BANK OF ISRAEL
Office of the Spokesperson and Economic Information

November 8, 2010

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

The discussions took place on October 24 and 25, 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 October interest rate on September 27 and the current decision on October 25), showed that economic activity continued to increase, but at a slower pace than that evident since the beginning of the year. The assessment of a weakening of economic growth was supported by the data on imports and exports in the third quarter, the composite state-of-the-economy index, and monthly indicators of tourist entries, the

[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.

Purchasing Managers Index, and consumer confidence indices. The Bank of Israel Companies Survey for the third quarter, however, presented a different picture, showing activity in that quarter at a level similar to that in the second quarter, in both the domestic and export markets. Government tax revenues and the Ministry of Industry, Trade and Labor Employers Survey are also consistent with an increase in economic activity at a rate no lower than that in the second quarter.

The National Accounts

According to the revised National Accounts data for the second quarter of 2010 published on October 16, GDP grew at an annual rate of 4.5 percent (compared with the estimate in September of 4.6 percent), following a growth rate of 3.7 percent in the first quarter (the September estimate was 3.8 percent). Business sector product expanded rapidly in the second quarter, by 5.2 percent. The revised data show that goods and services exports increased by 22.7 percent, and fixed investment by 13.1 percent, with a 17.8 percent increase in residential investment. Private consumption expanded by 8.5 percent, after remaining steady in the previous quarter, and imports continued to increase, with a 9.4 percent rise.

The composite state-of-the-economy index

The September composite state-of-the-economy index was unchanged from its August level. The indices for the previous months show that economic activity expanded more slowly than in the previous two quarters.

The stability in the index in September resulted from an increase in the indices of trade and services revenue and imports of production inputs, offset by falls in the indices of goods and services exports, consumer goods imports, and the index of manufacturing production. The index of manufacturing production declined by 6 percent in August, following its 2.4 percent rise in July; the index of trade and services revenue edged up by 0.1 percent in August, following its increase of 1.7 percent in July; the services exports index declined by 4.5 percent in September, after rising by 5.2 percent in August. See below for the foreign trade data.

The labor market

According to the Ministry of Industry, Trade and Labor Employers Survey, demand for labor in the business sector increased in the third quarter. The Ministry's data show that the number of vacancies grew by 1.4 percent in September (initial data).

The total number of employee posts increased by 3.6 percent in May–July compared with May–July 2009, and employee posts in the business sector by 3.7 percent. Employment increased in many industries, in particular banking and financial services, manufacturing and trade.

The nominal wage per employee post increased by 3.5 percent in May–July from its level in May–July 2009, and the nominal wage in the business sector by 4.1 percent. The real wage per employee post increased by 1.6 percent.

The trend data for the monthly unemployment rate showed unemployment at 6.3 percent in August 2010. The monthly data, however, are based on a relatively small sample, so that the estimate should be treated with caution.

Foreign trade

Goods exports (excluding diamonds) fell by about 5.4 percent in September from their August level (in dollar terms, seasonally adjusted). In the three months July–September exports dropped by 4.6 percent compared with their level in April–June (in dollar terms, seasonally adjusted).

Goods imports (excluding ships, aircraft and diamonds) declined by 0.7 percent in September from their August level (in dollar terms, seasonally adjusted). In the three months July–September imports fell by 0.5 percent compared with their level in April–June (in dollar terms, seasonally adjusted).

The Companies Survey

Data from the Bank of Israel Companies Survey for the third quarter indicated further expansion of economic activity in that quarter, at a rate similar to that since the beginning of the year. In most industries the Survey indicates that activity is expected to continue increasing in the fourth quarter. Companies in the manufacturing industry reported a slowdown in the rate of increase of both domestic and export orders. The increase in manufacturing activity in the third quarter related to domestic and export sales, whereas the increase reported by service companies was based on the domestic market. Most companies reported that if demand from the US and Europe declines, they will intensify their marketing efforts in other markets.

2. Budget data

Tax revenues increased at a faster pace in September, and seasonally adjusted and allowing for the postponement of tax rebates were 6.8 higher in September than the monthly average in June–August.

The domestic deficit from the beginning of 2010 to September was 1.3 percent of GDP, below the seasonal path consistent with 100 percent implementation of budgeted spending. Since the beginning of the year, domestic revenues, mainly from taxes, have exceeded the estimate at the time the budget was approved by about 4 percent, and expenditure has been about 2.8 percent lower than the seasonal path consistent with complete expenditure of the budget. Based on developments to date and on the assumption of almost complete expenditure of the budget, the total deficit in 2010, excluding credit, is expected to be between 3.7 percent and 4 percent of GDP. The gap between this forecast and the deficit in the budget proposal derives from higher than expected tax revenues and an increase in expected growth.

3. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) for September increased by 0.3 percent, exceeding the 0.2 percent average increase predicted by the private forecasters and the 0.1 percent forecast of the Research Department. The rise in the index was due mainly to the fruit and vegetables component, with the housing component also making a significant contribution.

Since the beginning of the year the CPI, seasonally adjusted, has increased by 1.8 percent, consistent with annual inflation of 2.4 percent.

In the last twelve months the CPI has increased by 2.4 percent.

The increase in the CPI since the beginning of the year was due mostly to the increase in house rentals. The housing index increased by 0.7 percent in September, and since the beginning of the year by 5.6 percent. The CPI excluding the housing component has increased by only 0.8 percent since the beginning of the year, and in September it increased by 0.1 percent (see below for a fuller description 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 to about 3 percent in October (the average to October 21), compared with an average of 2.8 percent in September.

The Israeli forecasters predict on average that inflation in the next twelve price indices (from October 2010 to September 2011) will be about 2.8 percent. On average they expect that inflation measured over the previous twelve months will be 2.4 percent in 2010, and 2.8 percent in 2011.

The forecasters expect, on average, that in the three months October–December 2010 the CPI will rise by a total of 0.5 percent.

On average the forecasters expect the Bank of Israel interest rate to remain unchanged for November, and that in twelve months' time it will be about 3 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 3 percent.

The makam and bond markets

From the beginning of the month to October 21, yields on 5-year CPI-indexed government bonds declined to an average of 0.6 percent from an average of 0.7 percent in September. The yield to maturity on unindexed 5-year government bonds fell to 3.6 percent, from 3.7 percent in September. The yield to maturity on one-year *makam* increased over the period to about 2.4 percent, from 2.3 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 1.75–2.0 percentage points higher than the US federal funds rate and 1 percentage point higher than the ECB rate.

The yield gap in shekel terms between ten-year unindexed Israeli and US government bonds contracted slightly from 189 basis points (b.p.) on September 27 to 180 b.p. on October 21.

The expected real interest rate

The Bank of Israel interest rate *minus* twelve-months-forward inflation expectations derived from the capital markets averaged *minus* 0.9 percent in October (to the date of the current discussions), close to its level of *minus* 1 percent in September.

The monetary aggregates

In the twelve months up to and including September 2010 the monetary base measured by the M1 monetary aggregate (cash held by the public and demand deposits) increased by 4.2 percent, and in September 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 1 percent, and in September by 1.7 percent.

The credit markets

The outstanding balance of credit to the business sector increased by 1.2 percent in August, after remaining unchanged in July. Bank credit to the business sector also increased by 1.2 percent in August. The balance of credit to households increased by 0.9 percent in August.

The housing market

The housing component in the CPI, which reflects the costs of housing rentals and accounts for about 20 percent of the total CPI, increased by 0.7 percent in September; since the beginning of the year it has increased by 5.6 percent.

House prices, which are not included in the CPI and which are taken from the Central Bureau of Statistics survey of house prices, increased by 1.3 percent in July–August relative to June–July, faster than their increase of 0.7 percent in June–July relative to May–June. In the last twelve months house prices, based on the survey, have increased by about 18.9 percent, and since the beginning of the year by 9.7 percent.

The volume of new mortgages granted in September decreased by a steep 30 percent compared with the level in August, to NIS 3 billion, with all types of mortgage showing reductions at this rate. It should be noted that there is an element of seasonality in these figures, and in September last year there was a sharp 17 percent drop in new mortgages compared with the previous month, apparently due to the period of the Jewish High Holydays. The decline this year occurred despite the fact that the interest rate on floating rate mortgages (indexed and unindexed) did not change and despite the reduction in the interest on fixed-interest indexed mortgages.

The Research Department assessment

The Bank of Israel Research Department assesses that inflation in the next twelve months will be 2.5 percent, and that the Bank's interest rate will increase gradually to reach about 2.7 percent in a year's time and 2.9 percent at the end of 2011. The main reason for the forecast being above the midpoint of the inflation target range is the housing component (rentals).

According to the Research Department's analysis, if the appreciation of the shekel persists, the increase in the interest rate will moderate, and so to some extent will growth. The main risks to real economic activity and inflation in Israel derive from developments abroad.

