BANK OF ISRAEL
Office of the Spokesperson and Economic Information

PRESS RELEASE

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

The discussions took place on July 25 and 26, 2010

General

Before the Governor makes the monthly interest rate decision,[1] 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

Indicators published in the last month (in the period between the decision on the July interest rate on June 28 and the current decision on July 26) support the assessment that in the second quarter of 2010 economic activity continued to increase, and at a similar rate to that in the previous two quarters. Growth in the second quarter is expected to be based on the increase in private consumption and in gross domestic

[1] When the Monetary Committee is appointed, in accordance with the new Bank of Israel Law, interest rate decisions will be made by the Committee.

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investment, due to the start of a recovery trend in nonresidential gross fixed capital formation. Exports, however, are expected to decline in the second quarter. The labor market continued to recover, and unemployment fell further.

Despite the generally positive picture relating to the economy in the second quarter, there are some indicators that suggest that during the quarter economic activity stabilized or even declined in some sectors, and the probability of a slower rate of growth in the third quarter increased. These indicators include the modest rise in the composite state-of-the-economy index (details below), the standstill in exports and the drop in export orders as reflected in the Bank of Israel's Companies Survey, the decline in the Purchasing Managers Index and in consumer confidence indices, and the slowdown in tax revenues.

The composite state-of-the-economy index

The June composite state-of-the-economy index rose by only 0.1 percent, and the indices for April and May were revised downwards from 0.1 percent increases to no change. The modest rise in the index in the last few months supports the assessment that the rate of recovery of economic activity has slowed.

The increase in the index in June reflects, among other things, the combination of a 0.6 percent increase in manufacturing production in May, following its 1.9 percent increase in April; an increase of 2.5 percent in the goods export index in June; a rise of 1.4 percent in imports of production inputs in June; a 1.3 percent decline in consumer goods imports in June; and a decline of 0.6 percent in trade and services revenue in May.

The labor market

Most labor market data show rapid improvement in the second quarter following a slower pace in the first quarter: thus, the Bank of Israel Companies Survey and the Manufacturers Association Survey of Expectations indicate significant increases in employment; the Central Bureau of Statistics (CBS) Survey of Vacancies indicates an increase in the number of employees and in the number of vacant positions in April–June; Employment Service data indicate a drop in the number of claims for unemployment benefit in April–May; according to the Manpower Index, the demand for workers increased in the second quarter and the trend data for the monthly unemployment rate show unemployment of 6.5 percent in May, about half a percentage point lower than the average in the first quarter of 2010. (The monthly data, however, are based on a relatively small sample, so that the figures should be treated with caution.)

In April the number of Israeli employee posts was 0.6 percent greater than the number in March (seasonally adjusted). In the three months February–April the number of employee posts increased by 1.7 percent compared with the number in the previous three months (annual rate, seasonally adjusted).

The nominal wage per employee post in the business sector (Israelis only) fell by 1.9 percent in April compared with the March level. In the three months February–April the nominal wage per employee post increased by 6.7 percent compared with the average in the previous three months, and the real wage increased by 5.9 percent (seasonally adjusted, in annual terms).

Foreign trade

Goods exports (excluding ships, planes and diamonds) increased by about 0.7 percent in June from their May level (in dollar terms, seasonally adjusted). In the three months April–June 2010 these exports declined at an annual rate of about 19.2 percent (in dollar terms, seasonally adjusted) from their level in the previous three months. That said, if changes in the nominal effective exchange rate are taken into account, the (quantitative) volume of exports in the second quarter was similar to that in the first.

Goods imports (excluding ships, aircraft and diamonds) declined by 0.2 percent in June from their May level (in dollar terms, seasonally adjusted). In the three months April–June these imports increased at an annual rate of 6.5 percent (in dollar terms, seasonally adjusted) from their level in the previous three months.

The Bank of Israel Companies Survey

Data from the Companies Survey for the second quarter show the continued expansion of total economic activity. Nonetheless, the data also indicate that companies expect a decline in export and domestic orders for the third quarter, particularly in the manufacturing industries.

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, at about 4 percent of GDP.

The main reason for the expectation of a deficit below the ceiling is that tax revenues at the beginning of the year were in excess of the forecasts made when the budget was prepared. Nevertheless, the rate of increase in tax revenues has slowed in the last few months: VAT on domestic production declined by 5 percent in the three months April–June compared with the level in the previous three months (seasonally adjusted).

3. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) for June rose by 0.3 percent, close to the Bank of Israel's Research Department forecast and within the range of the private forecasters' predictions. The seasonally adjusted June index (using the Research Department's seasonal adjustment method) increased by 0.2 percent.

In the last twelve months the CPI has risen by 2.4 percent, the lowest annual rate of inflation since December 2007.

