



BANK OF ISRAEL

Office of the Spokesperson and Economic Information

10 May 2010

Report to the public of the Bank of Israel's discussions prior to setting the interest rate for May 2010

The discussions took place on 23 and 26 April 2010

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 April the Bank of Israel revised its growth forecast for 2010 upwards, from 3.5 percent (its forecast in January) to 3.7 percent. The average rate of unemployment is expected to drop to 7 percent (compared with 7.1 percent in the January forecast). The Bank also published its first forecast for 2011—growth of 4.0 percent and an average rate of unemployment of 6.7 percent.

The composite state-of-the-economy index

The composite state-of-the-economy index rose by 0.6 percent in March, following its increase of 0.3 percent in February (each month compared with the previous month). The latest rise, following those in the last few months, strengthens the assessments that economic growth is becoming more firmly entrenched.

The increase in March reflects, among other things, a 0.9 percent increase in manufacturing production in February, a 1.4 percent decline in trade and services revenue in February, and a 6.6 percent increase in services exports in March. With regard to foreign trade, see below.

The labor market

The gradual improvement in the labor market continued. In January the number of Israeli employee posts increased by 0.5 percent compared with the number in December (seasonally adjusted). In the three months November 2009 to January 2010 the number increased by 2.9 percent compared with the previous three months (seasonally adjusted, in annual terms).

The nominal wage per employee post in the business sector increased by 1.3 percent in January compared with the December level. In the three months November–January the nominal wage per employee post increased by 4.8 percent compared with the average in the previous three months, and the real wage increased by 0.5 percent (seasonally adjusted, in annual terms).

The monthly unemployment rate according to trend data was 7.3 percent in February, similar to the January level. The monthly data, however, are based on a relatively small sample, so that the figures should be treated with caution.

Foreign trade

Goods exports (excluding diamonds) increased by about 7.2 percent in March from their February level (in dollar terms, seasonally adjusted). In the three months January–March 2010 these exports expanded at an annual rate of about 22.2 percent (in dollar terms, seasonally adjusted) from their level in the previous three months.

Goods imports (excluding ships, aircraft and diamonds) increased by 8.3 percent in March from their February level (in dollar terms, seasonally adjusted). In the three months January–March these imports increased at an annual rate of 51.0 percent (in dollar terms, seasonally adjusted) from their level in the previous three months.

The Companies Survey

The Bank of Israel Companies Survey for the first quarter of 2010 shows that business activity continued to follow the path of expansion evident in the previous quarter. In the first quarter the growth was due largely to increased domestic activity. Companies reported that they expected further improvement in the second quarter, with an increase in exports.

2. Budget data

An analysis performed by the Bank of Israel Research Department shows that under the assumption of a 3.7 percent growth rate in 2010 in Israel, the budget deficit is expected to be significantly lower than the ceiling of 5.5 percent of GDP. The main reason is that tax revenues are in excess of the forecast when the budget was prepared. Excluding the effect of statutory tax changes, revenues in January–March 2010 were about 9 percent higher, in real terms, than in that period in 2009: revenues from direct

taxes about 6 percent higher in real terms, and from indirect taxes, about 12 percent higher. During the last four months, however, taken month by month, it appears that the rate of increase of tax revenues has slowed.

Government expenditure in March, excluding credit, was higher than the seasonal path consistent with full budget expenditure; in February expenditure had been in line with the seasonal path, and in January, below it.

3. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) for March rose by 0.1 percent, in line with private forecasters' predictions, and slightly above the forecast of the Bank's Research Department of no change in the index. The seasonally adjusted index for March remained unchanged.

Since the beginning of the year the CPI has fallen by 0.9 percent, and seasonally adjusted it has not changed. Adjusting for seasonality, the reduction in indirect taxes and the abolition of the water surcharge, inflation since the beginning of the year was 0.6 percent.