4. The foreign currency market and the share market

The foreign-currency market

During the period from September 26 to October 22, the shekel appreciated by about 1.5 percent against the dollar, and depreciated by about 2.4 percent against the euro. In terms of the nominal effective exchange rate[2] the shekel depreciated by 0.5 percent. During this period the Bank of Israel bought foreign currency.

The share market

[2] Calculated as the trade-weighted average shekel exchange rate against 28 currencies (representing 38 of Israel's trading partners). The weight of the dollar in the effective exchange rate is about 25 percent, and that of the euro, about 33 percent.

Since the previous interest rate discussions, share price indices in Israel rose, similar to the trend in most stock markets around the world. The Tel Aviv 25 share price index increased by 3.7 percent and passed its previous peak level (recorded in April this year).

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

Israel’s risk premium, as measured by the five-year credit default swap (CDS) spread, decreased from 121 b.p. to 116 b.p. in the period between the previous and the current interest rate discussions, in line with the trend in CDS spreads around the world.

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

There is no uniform pattern of exit from the crisis around the world. In many advanced economies activity is still at a modest level, unemployment is high, governments have large deficits, and problems in financial systems are still evident. Activity in emerging and developing economies is sturdier. In the month since the previous discussions on the interest rate, the IMF published its forecast of global growth for 2010—4.8 percent, compared with its previous forecast, in July, of 4.6 percent. It reduced its forecast growth for 2011 from 4.3 percent to 4.2 percent. The advanced economies are expected to grow by 2.7 percent in 2010, and by 2.2 percent in 2011. The emerging markets are expected to grow by 7.1 percent in 2010, and by 6.4 percent in 2011.

In the month since the last interest rate discussions there was considerable inflow of capital into the emerging and developing economies, which resulted in more intensive central bank intervention in the foreign currency markets. In Colombia, for example, the central bank (Bank of the Republic) starting buying $20 million a day, the Reserve Bank of India intervened in the foreign currency market, the first time it did so this year, and the Bank of Korea continues to buy dollars from time to time. Some countries (Brazil, for example) decided to impose taxation on foreign investments in domestic bonds, and Thailand abolished the tax exemption on foreigners' capital gains on their investments in domestic bonds, in attempts to moderate the strengthening of the local currency.

Inflation is low in the advanced economies and is expected to remain so in the near future against the background of the continued weakness of their labor markets and their output gaps. Inflationary pressures are still evident in the developing countries, deriving from the increase in commodity prices.

The large investment houses assess that the central banks of the US and Europe will start increasing their interest rates in the third quarter of 2011, with increased expectations that the Fed, the ECB and the Bank of Japan will renew their quantitative easing. The Bank of Japan renewed its purchases of financial assets, and the Fed and the Bank of England are also expected to act in the same direction in the near future. Central banks in the emerging markets face a conflict, with the rate of growth and inflationary pressures supporting an increase in the interest rate, while the sizable capital inflows into their economies and concern over the effect of a global slowdown tend to hold back the process of raising the interest rate.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR NOVEMBER 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 current discussions on the interest rate for November, all the participating members of management recommended that the Governor leave the interest rate unchanged, at 2.0 percent.

Leaving the interest rate at 2 percent is consistent with the process of gradually returning the rate to a more "normal" level intended to position inflation firmly within the target range, and to contribute to the further growth of economic activity, while supporting financial stability. The pace of 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. At the current level of interest, monetary policy is still somewhat expansionary.

Several issues were discussed, the main ones being the assessment of the environment of real economic activity, and developments in the housing market and in inflation.

In the discussion it was noted that data published in the month since the previous interest rate discussions show the expansion in economic activity continuing, albeit at a slower pace. Special attention was drawn to the decline in exports in the last few months and the risk to growth deriving from the slowdown in growth in the advanced economies and its implications for Israel's economy.

One-year-forward inflation expectations derived from the capital market (break-even inflation) increased to about 3 percent in October, and private forecasters' expectations for the increases in the next twelve CPIs (the indices from October 2010 to September 2011) averaged 2.8 percent. On average, the forecasters expect inflation in 2010 to be 2.4 percent, and 2.8 percent in 2011. The Bank of Israel Research Department twelve-month inflation forecast is about 2.5 percent.

