BANK OF ISRAEL

November 2009

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

The discussions took place on 25 and 26 October 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

The Bank of Israel assessment at the time of the discussions on the interest rate for November was that the gradual recovery in economic activity was continuing, but there was uncertainty regarding its strength. The Bank's assessment of growth in the third quarter of 2009 was about 2.1 percent (annual rate, compared with the previous quarter, seasonally adjusted), compared with growth of 1 percent in the second quarter of the year, and a negative 3.3 percent in the first. The Bank expects GDP in 2009 to remain at its 2008 level, and in 2010 to grow by 2.5 percent.

The composite state-of-the-economy index

The Bank of Israel's composite state-of-the-economy index for September published in October rose by 1.2 percent (compared with the previous month), following increases of 1.1 percent in the August index and 0.9 percent in the July index. The rise in the latest index continues the upward trend that started in May 2009. That said, the adjustments to some of the components of previous months' indices were more significant than adjustments in the past, thus increasing the uncertainty about the information conveyed by the monthly index.

The increase in September reflects mainly increases in manufacturing production, trade and services revenue, services exports and goods imports. The manufacturing production index increased in August by 3.3 percent (seasonally adjusted), after falling by 2.4 percent in July. The trade and services revenue index rose by 1.9 percent in August, after dropping by 3 percent in July (seasonally adjusted, compared with the previous month).

The labor market

The nominal wage per employee post in the business sector increased by 1.2 percent in July from its June level. In the three months May–July the wage increased by 0.4 percent compared with the level in the previous three months (seasonally adjusted, annual rate).

The number of employee posts seasonally adjusted declined by 0.5 percent in July from its level in June. National Insurance data show a 1 percent decline in employment in May–July compared with the previous three months.

The unemployment rate increased to 8.0 percent in the second quarter, from 7.6 percent in the first quarter. According to the trend data the unemployment rate fell from 7.9 percent in May to 7.6 percent in August. However, this is derived from monthly data based on a relatively small sample and on the assumption of a constant participation rate in the labor market, and is thus not a fully reliable estimate.

The Companies Survey

Results from the Bank of Israel's Companies Survey for the third quarter (based on responses from 550 companies, most of the sample) indicate that the gradual recovery of economic activity continued, but the increase from the second quarter is not statistically significant, but indicates the continuation of positive developments evident in the last quarter. The responses show that firms' regard the probability of a slowdown in the next quarter as markedly lower than that in the previous quarter's survey.

Foreign trade

Goods exports (excluding diamonds) declined by about 0.9 percent in September from their August level (in dollar terms, seasonally adjusted). In the three months July–September these exports surged by 29 percent (in dollar terms, seasonally adjusted, annual rate) from their level in the previous three months.

Goods imports (excluding ships, aircraft and diamonds) increased by 1.1 percent in September from their August level (in dollar terms, seasonally adjusted). In the three months July–September these imports swelled by 56.6 percent (in dollar terms, seasonally adjusted, annual rate) from their level in the previous three months.

2. Budget data

The budget for 2009 and 2010 increased the ceiling deficit specified by law from 1 percent of GDP to 6 percent in 2009 and 5.5 percent in 2010. This step was taken due to the recession and the slump in tax revenues. Based on an analysis by the Research Department, the Bank of Israel expects the deficit in 2009 to be below the revised ceiling. In January–September 2009 the deficit (excluding credit) totaled NIS 21.9 billion, giving a path that would result in a deficit of less than 5.5 percent, even if budget expenditure is implemented in full.

Domestic government expenditure in January–September was NIS 3.8 billion (2.3 percent) lower than the seasonal path consistent with full budget expenditure. The amount of underspending reflects abnormally low expenditure in the first quarter of the year.

Tax revenues, mainly from indirect taxes, have recovered since July, and in 2009 as a whole are expected to exceed the budget revenue forecast by about 2.7 percent.

3. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) declined by 0.3 percent in September, below the range of forecasters' expectations of a change of between minus 0.2 percent and plus 0.2 percent. Since the beginning of 2009 the CPI has increased by 3.4 percent, and seasonally adjusted by 2.6 percent.

Since the beginning of the year the annual rate of inflation based on the seasonally adjusted CPI and excluding the effect of government actions (i.e., the effects of the increase in VAT, the increase in taxes on cigarettes and fuel, and the surcharge on water) was 1.9 percent, close to the midpoint of the target range.

In the last twelve months the CPI increased by 2.8 percent, in the upper half of the inflation target range, but excluding the influence of government actions the inflation rate was below 2 percent.

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") in October (to 22 October) averaged 2.2 percent, close to the 2.3 percent average in September.