In the last twelve months the CPI rose by 3.2 percent. Excluding the effect of government actions (i.e., excluding the effects of the changes in VAT, and the increases in taxes on cigarettes and fuel and surcharges), the index rose by 2.7 percent.

The housing component of the CPI increased by 0.6 percent in March, after declining by a cumulative 2 percent in the previous three months. The housing index increased by 4.7 percent in the previous twelve months. House prices, according to the house price survey, which are not included in the CPI, increased by 22.2 percent in the last twelve months (to February).

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") declined during the last month (to the 22 April), to an average of 2.7 percent, from an average of 3.0 percent in March.

The private domestic forecasters predict on average that inflation in the next twelve price indices (the indices from April 2010 to March 2011) will be 2.7 percent. They assess that inflation measured over the previous twelve months will be 1.8 percent in 2010. They expect inflation to enter the target range next month (with the publication of the April CPI), and predict that it will decline gradually to reach 1.3 percent in August, and that it will then rise, to reach 2.7 percent in a year's time. The Israeli forecasters expect, on average, that the CPI will rise by a total of 1.3 percent in the three months April to June 2010.

With regard to the interest rate, the Israeli forecasters assess on average that the Bank of Israel's rate will increase in the next three months by a cumulative 0.3 percentage points, and that the rate in twelve months' time will be 3.0 percent.

The slope of the *makam* yield curve indicates that the capital market expects the Bank of Israel interest rate one year forward to be about 2.6 percent.

The makam and bond markets

The yield to maturity on CPI-indexed five-year government bonds increased in April (to the 22nd of the month) to an average of about 1.3 percent, from about 1.1 percent in March. The yield on 5-year unindexed government bonds increased to an average of about 4.0 percent in April, compared with about 3.9 percent in March. The yield on one-year *makam* increased to about 2.2 percent in April, from about 2.0 percent in March.

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 1.25 percentage points higher than the US federal funds rate, and 0.5 percentage points higher than the ECB rate.

The yield gap on local currency unindexed ten-year was similar to its level in the previous month—at 114 basis points (b.p.) on 22 April compared with 112 b.p. on 28 March

The expected real interest rate

The Bank of Israel interest rate *minus* twelve-months-forward inflation expectations derived from the capital markets in April, prior to these discussions, averaged *minus* 1.1 percent, compared with *minus* 1.6 percent in March.

The monetary aggregates

In the twelve months up to and including March 2010 the monetary base measured by the M1 monetary aggregate (cash held by the public and demand deposits) increased by 25.1 percent; in March it increased by about 2.4 percent. In the last twelve months the M2 aggregate (M1 plus unindexed term deposits of up to one year) increased by 4.7 percent, with a decline in March of 0.8 percent. The rapid increase in M1 in the last year was mainly due to the public's switching from term deposits to demand deposits in light of the low level of the interest rate on term deposits.

The credit markets

The outstanding balance of bank credit to the business sector increased in February by 0.9 percent, after falling by 0.4 percent in January. Outstanding bank credit to households declined in February by 0.5 percent after increasing by 0.3 percent in January.

In the last few months the rate of increase of outstanding bank mortgage credit (to households) slowed. In December 2009 it increased by 1.4 percent, in January by 0.7 percent, and in February, by 0.2 percent.

The total amount of new mortgages granted increased in March to about NIS 3.6 billion, compared with NIS 3.1 billion in February, NIS 3.2 billion in January, and NIS 3.9 billion in December 2009. In the last few months the share in total mortgages of mortgages taken at adjustable interest rates increased, and reached 56 percent in March, compared with 53 percent in February, 52 percent in January, and 50 percent in December.

Excluding the financial sector, corporate bond issues increased from NIS 1.5 billion in February to NIS 2.3 billion in March. The risk rating of the issues indicates that the composition of the issues is a riskier one than that in 2009.

