BANK OF ISRAEL
Office of the Spokesperson and Economic Information

May 9, 2011

Report to the public on the Bank of Israel's discussions prior to setting the interest rate for May 2011

The discussions took place on April 21 and 24, 2011

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 this report 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 (the Deputy Governor and the Head of the Monetary and Finance Division of the Research Department) 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

Data published last month (between the date of the previous interest rate decision on March 28 and the current decision on April 24) support the assessment that the rapid growth of activity and demand continued in the first quarter of 2011, and that it is expected to continue also in the second quarter. The expansion of activity was

[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.

reflected in the increases in manufacturing production, goods exports, trade and services revenue, government tax revenues, and the labor market. The entrenchment and the extent of growth were backed by continued global growth and the increase in world trade, with most of the increase in demand coming from abroad. However, the effects of the continued increase in commodity prices, the natural disasters in Japan, and geopolitical events in the Middle East are still reflected in the indices of the public mood and the purchasing managers index, which declined further.

Indicators of real economic activity

Indicators published this month point to a continued increase in economic activity and expectations that this will persist in the second quarter. Preliminary results from the Bank of Israel Companies Survey for the first quarter suggest that the increase in companies' activity continued in most industries, and that companies in all industries expect growth to continue in the second quarter. The monthly data indicate that manufacturing production and trade and services revenue increased. The composite state-of-the-economy index for March rose by 0.5 percent, further to its rapid increases in previous months. The increase in real activity in the first quarter was led by exports, despite the persistent appreciation of the shekel.

In contrast, the purchasing managers index of manufacturing (of Bank Hapoalim) shows the reverse picture for the second month in succession (in February the index dropped to 48 points, and remained there in March). The drop in the index resulted from the decline in domestic demand, while export demand continued to expand. Slack demand in manufacturing in the first quarter was also reflected in the Companies Survey. Concurrently, the Bank Hapoalim Consumer Confidence Index declined in January–March to an average level lower than that in 2010 (both the current index and the index of expectations). The Globes Consumer Confidence index presented a similar picture. The reason, apparently, is the increased geopolitical uncertainty.

The labor market

The number of claims for unemployment benefits declined continuously in January–March, and the average level was lower than in the second half of 2010. According to the Labor Force Survey for the fourth quarter of 2010, the number of employees increased during the year in most industries. The rate of unemployment in the fourth quarter was 6.6 percent, and according to the trend data was 6.1 percent in January [see below]. The nominal wage increased by 1.9 percent in November–January compared with August–October, and the real wage by 0.5 percent (seasonally adjusted). Total health tax receipts in February 2011, which provide an indication of wage payments in that month, show an increase of 8.6 percent, in nominal terms, from their level in February 2010.

Foreign trade

The upward trend in goods imports and exports continued in the first quarter, including in March. Goods exports (excluding ships, aircraft and diamonds) increased in January–March by about 3 percent a month (all foreign trade data herein are in current dollars). Goods imports (excluding energy) increased by 3.4 percent in March, following their moderate drop of about 0.5 percent in February. Nevertheless, estimates of world trade (the Triple Trade Index[2]) indicate a small reduction in February alongside an increase in commodity prices, following the rise in the index in each of the previous three months.

2. Budget data

Government expenditure in January–March was 6 percent lower than the seasonal level consistent with full expenditure of the budget. In those three months the overall cumulative government surplus in the budget totaled NIS 2 billion, implying a budget performance about NIS 4.5 billion better than the seasonal path consistent with the budget target (the seasonal path consistent with the annual deficit ceiling would have given a deficit of NIS 2.5 billion in those three months). Tax revenues in January–March, after accounting for the effects of legislative changes and nonrecurring receipts, were 9.1 percent higher, in real terms, than in the first three months of 2010: direct tax revenues were 11.6 percent higher, and indirect tax revenues 7.6 percent higher.

3. Developments on the nominal side

Inflation

The March CPI rose by 0.2 percent, slightly less than the average increase predicted by forecasters, and at a monthly rate consistent with the seasonal path consistent with the achievement of the inflation target, after four consecutive months when the index was above the upper limit of the target range. It is important to note, however, that one single index does not provide evidence of a turnaround. The inflation rate measured over the previous twelve months continued to increase, and in March reached 4.3 percent. The CPI excluding the housing price component remained unchanged in March, and in the previous twelve months it rose by 3.6 percent.