The Israeli forecasters assess, on average, that inflation measured over the previous twelve months will be above the upper limit of the inflation target range in the first months of 2010, and towards the middle of the year it is expected to decline towards the midpoint of the range. If the effect of government intervention on prices (a contribution of about 1.2 percentage points to the inflation rate) is excluded (i.e., excluding the effect of the increase in VAT, the increase in taxes on cigarettes and fuel, and the surcharge on water), inflation (over the previous twelve months) is expected to remain within the target range in the first few months of 2010.

The Israeli forecasters predict on average that inflation one year forward will be 2.4 percent, and that in the three months October, November and December 2009 the change in the CPI will be a cumulative increase of 0.2 percent.

With regard to the interest rate, Israeli forecasters expect, on average, that the Bank of Israel rate for November will remain unchanged, and that twelve months hence the interest rate will be 2.6 percent.

An analysis of the slope of the *makam* yield curve shows that the capital markets expect the Bank of Israel interest rate to be about 2.4 percent in twelve month's time.

The makam and bond markets

Yields to maturity on CPI-indexed five-year government bonds declined (to 22 October) from their September level of about 1.4 percent to an average of about 1.1 percent. The yield on 5-year unindexed government bonds increased in October to an average of 3.9 percent, from an average of 3.8 percent in September. The yield on one-year *makam* fell to about 1.5 percent in October, from 1.7 percent in September.

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 0.5 to 0.75 percentage points higher than the US federal funds rate, and 0.25 percentage points lower than the ECB rate.

The gap between the unindexed ten-year shekel government bond yield and the ten-year US government bond yield narrowed this month, from 166 basis points on 29 September to 148 basis points on 23 October.

The expected real interest rate

The Bank of Israel interest rate *minus* twelve-months-forward inflation expectations derived from the capital markets remained unchanged in October at an average of *minus* 1.5 percent.

The monetary aggregates

In the twelve months to September 2009 the M1 monetary aggregate (cash held by the public and demand deposits) grew by 59.8 percent, but in September it dropped by 1.2 percent. In the last twelve months the M2 aggregate (M1 plus unindexed term deposits of up to one year) increased by 18.9 percent, and in September it increased by 0.7 percent. The rapid increase in M1 in the last year was partly due to the public's switching from term deposits to current accounts in light of the low level of interest on the term deposits.

The econometric models[1]

Various scenarios of economic development in the next year were examined using the Bank of Israel’s econometric models. The underlying assumptions were that GDP would be the same in 2009 as in 2008, that there would be growth of 2.5 percent in 2010, that the low interest rates around the world would start to rise in 2010, that prices of imported inputs would increase relatively moderately, and that world trade would decline by 14 percent in 2009 and would increase by 7 percent in 2010.

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

The baseline scenario of the quarterly DSGE (dynamic stochastic general equilibrium) model, which places great weight on expectations and which uses the Bank of Israel reaction function based in part on the smoothing of the interest rate path, under the assumption that the quarterly average NIS/$ exchange rate from the fourth quarter of 2009 to the end of 2010 would move between NIS 3.82 and NIS 3.89 to the dollar, gave a modest increase in the Bank of Israel interest rate to an average of about 0.9 percent in the last quarter of 2009 and a similar level in the last quarter of 2010. Inflation was expected to be 3.9 percent in 2009, and 0.7 percent in 2010.

The Error-Correction (EC) model yielded inflation of 3.7 percent in 2009 and 2 percent in 2010, with the Bank of Israel interest rate increasing from an average of 1.2 percent in the last quarter of 2009 to 2.9 percent in the last quarter of 2010. In this scenario the average exchange rate would be NIS 3.88 to the dollar in the last quarter of 2009, and NIS 3.90 in the last quarter 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 (i.e., from 23 September), the shekel strengthened by about 1.1 percent against the dollar, and weakened by about 0.8 percent against 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, remained unchanged in the period.[2] The weakening of the dollar against the shekel was not very different from the performance of dollar vis-à-vis other currencies, and a significant number of the major currencies strengthened against the dollar by more than did the shekel. The Bank of Israel’s activity in the forex market served to moderate the strengthening of the shekel against the dollar.

The share market

The Tel Aviv 25 share price index on 22 October was about 6 percent higher than on 24 September. In the same period the Dow Jones index rose by 2.7 percent.

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

Israel’s risk premium, as measured by the five-year CDS spread, declined from 1.10 percentage points to 1 percentage point in the period between the previous and the current discussions on the interest rate. The risk premium of most emerging market countries also showed some decline in this period.

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

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

The panic that seized the global economy following the collapse of Lehman Brothers is being replaced by a certain measure of optimism. The economic environment around the world continues to improve, both on the financial side and also from the aspect of real economic activity. That said, the recovery is not uniform around the world, and there is still concern over its strength and the path it will take.