Inflation during the last year has been due mainly to the housing component of the CPI (i.e., house rentals). In the last twelve months the CPI rose by 2.4 percent, and the CPI excluding housing by 1.4 percent. It was stressed that because of the gap between the rate of increase of house prices (which increased by almost 19 percent in the twelve months to July 2010) and that of house rentals (which increased by 6 percent in the twelve months to September), rentals may continue to increase. The fact that inflation in the next twelve months was expected to be higher than the midpoint of the target range was due mainly to the housing component (rentals). Concern over increases in commodity prices also plays a role.

During the last year house prices continued to increase against the background of the rapid increase in housing credit. The rise in house prices can be explained by the slow response of the supply of houses together with the effect of the low rate of interest. The point was made that in the last three months the rate of increase of this credit had slowed somewhat. It was emphasized, however, that there were pressures for continued increases in housing prices.

With regard to financial stability, and based on an analysis of the situation both by the Bank Supervision Department and by members of the narrow monetary forum, participants in the discussion recommended that additional macroprudential measures be introduced, further to those that the Supervisor of Banks introduced earlier that went into effect in July 2010. The participants stated that from the macroprudential aspect it was important to slow the rapid expansion of mortgage credit. Therefore, concurrently with the press release announcing the decision on the interest rate for November, the Supervisor of Banks published draft directives for consultation regarding the development of risks arising from housing loans. The directives imposed a requirement for banks to make a higher capital provision for housing loans above a certain level granted at floating interest rates.

With regard to financial stability, this step by the Bank of Israel would also support the policy to support price stability: it was expected to increase the rate of interest on some loans for house purchases and thus gradually to moderate the increase in housing costs.

Developments worldwide were reviewed, and it was noted that central banks in certain major advanced economies were expected to undertake further quantitative easing, particularly in the US, the UK and Japan, and the interest rates in the leading economies were not expected to change before the third quarter of 2011.

In light of the Bank of Israel's decision to introduce a further macroprudential measure with regard to housing finance, and its implications for inflation, and in light of the indications of a slowdown in growth, the Governor decided to keep the rate of interest unchanged for November, at 2 percent.

In its announcement of the decision, the Bank of Israel emphasized the following points:

- Inflation in the last twelve months has been within the target range for about five months, and is expected to remain within it in the next few months. However, inflation expectations calculated from the capital market for one year ahead and those of the private forecasters remain close to the upper limit of the target inflation range, partly due to expectations that housing prices will continue to increase. The housing component of the CPI, which relates to rentals, continues to feature prominently as a factor contributing to the rise in the CPI. House prices, taken from the Central Bureau of Statistics survey of house prices, continued to increase rapidly.

- From the financial stability aspect, the persistent increase in house prices and the growth in credit for house purchases, due in part to the low interest rate, necessitate the introduction of measures to counter these trends. Therefore, following steps taken previously by the Bank of Israel, the Supervisor of Banks issued draft directives to the banks instructing them to increase their capital provision for housing loans at floating interest with high loan-to-value (LTV) ratios. These measures are expected to restrain the increase in house prices, and hence also gradually to moderate the increase in the housing component of the CPI.

- This month's economic data indicate some slowing of the rate of growth of output, mainly reflecting a fall in exports, with increased uncertainty regarding the sustainability of growth deriving from uncertainty about global demand.

- Interest rates of the leading advanced economies' central banks are low, and in light of the latest developments are expected to remain low for a long time, and some central banks are preparing to renew measures of quantitative easing.

In its press release on the interest rate decision, the Bank of Israel stated that it will continue to use the instruments available to it to achieve its objectives of price stability, the encouragement of employment and growth, and support for the stability of the financial system, including keeping a close watch on developments in the housing market, and especially on house prices.

The decision was made and published on September 27, 2010.

Participants 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

The US

The US economy is still sluggish, with growth in the second quarter slowing to 1.7 percent (annual rate), and optimism waning with regard to the recovery. Activity remains below the pre-crisis levels, and reflects slower than expected recovery in expenditure by consumers and businesses. Manufacturing production declined in September despite increases in company expenditure on equipment, retail sales and demand for exports.

Moreover, the level of growth has not managed to boost employment, and the unemployment rate was still 9.6 percent in September. In addition, the persistent weakness in the housing market continues to cast a shadow over growth. Fiscal restraint is expected to continue, even if it assumed that some of the expansion programs that are due to end will be extended. This is especially the case bearing in mind the fact that municipalities must deal with reduced tax receipts, and the forthcoming congressional elections which are expected to make fiscal expansion more difficult. Against this background the IMF forecasts US growth of 2.6 percent in 2010, declining to 2.3 percent in 2011.