The housing index rose by 0.6 percent in June, and in the last twelve months by a cumulative 4.9 percent (see below for a more detailed discussion of the housing market).

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") increased in July to 3.0 percent (average to 25 July), compared with the June average of 2.9 percent.

The Israeli forecasters predict on average that inflation in the next twelve price indices (from July 2010 to June 2011) will be 3.2 percent, i.e., above the upper limit of the inflation target. In the three months July–September, the forecasters expect, on average, that the CPI will rise by a total of 1.1 percent. They assess that inflation in 2010 measured over the previous twelve months will be 2.2 percent, and in 2011, 2.7 percent.

Seven of the ten forecasters who updated their reports to the Bank of Israel after the publication of the June CPI expected the Bank to increase the interest rate for August, while the others expected an increase in September. On average they assess that the interest rate in twelve months' time will be 2.7 percent.

An analysis of the slope of the *makam* yield curve indicates that the capital market expects the Bank of Israel interest rate one year hence to be about 2.5 percent.

The makam and bond markets

The yield to maturity on CPI-indexed ten-year government bonds declined in July (to July 25) to an average of about 2.1 percent, from an average yield of about 2.2 percent in June. The yield on ten-year unindexed government bonds declined to an average of about 4.85 percent in July, from about 5.0 percent in June. The yield to maturity on one-year *makam* remained unchanged in July at about 2.1 percent.

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 1.25–1.50 percentage points higher than the US federal funds rate, and 0.5 percentage points higher than the ECB rate.

The yield gap between local currency unindexed ten-year bonds and ten-year US Treasury bonds increased from 151 basis points (b.p.) on June 25 to 156 b.p. on July 22.

The expected real interest rate

The July Bank of Israel interest rate *minus* twelve-months-forward inflation expectations derived from the capital markets averaged *minus* 1.4 percent, compared with *minus* 1.3 percent in June.

The monetary aggregates

In the twelve months up to and including June 2010 the monetary base measured by the M1 monetary aggregate (cash held by the public and demand deposits) increased by 8.9 percent; in June it decreased by about 1.9 percent. In the last twelve months the M2 aggregate (M1 plus unindexed term deposits of up to one year) increased by 2.3 percent, and in June it decreased by 1.6 percent.

The credit markets

The outstanding balance of bank credit to the business sector contracted in May by 0.6 percent, after increasing by 1.1 percent in April. Outstanding bank credit to households increased in May by 1.8 percent following its 0.5 percent increase in April.

The housing market

The housing component in the CPI (which reflects the costs of housing rentals) increased by 4.9 percent in the twelve months to June (inclusive). In the course of the discussion the result of an econometric equation for forecasting housing prices—based on factors such as house prices, the mortgage interest rate, the rate of unemployment, the number of building starts, the ratio of the population to the stock of houses, and the exchange rate—was presented. Based on the equation, the CPI housing component (i.e., rentals) is expected to rise faster than was estimated previously.

Based on the survey of house prices (which are not included in the CPI, see above), these increased in April by 1.2 percent, and in the twelve months to April (inclusive) by 21 percent, due both to the low rate of interest and to the slow response of the supply of houses to higher prices. Another econometric equation, for forecasting changes in house prices, gives the result that the rate of increase in house prices is expected to moderate in the next twelve months.

An up-to-date analysis of house prices shows that their level does not differ significantly from the level derived from economic fundamentals. Nevertheless, house prices continue to rise very rapidly, and did so in April too, and if this rate persists, it will distance them from the level consistent with the economic fundamentals.

Total mortgages granted in the first half of 2010 were 52 percent higher than in the first half of 2009 (this can also be attributed to the rise in house prices). The share of unindexed floating-rate mortgages in the total of new mortgages fell again in June, following its decline in May, but it is still high, at about 50 percent.

The Research Department assessment

In the course of the discussions the Research Department presents a quarterly forecast that combines indicators derived from a number of models for forecasting inflation and real developments with judgmental assessments. These are incorporated in a medium-scale DSGE (dynamic stochastic general equilibrium) model along with judgmental assessments that bring together the information used to develop the staff forecast.

In the forecast presented to the senior monetary forum discussing the July interest rate, inflation in the next twelve months was expected to be close to the midpoint of the target inflation range. The forecast also gave a derived gradual increase in the Bank of Israel interest rate to an average of 2.8 percent in a year's time (the average in the third quarter of 2011). Since that forecast was prepared, there have been several developments that are expected to increase inflation above the level predicted then: in terms of the effective exchange rate, the shekel depreciated somewhat; there were firmer assessments that in the coming year the rate of increase in housing prices (rentals) would rise; and the government decided to increase several indirect taxes. These developments are expected to bring inflation in the next twelve months into the upper part of the target range, and to bring forward the timing of the expected increases in the interest rate a little.