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

The average of forecasters' inflation expectations for the next twelve monthly CPIs was the same as the average in the previous month, 3.1 percent, slightly above the

[2] The Triple Trade Index measures the total foreign trade of Germany, Japan and the US, and is a leading index of world trade.

upper limit of the target inflation range. Expectations calculated from the capital market declined in April to an average of 3.1 percent, due in part to the increase of a half a percentage point in the interest rate in the previous month. It appears that inflation expectations for the medium and long terms were also affected by the most recent hike in the interest rate—so that most of the curve is now within the target inflation range. According to forecasters' predictions and the Bank of Israel staff forecast, the April CPI is expected to be high, with an increase of 0.8 percent, on average, which is in line with the seasonal path consistent with the midpoint of the target inflation range. Forecaster's predictions and the Bank of Israel Research Department staff forecast of inflation in the next twelve months are that it will remain above the target range during the rest of 2011, and that it will decline at the beginning of 2012 to the upper limit of the target range. Based on the Telbor market (Tel Aviv Inter-Bank Offer Rate), the Bank of Israel interest rate in a year's time is expected to be 4.4 percent, and forecasters' predictions on average are that it will be 4.2 percent, both representing increases from the forecast of the interest rate last month. Most forecasters expect the Bank of Israel to leave the interest rate for May 2011 unchanged.

The makam and bond markets

Between the date of the previous interest rate decision on March 28 and the current decision on April 24, yields on government bonds increased, against the background of the latest increase in the interest rate, expectations of faster rates of increase in the interest rate, and geopolitical uncertainty. Over the period the yield on *makam* increased by about 20 basis points (b.p.) along the entire curve. The decline in nonresidents' activity in the *makam* market halted this month, as foreign investors reentered this market. Yields unindexed government bonds increased by about 20 b.p., primarily in short-term maturities. Yields on CPI-indexed government bonds rose sharply, by about 10–50 basis points, as the yield curve flattened somewhat, reflecting a sharp drop in inflation expectations derived from the capital market.

In the corporate bond market the rate of new issues picked up again compared with the extent of issues in March and February. The TelBond indices of CPI-indexed bonds fell sharply, by about 1.5 percent, against the background of the increase in the interest rate for March, while the TelBond shekel index hardly changed.

The interest rate differential and the yield gap between Israel and abroad

The yield gap between Israeli and US unindexed 10-year government bonds was unchanged this month, at 186 b.p. Prior to the current interest rate decision, the Bank of Israel interest rate was 2.75 percentage points higher than the US federal funds rate and 1.75 percentage point higher than the ECB (European Central Bank) rate.

The monetary aggregates

In the twelve months up to and including March, the M1 monetary aggregate (cash held by the public and demand deposits) increased by 5.2 percent, and the M2 aggregate (M1 *plus* unindexed deposits of up to one year) increased by 7.6 percent.

The housing credit market

The balance of housing credit increased by 12.8 percent in the twelve months up to and including February. Forty-eight percent of housing loans granted in March were indexed to the (nominal) prime rate, so that in total 80 percent of all housing loans, (i.e., whether CPI-indexed or not) were at variable interest rates, similar to the share in previous months. Mortgage interest rates continued to increase this month, against the background of the latest increases in the Bank of Israel interest rate, among other things.

The housing market

House prices—which are presented in the Central Bureau of Statistics survey of house prices but are not included in the CPI—continued to increase, and in January–February they increased at a rate of 1.7 percent a month, following their increase of 0.8 percent a month in December–January. In the last twelve months house prices increased at the high rate of 16.1 percent. Unlike the increase in house prices, the housing cost price index, which is based mainly on renewed rental contracts and which is included in the CPI, rose by 0.6 percent in March, and in the last twelve months it increased by 6.4 percent, similar to the increase in the twelve months to February.

The Research Department assessment (staff forecast)

The Bank of Israel staff forecast**,** which was updated this month**,** is that inflation in 2011 will be above the upper limit of the target inflation range, and that it will come down and approach the upper limit of the target toward the middle of 2012, with the interest rate increasing gradually to about 4.4 percent in a year’s time. GDP is expected to grow by 4.5 percent in 2011 (compared with 3.8 percent in the initial forecast) and the unemployment rate is expected to average 6.1 percent in 2011.