The econometric models¹

Various scenarios of economic developments were examined using the Bank of Israel's econometric models, under the following assumptions: an increase of 4.3 percent in business sector product in 2010 (consistent with the Bank of Israel's forecast of about 3.7 percent growth in GDP); a 4.6 percent increase in business sector product in 2011 (consistent with 4.0 percent growth in GDP); low interest rates around the world that start to increase very gradually in 2010; a moderate increase in prices of imported inputs till the middle of 2010; and an increase of 7.0 percent in world trade in 2010 and of 6 percent in 2011.

According to the baseline scenario of the DSGE (dynamic stochastic general equilibrium) model—which places great weight on expectations and which uses a Bank of Israel reaction function based in part on the smoothing of the interest rate path—gives an increase in the rate of interest from an average of about 1.3 percent in the first quarter of 2010 to 2.9 percent in the last quarter of 2010 and to 4.8 percent in the last quarter of 2011. The model also gives an average exchange rate of about NIS 3.7 to the dollar in 2010, and inflation of about 1.1 percent in 2010 and 2.1 percent in 2011.

The error-correction (EC) model gives inflation of 1.6 percent in 2010 and 1.1 percent in 2011, with the Bank of Israel interest rate increasing from an average of 1.3 percent in the first quarter of 2010 to 2.4 percent in the last quarter of the year and to 3.2 percent in the last quarter of 2011. In this scenario the exchange rate is NIS 3.79 to the dollar.

In the discussion it was noted that the difference in the inflation environments in the two models focus on the different ways they relate to potential GDP, which is used to calculate the output gap—the difference between the expected actual GDP and potential GDP.

Based on the results of the models, other indicators and economic forces not reflected by the models, the assessment of the Bank of Israel Research Department is that inflation will moderate, and that in 2010 it will be below the midpoint of the target inflation range. This result is obtained along with an increase in the interest rate during 2010, against the background of the recovery from the recession and the low starting level of the interest rate.

4. The foreign currency market and the share market

The foreign-currency market

During the period since 31 March to the current discussions (23 April), the shekel depreciated slightly, by less than one percent, against the dollar, and appreciated

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.

slightly, also by less than one percent, against the euro. Measured by the nominal effective exchange rate of the shekel, calculated as the trade-weighted average shekel exchange rate against 28 currencies (representing 38 of Israel's trading partners), the shekel depreciated by about 0.7 percent.²

The share market

The Tel Aviv 25 share price index was about 2.9 percent lower on 22 April than on 31 March. The Dow Jones index rose by about 2.6 percent in that period.

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

Israel's risk premium, as measured by the five-year credit default swap (CDS) spread, declined slightly between the previous and the current interest rate discussions, to 1.09 percentage points, following a similar path to that in the CDS spreads of the emerging market economies

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

In light of the continued recovery in global economic activity, the IMF in April revised its forecast of world growth in 2010 to 4.2 percent, compared with its forecast in January of 3.9 percent.

The IMF noted that among the advanced economies the recovery in the US is stronger than that in Europe and Japan. It forecasts growth of 3.1 percent in the US in 2010, 1 percent in the eurozone, and 1.9 percent in Japan. Global growth is being led by China, with an expected growth rate of 10 percent in 2010, and India, also with an expected rapid rate, 8.8 percent.

Alongside the continued global economic recovery, risks are still present. The risk of a debt crisis in Europe, or difficulties in rolling over debt, are expected to persist during the coming year, and the expected increase in financing costs will make it difficult for most advanced economies to improve their fiscal situation.

Expectations regarding changes in interest rates around the world, reflected by the conduct of those active in the financial markets, are that the Fed will increase its rate in the second half of 2010, with Europe expected to follow the US lead.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR MAY 2010

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 on the interest rate for April, all the participating members of management recommended that the Governor hold the rate unchanged at 1.5 percent.

² The weight of the dollar in the effective exchange rate is about 25 percent, and that of the euro, about 33 percent.