4. The foreign currency market and the share market

The foreign-currency market

During the period from June 27 to the current discussions on July 25, the shekel depreciated by about 2.1 percent—measured by its nominal effective exchange rate, calculated as the trade-weighted average shekel exchange rate against 28 currencies (representing 38 of Israel's trading partners).[2] This was due mainly to the 4.6 percent depreciation of the shekel against the euro, from NIS 4.76 to the euro to NIS 4.98. Against the dollar, however, the shekel remained stable, and at the end of the period the exchange rate was NIS 3.85 to the dollar.

The share market

Since the previous interest rate discussions, share price indices in Israel and around the world rose. The Tel Aviv 25 share price index on July 25 was about 2.9 percent higher than on June 27. The Dow Jones index rose by about 2.8 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, stayed at a level of about 1.15 percentage points between the previous and the current interest rate discussions. CDS spreads around the world also remained stable.

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

There are increasing signs indicating that the pace of recovery in the global economy is slowing. This assessment comes against the background of weaker-than-expected macroeconomic figures in the US, fiscal tightening in Europe and the US, tightening policy measures in China, and persistent uncertainty over the fiscal crisis in Europe and the steps taken there to cut deficits.

The IMF revised its forecast of world growth in 2010 from 4.2 percent to 4.6 percent, entirely due to the high growth rate in the first quarter of the year. The IMF did not change its forecast for 2011, but stressed that its realization depends on fiscal policy measures being introduced, particularly in Europe. Unlike the IMF, the foreign investment houses started to lower their growth forecasts for various economies. In the next few months, however, global growth is expected to continue at forecast levels, based essentially on the very low interest rate environment and the rapid growth in the East Asian countries.

Stock market prices rose this month against the background of the easing of the debt crisis in Europe—due to the fiscal policy measures introduced in countries with refinancing problems—and positive financial statements in the second quarter. The investment houses expect the positive atmosphere in the capital markets to continue in the short term. Nonetheless, volatility in the global capital markets and the level of concern and uncertainty remained high this month. The VIX index of market volatility

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

is at a relatively high level, and the Bloomberg index of global financial pressure continued to indicate increased pressure.

Global inflation remained contained, against the background of the apparent slowdown in the rate of global growth, the general stability of commodity prices, and the output gaps in the advanced economies.

Interest rates of the leading central banks are expected to stay low for some considerable time, constituting alternatives for the fiscal stimulus programs that are coming to an end. Some other central banks, however, increased their interest rates this month, and further increases are expected in the next few months.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR AUGUST 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 August, all the participating members of management recommended that the Governor increase the rate by 25 basis points, to 1.75 percent.

As stated in the reports of previous interest rate discussions, the Bank of Israel's policy is to continue with the gradual process of bringing the interest rate back to a more "normal" level intended to position inflation firmly within the target range, and to contribute to the further recovery of economic activity, while supporting financial stability. The pace of the interest rate increases is not predetermined, but is set in accordance with the inflation environment, growth in Israel and globally, the monetary policies of the major central banks, and in light of developments in the exchange rates of the shekel.

In the discussion, participants spoke of the upward revision in the Research Department's assessment of inflation, and of the increase in inflation expectations derived from the capital market and the private forecasters' inflation assessments to around the upper limit of the target inflation range. The point was made that the upward revision in the Research Department's inflation forecast derived mainly from the shekel depreciation shown by the effective exchange rate, the expectation that housing prices would continue to rise, and the government's decision to increase indirect taxes.

Turning to the real economy, it was noted that there was apparently rapid growth in the second quarter, despite the decline in exports resulting from the slowdown in global activity. Moreover, particular mention was made of the continued recovery in the labor market: the wage is rising and unemployment is still falling. Nevertheless, attention was also drawn to the fact that indicators such as the composite state-of-the-economy index, the Bank of Israel's Companies Survey, the Purchasing Managers Index, and foreign trade data suggest that growth slowed during the second quarter, and this will be reflected in the data for third quarter. Some participants thought that despite the less buoyant figures expected for the third quarter, it seems that uncertainty and the real-side risks actually declined this month due to the reduction in the risk that the debt crisis in Europe would become more severe. An analysis of all the factors led to the assessment that positive growth would continue in line with the Bank of Israel's previous forecast—that 2010 growth will be 3.7 percent, along with a gradual contraction of the output gap.

With regard to the housing market, participants discussed the rise of 21 percent in house prices in the twelve months to May and the continued increase in mortgage credit. They referred to the extent of the need for macroprudential measures in light of the increase in house purchases for investment purposes and the high share of mortgage credit at floating interest rates. Reference was made to the Supervisor of Banks directive which went into effect at the beginning of July, requiring banks to make an additional provision for housing loans given with high loan-to-value ratios. It was suggested that the increase in new mortgages in the last few months may have resulted from buyers preempting the new directive by bringing forward their house purchase. Most of the participants thought it best to wait till the effects of the steps already taken have been further evaluated before introducing other macroprudential measures.