In October the IMF revised its forecast of world growth upwards, to a decline of 1.1 percent in GDP in 2009 (compared with an expected 1.4 percent decline in its previous forecast in July), and growth of 3.1 percent in 2010 (compared with 2.5 percent in its previous forecast).

Expansionary monetary policy and significant budgetary expansion in most countries continue to support the global economic recovery.

In the US, the investment houses expect (on average) that the Fed interest rate will remain at its current low level of 0 percent to 0.25 percent into 2010. The ECB interest rate is also expected to be maintained at its current level of 1 percent for some time.

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

The Bank of Israel's previous interest rate decision left the rate for October unchanged at 0.75 percent. At the same time the Bank continued with the policy it announced at the beginning of August, of purchasing foreign currency from time to time when there were abnormal movements in the exchange rate that were not consistent with the basic economic conditions or when the forex market was not functioning properly.

In the narrow-forum discussion, four members of management make recommendations to the Governor regarding the appropriate rate of interest for the economy. In the discussions of the interest rate for November, one of the participating members of management recommended that the Governor increase the interest rate by a quarter of a percentage point, and the other three recommended that the Governor leave the rate unchanged.

The member who recommended an increase in the interest rate noted that the interest level was low bearing in mind that inflation in 2010 is expected to be close to the midpoint of the target range, and that growth is expected to be higher than 2 percent. The current highly expansionary monetary policy had been adopted against the background of a deep crisis and concern that the recession would be severe and prolonged. This member thought that in the current economic activity and inflation environment the interest rate should be increased for November.

The other three members of management, who recommended that the Governor leave the interest rate unchanged, stated that inflation measured over the previous twelve months was within the target range. If the effects of government decisions are deducted (i.e., the increases in VAT, in taxes on fuel and cigarettes, and the imposition of the water surcharge), inflation since the beginning of the year (in annual terms) was close to the midpoint of the range. Although inflation in the coming months is expected to be above the target range, inflation (in the previous twelve months) net of the effects of government-initiated price increases is expected to remain within the range. Moreover, the existence of an output gap, reflected by a higher than full-employment rate of unemployment is expected to moderate inflation over the next year.

The three members recommending no change in the interest rate also argued that the economic recovery was a gradual one, and it was important to continue to support it. Leaving the interest rate unchanged would prevent the widening of the differential between interest in Israel and that abroad, and would thus reduce the supply of foreign currency on the forex market (compared with the situation that would result from an increase in the interest rate). This, when the policy of the Bank of Israel is to purchase foreign currency as and when necessary. The bank's forex purchases moderate the strengthening of the shekel, and support the recovery trend in economic activity. The three "no change" participants added that the interest rates of the world's leading central banks are expected to remain at their current low levels into 2010. They also noted that despite the continued recovery of economic activity in Israel and the higher rate of growth expected in Israel and world wide, there is uncertainty about the strength of the process. The global recovery is expected to be slow, as is the process of increases in interest rates

The point was also made that the monetary environment, which affects overall inflation, incorporates changes in the interest rate and also changes in the exchange rate, and that the strengthening of the shekel (appreciation of the effective exchange rate in the last half year) constitutes a factor tending to moderate inflation.

After considering all the points raised in the discussion, the Governor decided the keep the interest rate for November unchanged at 0.75 percent, in order to continue to support economic activity and price stability, while preserving financial stability.

In its announcement of the decision, the Bank of Israel stressed the following:

- Inflation measured over the previous twelve months is in the upper part of the target range. Inflation from the beginning of the year, however, excluding the effects of increased tax rates and seasonally adjusted, is around the midpoint of the target range. Inflation expectations for the next twelve months, both those of the forecasters and those derived from the capital market, are slightly above the midpoint of the range. The output gap and the ending in due course of the effects of the non-recurring price increases that resulted from government actions (indirect taxes and surcharges) will restrain inflation in the coming year.
- The continued gradual recovery in economic activity suggests that the current environment is one of recovery from the recession but there is uncertainty regarding the strength of the recovery in Israel, in part because of the uncertainty about the recovery in the global economy.
- Interest rates of the leading central banks around the world are low, and are expected to remain unchanged during the coming months.

The Bank of Israel added that it will continue to use the instruments available to it to achieve its objectives of price stability and support of employment, growth, and the stability of the financial system.