The Research Department’s forecasts for 2012 are of 4 percent growth, with unemployment averaging 5.9 percent. The main factors that could affect the forecasts of real activity and inflation in Israel are changes in the global economy, including increases in commodity and oil prices, developments in the housing market, the possible realization of geopolitical risks, and a possible increase in wage pressures in the public sector. An acceleration in world trade, on the other hand, is likely to help boost exports, and the recent appreciation of the shekel is likely to assist in returning inflation to within the target range, which would slow the pace of interest rate increases.

4. The foreign currency market and the share market

The foreign currency market

From the previous monetary policy discussion held on March 27 until April 20, the shekel appreciated by 3.7 percent against the dollar, and by 1.9 percent against the euro. In terms of the nominal effective exchange rate the shekel appreciated by about 2.5 percent. Despite the increase in the interest rate in Israel, the strengthening of the shekel was similar to that of the currencies of other countries with rapid growth, and occurred alongside the Bank of Israel's continued intervention in the foreign exchange market.

The share market

Between the previous monetary policy discussion and the current one, most Tel Aviv share price indices rose, in contrast with the trend in stock markets in the advanced economies, and similar to developments in several emerging market economies.. The Tel Aviv 25 index rose by 2.5 percent and reached record levels, and the Tel Aviv 100 index rose by 1.7 percent.

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

Israel's sovereign risk premium as measured by the five-year CDS spread continued to decline, and reached 142 b.p. compared with 153 b.p. last month.

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

The recovery in the global economy continued this month, based mainly on the strong growth in East Asian economies, the marked improvement in the major European economies, and the continued increase in employment and in private consumption in the US. The expansion of global activity was also reflected in an increase in commodity exports around the world in the first quarter, and in a steady increase in manufacturing production indices in the US, the eurozone, Japan, and other countries. In addition, the switch from government demand to private demand continued, and concern that the ending of the quantitative easing programs introduced because of the crisis would result in renewed contraction of the global economy eased. Nonetheless, the main risks to the global economy are the continued increase in commodity prices, the persistent instability in the Middle East, uncertainty regarding the implications of the natural disasters in Japan, the debt crises in several European countries, which became more severe this months, and the closer attention being paid by one of the rating companies to the level of the US debt and deficit. This month the IMF left its growth forecasts unchanged, but stressed the downside risks of those forecasts. Against the background of rising prices and more rapid inflation, central banks in the emerging market economies continued to react with tighter monetary measures, and this month the ECB also joined this trend.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR MAY 2011

In the monthly narrow-forum monetary policy discussion, four members of management make recommendations to the Governor regarding the appropriate rate of interest for the economy. At the end of the current discussions on the interest rate for April, three members of management recommended that the Governor leave the interest rate unchanged for May, and one member recommended that he increase the interest rate by 0.25 of a percentage point, to 3.25 percent.

Leaving the interest rate unchanged at 3 percent for May would be consistent with the process of gradually restoring a more normal interest rate environment—a process aimed at stabilizing inflation within the target range, and supporting further growth of economic activity while maintaining financial stability. The pace of interest rate increases is not fixed, but depends on the inflation environment, growth in Israel and globally, the monetary policies of the major central banks, developments in asset prices, and the exchange rates of the shekel. At the current rate of interest, monetary policy continues to be expansionary.

Several issues were discussed, including the expected path of inflation, an assessment of the environment of real economic activity including reference to developments around the world, the housing market, and the possible effect on the exchange rate of an increase in the differential between the interest rate in Israel and rates abroad.

In the discussion it was noted that following last month's increase in the interest rate, inflation expectations for the coming year—both those derived from the capital market and those of forecasters–declined, to about 3 percent, the upper limit of the inflation target range. Inflation expectations for longer terms derived from the capital market[3] also declined—the longer the term, the greater the decline, reaching a level of 2.5 percent for 10 years forward. The Research Department staff forecast also predicts a return to within the target inflation range next year, under the assumption that the interest rate increases gradually to about 4.4 percent. The point was stressed that inflation in the last twelve months was 4.3 percent, above the upper limit of the target range, while in the last six months the rate of inflation (annual rate, seasonally

[3] Apart from expectations for 8–10 years forward derived from forward transactions, which increased slightly.

adjusted) was even higher. It was noted that the factors contributing to inflation related to the housing market (during the last year) and food and energy prices (in the last half year), factors which are expected to continue to exert inflationary pressure next year, particularly in light of the persistent increase in commodity prices. According to the staff forecast, possible wage pressures in the public sector are also likely to contribute to inflation. The strengthening of the shekel in recent months, however, is expected to slow the rate of inflation.