Inflation indices remain low, and the risk of deflation is increasing. The rate of inflation dropped from 0.3 percent in August to 0.1 percent in September. Core inflation was unchanged in August. In the last twelve months the CPI rose by 1.1 percent, and core inflation by 0.8 percent, far below the average core inflation rate of 2 percent in the last ten years. The Fed continues to express concern over the low levels of inflation, and noted that inflation is below the levels consistent with full employment and price stability. Expectations of further quantitative easing pushed up inflation expectations, but real yields stayed close to their lowest levels. Against this background of a slowdown in economic activity with high unemployment and low inflation, the Fed commented that the economic conditions are expected to justify very low levels of monetary interest for a long while, and additional monetary expansion might be required. The investment houses on average expect that the interest rate will remain unchanged at least until the third quarter of 2011. Futures contracts factor in similar expected trends.

Europe

The recovery in the EU lost some momentum and remains fragile, with great differences between the performances of different member countries. Unemployment stayed at 10.1 percent in August, close to its ten-year peak level. The strengthening of the euro and the expected slowdown in global demand are expected to lead to a slowdown in EU exports.

Uncertainty over the debt crisis, the stability of the European banking systems and the effects of the deep budget cuts in EU member countries continue to make the European picture a gloomy one. Moody's rating agency reduced Spain's rating this month to AA+. Fitch reduced Ireland's rating to A+, and left its outlook negative, against the background of assessments that the cost of supporting the financial system will be greater than expected, and warned of a further downgrade. Nevertheless, it seems that the concern prevailing a month ago regarding systemic risk has declined.

The IMF lowered its forecast growth for the EU to 1.7 percent in 2010, and 1.5 percent in 2011.

Inflation in the previous twelve months increased in September to 1.8 percent, the highest rate since November 2008, and it was mainly due to the increase in energy prices, while the twelve-month core inflation rate was 1 percent.

The ECB kept its interest rate unchanged at 1 percent, but for the time being maintained a less expansionary stance than that taken by the central banks in the leading advanced economies The investment houses on average assess that the ECB will start to increased the interest rate only in the third quarter of 2011. Futures contracts reflect expectations of an earlier increase in interest, with the start of a gradual increase to 1.5 percent already in the fourth quarter of 2010.

Growth in the UK slowed in the last few months. The expected heavy budget cuts are likely to have a negative impact on growth. The Bank of England left the interest rate at 0.5 percent this month. Expectations are rising that the central bank will increase its bond purchases in order to support growth.

Japan

Most recent data show that Japan's economic growth is slowing. It declined in the second quarter to 1.5 percent (annual rate), following a 5 percent growth rate in the first quarter. The IMF forecasts growth of 2.8 percent in 2010, slowing to 1.5 percent in 2011.

At the same time Japan continues to deal with its strong currency, intensifying the persistent deflation. On average the investment houses expect deflation to continue in the coming quarters. Against this background the Bank of Japan surprisingly cut its interest rate to an almost zero level of 0–0.1 percent, and announced a program of financial asset purchases in order to boost growth and inflation.

The emerging markets

Strong growth continued in the emerging markets in general, and in Asia in particular. Nevertheless, those economies too, which have benefited from the recovery in global manufacturing production and world trade, are feeling the effects of the slowdown. However, domestic demand and improved financial conditions continue to support their growth. (It should be noted, though, that growth in the emerging markets remains heavily dependent on that in the advanced economies, which represents a downside risk to their growth.)

Inflationary pressures are evident, and reflect the positive output gaps in those countries and increased energy and food prices.

China's economy grew at an annual rate of 9.6 percent in the twelve months ending with third quarter of 2010, after rising by 10.3 percent in the twelve months ending with the second quarter. Data on economic activity in September continue to show strong economic growth in both the manufacturing and services sectors. Although the trade report for August shows a decline in China's trade surplus, with both imports and exports falling, China remains a key factor in world trade.

The real estate bubble in China continues to give rise to concern, with prices rising markedly. As a result, the government this month increased the down-payment required for the purchase of a first house, halted loans for the purchase of a third house, and is expected to introduce a trial property tax. Inflation accelerated in September faster than the government target, and inflationary pressures are still evident. In light of this, the central bank, the People's Bank of China, increased the rate of interest on deposits and loans by 25 basis points, the first increase since 2007. At the same time the central bank continued to operate quantitative tools, and this month directed six banks to increase their capital ratios, a move intended to absorb some of the liquidity in the economy.