened by about 0.3 percent against the euro, to NIS 5.50 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 appreciation of 0.6 percent in the period from 21 June to 26 July.[2]

The share market

The Tel Aviv 25 share price index rose by 11.3 percent between 21 June and 26 July, while the Dow Jones index rose by 9.3 percent.

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

Israel's risk premium, as measured by the five-year CDS spread, remained almost unchanged at about 1.7 percentage points. The risk premium of most emerging market countries showed a very modest decline in this period.

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[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. In the abnormal conditions prevailing in the financial markets since the outbreak of the global financial crisis, and bearing in mind that the models do not direct reflect such events, the weight that can be attached to the forecasts derived from the models is reduced.

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

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

Recent indicators of economic activity in economies around the world give the first signs of stabilization, albeit at low levels, with indications of recovery in some countries, including China.

The optimistic atmosphere also encompassed the global share and bond markets, with increases in prices and reductions in risk indicators, against the background of financial statements for the second quarter that generally exceeded expectations.

The OECD increased its forecasts of growth among its members to a negative 4.1 percent in 2009 and positive growth of 0.7 percent in 2010. The IMF reduced its forecast of global growth in 2009 slightly, but increased its forecast of growth in 2010 to 2.5 percent (compared with the forecast in May of 1.6 percent).

The investment houses' forecast of global inflation in 2010 averages 2.3 percent, with inflation of about one percent in the US and Europe.

The slower rate of reduction of central bank interest rates around the world is evident, but investment houses still forecast stability in interest rates in the US, Europe and Japan in the next twelve months. In addition to keeping its interest rate at the low level of 0 to 0.25 percent, the Fed is continuing to use additional instruments to support growth and maintain price stability. It also detailed its exit strategy from monetary expansion (to be used when the time is right).

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

In the narrow-forum discussion, four members of management make recommendations to the Governor regarding the appropriate rate of interest for the economy and regarding the operation of additional instruments to implement the Bank's monetary policy. In the discussion of the interest rate for August, all four recommended that the Governor leave the interest rate unchanged at its current level. They also recommended that the Bank announce that it is ending its purchases of government bonds as the program reaches its conclusion. These decisions would strengthen the ability of the economy to deal with the effects of the global crisis.

The participants in the discussion spoke of the latest indications that the contraction of economic activity was moderating, and that some industries were showing first signs of recovery, although activity was still at a low level and there was uncertainty regarding the timing and the rate of recovery.

The participants referred to the price increases expected in the next few months resulting from the increase in VAT and water tariffs. These are non-recurring increases that do not reflect a change in the inflation environment, but that will be expressed in high rises in the CPI in the next few months and that will keep inflation, measured over the previous twelve months, close to the upper limit of the inflation target range. On the other hand, they noted that the output gap and unemployment were relatively high and would act to moderate inflationary pressures.

They also noted that the monitoring of inflation over the next few months was especially important in order to assess whether the surprisingly high rise in the June CPI was a temporary deviation or whether it indicates a change in the inflation environment.

The participants in the discussion also related to the increase in the relative price of housing in the last year and the difficulty in assessing the trend in housing prices in the next year.

At the end of the discussion, the Governor decided to leave the interest rate unchanged for August at 0.5 percent, and to end the program of buying government bonds as planned. The decision strikes a balance between the pressures raising prices, which are expected to moderate following the expected one-off price increases, and the assessment that the economy has not yet emerged from the recession.

The Bank of Israel announced that it will stop buying government bonds on the secondary market on 5 August 2009, and announced that it does not intend to sell the securities it purchased. It noted that open-market activity (buying, selling, central bank lending of government securities) is an important central bank instrument in implementing its monetary policy. The view in the Bank of Israel is that the purchases of bonds that the Bank started on 25 March 2009 helped the capital market to return to more normal functioning, particularly with regard to the renewal of issues and raising capital by the business sector.

In its announcement of its decision the Bank of Israel related to the factors supporting the decision to leave the interest rate unchanged for August and to stop purchasing government bonds with the completion of the program:

- Inflation over the previous twelve months and one-year forward inflation expectations are close to the upper limit of the target inflation range. Following the increases in the CPI which are expected to be high in the next two months, mainly because of the increases in VAT and government-supervised prices, the output gap and unemployment constitute forces that will moderate price increases thereafter.
- The latest information on real activity in Israel and the rapid improvement in the financial markets strengthen the assessment that the reduction in GDP is moderating and may actually have ended. That said, in light of the uncertainty regarding developments in the global economy it is too early to determine whether this represents a turning point.
- Many central banks around the world are keeping their interest rates low and are continuing to operate the additional monetary instruments they introduced.

The Bank of Israel announced that it will continue to monitor Israeli and worldwide economic developments, and will use the instruments available to it to achieve its objectives—price stability, the encouragement of employment and growth, and support for the stability of the financial system.