The continued rapid rise in house prices was also discussed; these increased by about 1.7 percent this month, bringing the increase in the last twelve months to 16.1 percent. Together with the increase in house prices, the amount of mortgage lending also increased in March, and since the beginning of the year the outstanding balance of mortgages has increased by 1.9 percent, following its increase of 11.4 percent in 2010. Mortgages of all types increased, despite the increase in the interest rates. One participant in the discussion noted that the high demand for houses was in contrast to the moderation of private consumption and the indices of the public mood, so that this development is exceptional. The participants discussed the implications of the increase in housing credit on financial stability, particularly in light of a possible significant drop in house prices in the future, although the probability of that occurring was thought to be slight. Emphasis was also placed on the financial risks in the medium term that could arise from a significant increase in unemployment. As a result of the above points, all participants favored the introduction of serious macro-prudential steps in the field of housing credit.

Another issue discussed was the exchange rate, particularly the continued appreciation of the shekel vis-à-vis the dollar and the euro, and the strengthening of the nominal effective exchange rate, developments resulting from the interest rate differential between Israel and abroad and the re-entry of nonresident investors into the *makam* market. Other currencies too, as well as the shekel, strengthened against the dollar, mostly the currencies of economies with high growth rates. Nevertheless, as participants noted, exports had increased considerably despite the appreciation of the shekel, and the possibility was suggested that there were other positive factors affecting exports that outweighed the negative effect of the appreciation. The point was also made that the effect of exchange rate changes is felt with a lag, so that the results of these changes may take place in the future.

Steps taken buy other central banks to reduce short-term capital inflows and to moderate the pace of their currency appreciation were discussed.

In light of the arguments put forward, most of the members of management recommended leaving the interest rate unchanged at 3 percent. They stressed the decline in inflation expectations following last month’s increase in the interest rate, and the wide differential that already existed between Israel's interest rate and those abroad, which affects the exchange rate. One member of management recommended increasing the interest rate by 0.25 of a percentage point in light of (a) the fact that actual inflation is above the target range and inflation expectations are still at the upper limit of the target range, and (b) the continued increase in house prices.

Taking all the above points into consideration, the Governor decided to leave the interest rate for May unchanged, at 3 percent.

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

- Inflation expectations for the next twelve months derived from the capital market declined, due in part to the increase in the interest rate for May. However, at 3.1 percent, similar to the average of the forecasters' expectations which did not change this month, the expectations are still above the upper limit of the inflation target range. Inflation expectations for periods longer than a year also declined, and most are now within the target range.

- The recent appreciation of the shekel and the recent increases in the interest rate are expected to moderate the rate of inflation in the coming months.

- Indicators of economic activity published this month support the assessment that the rapid expansion of activity and demand continued in the first quarter of 2011. The Bank of Israel staff forecast was updated, and now predicts GDP growth of 4.5 percent in 2011, compared with the previous forecast of 3.8 percent. The global economy is continuing along the path of recovery. Nevertheless, there are several risks that are still raising the level of uncertainty regarding future global growth.

- House prices continued to increase this month, and in the last twelve month have risen by 16.1 percent. The balance of housing credit increased by 12.8 percent in the twelve months to February 2011. About 80 percent of housing loans granted in March were at floating interest rates. Against the background of these developments, the Bank of Israel is considering the introduction in the near future of additional measures in the housing credit field.

- Central bank interest rates in the major advanced economies are still low. The ECB, however, recently increased its interest rate by 25 basis points, and against the background of the acceleration in inflation in emerging market economies, a relatively large number of central banks primarily in emerging market economies are continuing to raise their interest rates and are introducing other contractionary measures. The interest rate differential between economies with relatively rapid growth rates, including Israel, and the advanced economies presents policy makers in the former with a serious challenge—how to balance the domestic pressures to increase the interest rate with the effect of such an increase on the appreciation of their currencies and its effect on their exports, and hence on economic activity.