As was stated in the report of the discussions prior to the previous decision (about the interest rate for April), the Bank of Israel's policy is to continue with the gradual process of bringing the interest rate back to a more "normal" level that reflects the recovery in economic activity, and that is required to bring inflation into the target inflation range and to keep it there. The gradual nature of the process is expressed by the fact that the Bank is not changing the interest rate every month, but only in accordance with the inflation environment, the firm entrenchment of growth in the global economy, and the interest rates of the major central banks, while taking into consideration the exchange rate of the shekel..

In the discussion, participants noted that real activity is continuing to expand and growth is becoming more firmly established, against the background of the continued global recovery, reflected by the upward revision of the Bank's forecast of growth in Israel in 2010 to 3.7 percent. Despite the firmer growth, participants in the discussion emphasized that there was still much uncertainty about the global growth rate and the rate of expansion of world trade.

Participants stated that the econometric models used by the Bank point to inflation (over the previous twelve months) being below the midpoint of the target range in 2010, and to be within the range in a year's time. This forecast is consistent with those of private Israeli forecasters, who expect inflation (over the previous twelve months) to enter the target range in the coming month, and the annual inflation rate in 2010 to be slightly below the midpoint of the range. This, alongside an increasing interest rate in the coming year. One-year-forward inflation expectations calculated from the capital market declined last month, and are in the upper part of the target inflation range.

Members of the narrow forum spoke of the rapid increase in asset prices during the last year, in particular house prices. In this context the point was made that the increase in house prices, according to the survey of house prices, continued at the beginning of 2010, following their rapid rise in 2009. Participants in the discussions examined the increase in new mortgages granted in the last few months, in particular those at adjustable shekel interest rates. Some of the participants noted that there were forces acting to moderate the rate of increase in housing prices. It was stated that the Bank of Israel would continue to monitor asset prices in Israel. House prices affect rentals, and thus affect the CPI.

The timing of increases in the interest rate in Israel relative to increases by leading central banks around the world affects the exchange rate of the shekel. The participants expressed concern that too rapid a pace of increases in the interest rate would result in too great appreciation of the shekel.

Bearing in mind the increase in the interest rate in the previous month, and in light of the various arguments put forth in the discussion, the Governor decided to keep the interest rate for May unchanged at 1.5 percent.

In its announcement of the decision, the Bank of Israel stressed the following background conditions that led to the decision to leave the interest rate unchanged for May, following the increase in the rate for April:

- The inflation environment: the CPI rose by 3.2 percent in the last twelve months, and since the beginning of 2010 it has declined by 0.9 percent. Seasonally adjusted and excluding the effect of tax reductions and the removal of the water surcharge, inflation since the beginning of the year was 0.6 percent. Following the publication of the CPI for April, inflation over the previous twelve months is expected to enter the inflation target range (an annual rate of 1–3 percent), and the annual rate for the whole of 2010 is expected to be slightly below the midpoint of the range. One-year-forward inflation expectations derived from the capital market declined in April to 2.7 percent, the lowest level for several months. The Israeli forecasters expect, on average, that CPI inflation in the next twelve months will be 2.7 percent. These expectations and forecasts are accompanied by expectations of gradual increases in the Bank of Israel interest rate.
- Data published this month, including the Bank of Israel Companies Survey for the first quarter of 2010, and foreign trade data, suggest that growth is becoming more firmly established, but uncertainty remains regarding the rate of global growth. That said, the process of narrowing the output gap is expected to be a gradual one.
- Interest rates of the leading central banks around the world are very low, and are expected to remain so during the coming months. Nonetheless, some leading central banks are continuing to reduce their use of unconventional instruments of monetary accommodation, and some central banks have started to increase their interest rates..

The Bank of Israel will continue to act to achieve its objectives of price stability, the encouragement of employment and growth, and support for the stability of the financial system.

The decision was made and published on 26 April 2010.