The decision was made and published on 26 October 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
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, Advisor to the Governor and Bank of Israel Spokesperson

Appendix: Major Global Economic Developments

US

Most of the indicators published in the last few weeks point to a recovery in economic activity in the US, and show positive growth in the third quarter of 2009. In particular an increase in manufacturing activity was evident, partly explained by recovery in the motor industry and in exports. The housing market also yielded some encouraging signs of stabilization, although the data are still mixed. Consumer spending stabilized, the fiscal steps taken resulted in the stabilization of consumption, but it is not expected to return to rapid rates of increase in the next few months due to the persistent weakness in the labor market, and in particular employment insecurity, the slow rate of wage increases, and the tight credit conditions. In the business sector companies are still cutting back on fixed investment, though at a slower pace.

The IMF currently expects negative growth (i.e., contraction) of 2.7 percent in the US economy in 2009, and positive growth of 1.5 percent in 2010.

Inflation continues downwards, despite the increases in commodity and energy prices and the continued weakening of the dollar, and it is expected to remain in check in light of the considerable surplus capacity and stable long-term inflation expectations. CPI inflation in the twelve months fell by 1.3 percent in September (measured over the previous), while core inflation increased by 1.5 percent.

In its monthly statement, the Federal Open Market Committee noted that although economic activity was stabilizing, it expects it to remain weak for a time. The Fed Chairman this month referred to the process of exiting from the expansionary policy in light of the improvement in the economic forecast, but stated that it this stage the expansionary policy will continue. Accordingly, the Fed kept the interest rate unchanged this month at 0–0.25 percent. At the same time it is allowing some of its aid programs to end or to run down. The Fed also announced that it would extend the program of buying mortgage-backed bonds till the end of the first quarter of 2010, but would reduce the rate of its purchases.

The investment houses expect, on average, that the interest rate will remain unchanged in the first half of 2010. Futures contracts, however, currently price in expectations of an interest-rate increase in the first quarter of 2010.

Europe

The decline in the eurozone economy started to moderate, but is still lagging behind the global rate of recovery, mainly because of the relatively small improvement in industrial production and in the money market and financial markets indicators. The eurozone economy continued to contract in the second quarter against the background of weak consumer spending, investment and exports, but is expected to show modest growth in the third quarter due to government acceleration programs that supported consumer expenditure. Industrial production increased in August for the fourth consecutive month, but investments declined, and there was a sharp 5.8 percent drop in exports, along with a 1.3 percent reduction in imports. The strengthening of the euro acts as a brake on the economic recovery.

The IMF expects recovery in Europe to be slow and fragile, and currently forecasts negative growth (i.e., contraction)of 4.2 percent in 2009, and positive growth of 0.3 percent in 2010. The IMF expects that Spain will be the only EU economy to contract next year too.

Inflation continued to decline in September for the fourth month in a row, against the background of the reductions in energy prices and the increase in the rate of unemployment to 9.6 percent, its highest level in ten years. Inflation is expected to remain in check, with the ECB forecasting inflation of 0.4 percent in 2009 and 1.2 percent in 2010.

Against this background, the ECB left its interest rate unchanged at 1 percent, and indicated that its expansionary policy will continue, and that it will not increase the interest rate in the near future. The investment houses expect that the ECB will leave the interest rate unchanged until the end of the second quarter of 2010, whereas futures contracts reflect expectations an increase in the interest rate already as in the first quarter of 2010.

Japan

Japan's economy is recovering due to the global recovery and government aid programs, but its situation remains serious. Growth in the first quarter reached 3.7 percent, annual rate, after four quarters of contraction, including a drop of 11.7 percent in the first quarter of 2009. In September production increased and consumer confidence indices improved. Nevertheless concern persists that the recovery is non sustainable and that it will halt when the effects of government aid packages around the world come to an end. This concern is based largely on the fact that domestic private demand in Japan remains weak in light of the high unemployment rate and the longlasting decline in wages. In addition, the persistent weakness of exports and the strengthening of the yen against the dollar constitute a threat to continued recovery.

The IMF expect a contraction of 5.4 percent in Japan's economy in 2009, and positive growth of 1.7 percent in 2010.

As expected, the Bank of Japan left its interest rate unchanged at 0.1 percent. At the same time, it indicated that it might end some of its programs of aid to the business sector in light of the improvement in the credit markets.

The emerging markets

The emerging market countries are showing considerable recovery, and stronger growth is expected there, on average, with China and India leading with the highest growth rates. Financial conditions and credit terms also improved markedly. There are some reservations regarding China's economy, that it may not be on a stable growth path, and concern is actually increasing about the creation of an asset bubble. The government and central bank are nonetheless expected to continue with their expansionary policy.

In some emerging European economies the situation still give cause for concern—countries with excessive leverage. As a result, some of the countries, particularly the Baltic countries (Latvia, Lithuania and Estonia) are still mired in a deep recession, and their recovery is expected to lag behind that in other emerging markets.