The Bank of Israel will continue to monitor developments in Israel's economy and the global economy and in the financial markets. The Bank will 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 assets market, and especially in the housing market.

The decision was made and published on April 24, 2011.

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. David Zaken, Supervisor of Banks

Mr. Eddy Azoulay, Chief of Staff to the Governor

Dr. Yossi Saadon, Advisor to the Governor and Bank of Israel Spokesperson

Ms. Esti Schwartz, Secretary of the Monetary Committee

Mr. Noam Michelson, Economist, Research Department

Appendix: Major Global Economic Developments

The US

Growth in the US continues and is even stabilizing and becoming sustainable in certain sectors. The labor market shows the main improvement, with the latest jobs report showing 230,000 jobs added in the private sector (and the report from the month before was revised upward). However, another 7 million jobs need to be added just to get back to the employment level from before the Lehman Brothers crisis. Likewise, the number of people unemployed for more than 27 weeks remains at record levels (about 6 million).

The improvement in the labor market comes from continued expansion in business activity and a rise in firms' confidence in the economy's recovery, as well as parallel growth in private consumption in the US, which continued to rise this month (for the ninth consecutive time), and in consumer credit (for the fifth month in a row). This trend is the most important one to US economic recovery – growth in employment increases confidence of consumers who in turn increase private consumption (about 70 percent of GDP) and business activity, and the cycle renews.

The level of inflation has been rising in recent months, although core inflation is still low, at about 1 percent. Facing large employment and output gaps, the US Federal Reserve continues to leave the Fed Funds rate at its low level, and market expectations are that the first increase in the interest rate in the US will only be in the beginning of 2012. With that, inflation is beginning to receive attention in Fed announcements.

A very central issue is the US debt situation, which continues to deteriorate. A US government shutdown was avoided this month almost at the last minute, after President Obama reached an agreement on cutting the budget by $38 billion. This event serves as an important reminder of the tough debt problems of the federal and local governments.[4] The current debt ceiling remains about $14.3 trillion, while the public debt is at $14.2 trillion, which leaves the US government about $80 billion for various activities, including debt repayment.[5] The US Treasury can continue to take steps to increase the cash inventory but this step can take a toll on investor confidence. It should be noted that all this is taking place at a time when the US debt and fiscal deficit levels are at record levels, and there is a growing risk of a debt crisis in the US in the medium term. S&P, which lowered its US credit rating outlook this month from "Stable" to "Negative" apparently also feels this way.

The International Monetary Fund (IMF) in its most recent survey pointed out the growing debt risk and the need for significant fiscal adjustment in the medium term. The US government is aware of the danger, and this month, for the second time this year, President Obama presented a $4 trillion multi-year deficit cutting plan, through

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[4] According to Reuters, the total revenues of local authorities in the US is at a low, at about $32.5 billion since the beginning of the year, compared with nearly double that figure in the corresponding period of the year before.

[5] Since 1940, the debt ceiling has been raised 80 times.

reducing the deficit to 2.5 percent of GDP by 2015. In the background, the second quantitative easing program (QE2) is expected to end in June, while in the market there are conflicting assessments regarding the effect of ending the program on returns and on the funding costs for the government.

The real estate market continues to be the weak link in US economic recovery. The number of houses expected to be foreclosed this year is 1 million. The average home price at the end of February was $160,000, a nine year low, as home sales data continues to disappoint.

Europe

For the first time since the crisis, the European Central Bank (ECB) raised its main interest rate, to 1.25 percent. The hike had been expected, as inflation continued to rise in the euro bloc in recent months (2.7 percent year on year in March, while the target for the ECB was slightly below 2 percent), and with a noticeable improvement in Europe's major economies. Many question marks surround the need for that interest rate hike, primarily in light of the damage that the move can cause to Europe's weaker economies. Europe still needs to deal with the continuing debt crisis, financing difficulties for many economies, the banking system's dependence on the central bank's liquidity tenders, and sharp fiscal restraining that several imposed on themselves. This rise (especially if it continues) will increase the cost of funding in the market, and will make even more difficult rehabilitation efforts by PIGS economies, recovery of domestic demand, and competitiveness against the world.

Portugal's joining the club, this month, of economies requiring economic aid emphasizes the fact that the debt crisis continues to be a prime systemic risk to Europe's economy in particular, and to financial markets in general. The main problem is in the huge levels of debt of PIGS economies relative to the size of their GDP and to potential growth, and it appears that fiscal cuts are liable to only worsen this problem.