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 Rony Hizkiyahu, the Supervisor of Banks

Dr. Ohad Bar-Efrat, Advisor to the Governor and Head of the 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

In April the IMF published its revised forecast of economic growth in the US in 2010, 3.1 percent, compared with 2.6 percent in its January forecast.

Economic indicators point to the continued recovery in the US economy, and growth in the first quarter of 2010 may be surprising, above 3 percent.

In March the number of new employees taken on in the private sector increased markedly. Nonetheless, the high unemployment rate, 9.7 percent, is the major problem of the US economy.

Private consumption continued to expand, for the fifth month in succession, as can be seen from the data on retail sales. Nonetheless, the disappointing figures on wages in the last two months threaten the continuation of this trend.

The housing market also constitutes a problem in the US economy. House sales fell again in February. The government's support programs are expected to help mortgage repayments.

The minutes of the Fed meeting suggest that it will not hurry to increase the interest rate, given the low level of inflation and the weakness in several sectors, including small businesses that are still affected by difficulties in the credit market.

The US Treasury has not encountered problems in borrowing, and yields on 10-year bonds are declining again.

Europe

The April IMF growth forecast for 2010 for the eurozone was 1 percent, similar to its previous forecast in January.

Clouds hovering over Europe, in addition to the volcanic ash cloud from Iceland, include Greece's and other countries' debt problems, as yet not completely solved and possibly even becoming more severe. The growth forecast for the eurozone for the fourth quarter of 2010 was revised downwards to zero, and unemployment climbed to 10 percent.

The main announcement this month was the EU statement that it agreed to a support package for Greece, which is also negotiating with the IMF for support from the Fund. Following the announcement, yields on bonds longer than two years fell by more than one percent, but not for long, and later they surged to about 9 percent, with the effects of the crisis likely to spill over to other countries.

The serious structural problems in Europe (unemployment, competitiveness and marked inequality between the different countries) will continue to hold back the very slow economic recovery.

The ECB is not expected to change its interest rate in the near future, and there are assessments that it will not increase its rate before the Fed increases its interest rate.

In the UK, the forthcoming General Election set the tone last month, with the main economic topic featured in the election campaign is the size of the cut in public expenditure. After several months of relatively disappointing economic indicators, the

data published this month were generally positive, and pointed to renewed recovery. Inflation in March exceeded the Bank of England's target and expectations.

Japan

The IMF 2010 growth forecast for Japan in April was 1.9 percent, compared with 1.7 percent in the January forecast.

Economic indicators this month painted a mixed picture: manufacturing and construction were weak, but retail trade and car orders were strong. The economic forecasts, and in particular that of the Governor of the Bank of Japan, were revised upwards, essentially due to the improvement in the export sector which reaped the benefit of the continued recovery in East Asia.

The starting point of the economic recovery in Japan is at a very low level of activity, and there is a wide gap between that level and the peak levels in various sectors. Moreover, the economic environment is one of deflation which is expected to persist next year too.

The emerging markets

China and India are leading the growth in the emerging market economies. The IMF April growth forecast for 2010 is of 10 percent growth in China (the same as in the January forecast) and of 8.8 percent growth in India (compared with 7.7 percent in the January forecast).

Growth in China in the first quarter of 2010, 11.9 percent, annual rate, exceeded expectations. One of the main bones of contention between China and the US is the matter of the appreciation of the renminbi. Pressure on China is expected to continue, and China is expected to carry out a measure of appreciation closer to summer. Efforts to absorb the high level of liquidity are continuing. There is still concern regarding the overheating of China's economy, and this was strengthened by the Fitch rating agency's report that asset bubbles are being created in China, and by the Chairman of the China Development Bank who announced that economic in China was problematic, and inflation and bubbles are to be expected (meanwhile there is no inflation). Expectations firmed recently that the interest rate would be increased in China towards the end of the second quarter in light of concern over a significant increase in inflation in the next few months.