The decision was made and published on 27 July 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
Mr. Eddy Azoulay, Chief of Staff to the Governor
Dr. Yossi Saadon, Bank of Israel Spokesperson
Dr. Sigal Ribon, Head of Monetary Analysis Unit, Research Department

Appendix: Major Global Economic Developments

US

The latest economic data indicate that the pace of contraction of activity in the US has slowed significantly. The updated figure for the change in GDP in the first quarter of 2009 showed a small improvement, to a negative 5.5 percent. The IMF revised its forecast of growth in 2010 in the US upwards to 0.8 percent (compared with zero growth in the previous forecast). The OECD also revised its forecast for 2010 upwards to 0.9 percent, and the Federal Reserve upped its forecast for 2010 to between 2.1 percent and 3.3 percent. Nevertheless, the Fed also increased its forecast of unemployment in 2010 slightly.

The main positive factor this month related to housing. Building starts, building permits and mortgage approvals increased and housing prices showed signs of at least stabilizing. Nonetheless, the large stock of houses under foreclosure still casts a shadow over the housing market. On the other hand, private consumption, that provides the main impetus to growth, remained unchanged in the last few months, and last month an actual decline was recorded in sales in chain stores. This was the result of the increase in private saving, despite the increase in disposable income.

The labor market continued to deteriorate, and the rate of unemployment rose further in June, to 9.5 percent.

The rate of inflation in the twelve previous months remained at a low level of minus 1.4 percent. The rate of price increases excluding energy and food (core inflation) was 1.7 percent The investment houses expect inflation in the US to be 1.2 percent in 2010.

At its last meeting on 24 June, the Fed left the interest rate unchanged, between zero and 0.25 percent, and related to the slower contraction of economic activity and the improvement in the financial markets. The Fed announced that it would continue to use the all the available instruments to encourage activity and to preserve price stability, and that it expects to keep the interest rate at a low level for some time. The investment houses expect no change in the interest rate until the beginning of 2010. The capital market factors in the start of an increase in the rate at the end of 2009.

Europe

Unlike in the US, the data and assessments point to a deterioration in the state of activity. The figure for the change in GDP in the first quarter of 2009 was revised downwards to minus 4.5 percent, and both the IMF and the OECD reduced their forecasts for 2009 by more than a half a percentage point to minus 4.8 percent, and kept the forecast for 2010 at zero or even negative growth.

Unemployment in the eurozone increased to 9.5 percent, and it particularly high in Spain—18.5 percent. European indices of consumer confidence are very volatile; the ZEW (the German Center for European Economic Research) index dropped sharply after rising in the three previous months.

One positive indicator is provided by the data on German manufacturing production, which increased significantly, and which may indicate the start of recovery of activity in the German economy.

Against the background of the continued deterioration in economic activity, the ECB left the interest rate unchanged at one percent. It also announced, at the beginning of July, that it would purchase some €60 billion of covered bonds. The investment houses expect a slight increase in the ECB interest rate only in second half of 2010.

In the UK the figure for the change in GDP in the first quarter of 2009 was revised downward, from minus 4.1 percent to minus 4.9 percent, mainly due to the slump in investment and foreign trade. Nevertheless, the IMF increased its forecast of growth in the UK by 0.6 percentage points, and it currently forecasts low growth in 2010. As in the US, reports from the real estate industry constituted the main positive factor. The purchasing managers index and the index of consumer confidence generally also provided pleasant surprises.

Japan

Japan's economy is showing more signs of recovery than are the other advanced economies. The IMF revised its growth forecasts for 2009 and 2010 upwards quite significantly, to minus 6 percent and plus 1.7 percent respectively. The decline in activity in 2009 occurred mainly in the first half of the year, whereas in the second half of the year and in 2010 relatively rapid growth is expected. An increase of about 6 percent in manufacturing production and in factory orders is evident already in April and May, and activity in the motor industry increased to its highest level this year. In his monthly announcement in July, the Governor of the Bank of Japan declared that the economic deterioration had ended, and added that he would extend the program to return liquidity to the market by three months (instead of six) due to the expected improvement in the economy. He stressed, however, that the level of activity was still very low.

The emerging markets

The emerging market countries, and particularly those in Asia, are also showing signs of recovery. A new composite index defined by UBS this month for East Europe, the Middle East and Africa,[3] expects recovery to start in the third quarter of 2009. Turkey and Poland stand out, as they have already started to recover, and Russia, too, is showing signs of recovery, with the increase in oil prices. The optimistic atmosphere regarding the emerging market countries was accompanied by the start of a significant

[3] Including the Czech Republic, Hungary, Israel, Poland, Russia, South Africa and Turkey.

flow of capital to funds that specialize in investments in those markets, and this was reflected by a rise in the indices describing those markets.

Growth continues in China. In the second quarter it increased to an annual rate of 7.6 percent, higher than the forecasts. With the rapid growth, housing prices are also increasing steeply.