Finally, the participants stressed that even after the recommended increase of 25 basis points in the interest rate, policy would still be expansionary.

Taking into consideration the various points made in the discussion, the Governor decided to increase the interest rate for August by 25 basis points, to 1.75 percent.

In its announcement of the decision, the Bank of Israel stressed the following conditions that led to the decision to leave the interest rate unchanged for July:

- Inflation forecasts of the Bank of Israel, of the private forecasters and the capital market for one year ahead are around the upper limit of the target inflation range.

- Housing prices and the housing index (rents) are continuing to increase rapidly, together with a rapid expansion of housing credit.

- An analysis of the whole range of data on the real side and the labor market leads to the assessment that positive growth will continue in accordance with the Bank's previous forecasts, with a gradual contraction of the output gap.

- Interest rates of the central banks of the major advanced economies are at very low levels, and in light of recent developments are expected to remain so for some considerable time. Nonetheless, central banks in several countries that are already growing relatively rapidly continued with the process of increasing their interest rates last month, and are expected to continue to do so in the near future.

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 July 26, 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
Mr. Eddy Azoulay, Chief of Staff to the Governor
Dr. Yossi Saadon, Advisor to the Governor and Bank of Israel Spokesperson
Mr. Eyal Argov, Research Department economist

Appendix: Major Global Economic Developments

US

The macroeconomic data on the US economy published in the last few weeks indicate a general deterioration and a greater probability of a slowdown in the rate of growth in the next few quarters (but not a recession), against the background of, among other things, the ending of the fiscal programs and the continued weakness in the labor and real estate markets. There is concern that growth engines such as business sector investment and private consumption are not strong enough yet to replace the fiscal stimuli. Against this background the Fed reduced its growth forecast for 2010 by 0.2 percentage points to between 3.0 percent and 3.5 percent.

The main problem continues to be the labor market. The rate of unemployment declined only because of the reduction in the rate of participation, the number of new employees was lower than had been forecast, and the proportion of the unemployed who were out of work for more than 27 weeks remained high, at 45 percent.

The real estate sector is still weak: the number of building starts fell in June by 5 percent to its lowest level in eight months; the number of house foreclosures by the banks started rising, and the number of short sales (in which a home is sold at a price 30 percent below the mortgage) has been increasing since the beginning of the year. It should be noted that the weakness in the real estate market is also related to the ending of the home purchase aid program.

The above led to the postponement of the predicted timing of the start of increases in the interest rate. Some of the forecasters even expect that the first increase will not be before some time in 2012. In addition, a greater number of assessments expect that the Fed will introduce additional measures and that the aid programs will be extended. Such expansionary activity will apparently continue to constitute the main basis of the US economic recovery.

Europe

The fiscal measures introduced in the problematic European economies, the good results of the stress tests of the European banks, and the positive macroeconomic data of the EU, all these served to alleviate concern over the European debt crisis. The fiscal steps taken in the last few months (the cutbacks in public expenditure and increases in taxes) eased investors' concern regarding some countries' insolvency, so that bond issues countries such as Spain, Portugal and Greece were successful. Furthermore, the other EU countries are meeting their requirements for finance, having so far raised some 60 percent to 70 percent of their requirements for this year.

The successful results of the stress tests of the banks calmed the concern over the European banking system. In the scenario examined, of the 91 banks (that constitute about 65 percent of the European banking market), only 7 failed, and the additional capital required amounted to only $4.5 billion.

The overall European data published in the course of the month were positive, and exceeded expectations, mainly regarding Germany, that continues to be the major engine of growth in the eurozone. This was partly due to the weakening of the euro during the crisis, which helped the competitiveness of the export sector—which occupies a dominant position in the European economy.

Despite the lower level of concern in Europe, the ECB is expected to leave the interest rate at its current level in the next few months and to continue to buy bonds (albeit on a smaller scale).

The emerging markets

Various tightening policy measures taken in China are showing some success: The annual growth rate in the second quarter of 2010 was 10.3 percent, lower than the market's expectations. In addition, the rate of increase in credit continues to decline, and house prices started falling again in June. The various purchasing managers indices continue to reflect a slowdown in the Chinese economy. Against this background, inflation slowed this month, and fell back to less than 3 percent.

In the other emerging markets, particularly those in East Asia, rapid growth persisted in the second quarter. Those economies continue to benefit from increasing intra-regional trade and from the ongoing capital inflow from foreign investors who prefer these economies to the advanced economies.