European governments have agreed to increase the effective amount of the European Financial Stability Facility (EFSF) fund to $440 billion. The money, in conjunction with the IMF, is intended, at least in theory, to reduce Spain's debt problems as well. However, the continued rise in yield levels (and in spreads versus Germany) of PIGS economies to new records[6] (primarily in Greece, despite the dramatic improvement in aid terms, which included extending the program to seven and a half years, and lowering the cost by 1 percent, to 4.2 percent) reflect possibly more than anything else the lack of investor confidence in the various aid programs' credibility, and the growing expectation that a debt restructuring deal, which will hurt various investors, is unavoidable.

In the meantime, the concern about Spain's debt problems continued to diminish, among other things against the background of significant fiscal steps, including raising the retirement age, and delaying steps to increase capital at regional banks in Spain. At the same time, the Spanish economy is still in a serious crisis, employment

[6] The yield on Greek two year debt securities jumped to more than 20 percent, in Portugal the yield for the same maturity rose above 10 percent, and in Ireland the yield is close to 10 percent.

levels range around 20 percent, and the difficulties in the real estate sector are still not fully reflected. In addition, the Spanish banking system's exposure to Portugal's economy is the European Union's highest.[7] Nonetheless, banks in Spain are not the only ones in trouble: most of the risk to the European Union's economy and recovery efforts originate in the balances of various banks. These banks must raise record amounts of about €2.5 trillion over the next two years (according to the IMF), at a time when there are expected to be marked pressures on the issues market, in light of debt problems of the various governments in Europe. Most of the pressure is at German banks, but in recent weeks many banks have begun to raise funds from the markets, ahead of expected stress tests in Europe in June.

The emerging markets

Asian economies (led by China, which grew 9.7 percent in the first quarter, above expectations) continued to be the base of global economic recovery in the past month as well. However, the main risk (in the short term) seen for the global economy–the continued rise in commodity prices (gold and silver continue to break records, as did the CRB non-energy index, Brent crude oil is up 25 percent since the beginning of the year)–especially threatens emerging markets, where the commodities component of GDP is more significant.

The continued rise in commodity prices and accompanying inflation present a challenge to central banks. A considerable number of central banks in emerging markets continue to respond with monetary restraint policies. China this month raised the interest rate for the fourth month in a row since October (a trend which is expected to continue against the background of the additional rise in the latest inflation figure, which showed the inflation rate was 5.4 percent in the twelve months ending March). Denmark, Taiwan, Poland, and Chile (+50 basis points) took similar steps.

This month as well, central banks around the world continued to intervene in foreign currency markets. Investment house UBS expects that G-7 economies will continue to increase their foreign currency reserves over the coming years, in order to deal with the high volatility in global foreign currency markets. In addition, at a BRICS meeting in China this month, participants expressed their interest in a world reserve currency which would replace the dollar in that role.

The Capital Markets

There was a negative trend in most world capital markets during the period, primarily against the background of rising uncertainty with regard to the earthquake in Japan, continued instability in the Arab world, and the recent deterioration in the in the debt crisis in Europe (and the US). The continued rise in commodity prices and a relatively disappointing opening to the earnings reporting season also led to the change in sentiment, despite assessments that with time, it will become clear that profits at the companies which make up the S&P 500 Index actually rose. Despite this, over the course of the month there were price rises (some of them quite strong) in emerging markets while there were losses, some of them sharp, in developed markets.

[7] Total exposure as of the end of 2010 was about €65 billion, according to BIS.

Various risk indices are also at low levels. The VIX (CBOE Volatility Index) hovered around 16 during the period surveyed, after approaching 30 in the previous month. At the same time, the spreads on returns at various rating levels (in the US) are at low levels. On the other hand, the EMBI spread returned in recent weeks to increase to 273 basis points.

Yields on government debt around the world were very volatile this month. In Europe, there was a general rise in yields, against the background of the interest rate increase, the debt crisis in Portugal, and growing expectations that a debt deal in Europe will be unavoidable. In Australia, New Zealand, and Japan, yields rose as well, also amid rising commodity prices and as a result of the crisis in Japan. In the US, in contrast, there was a drop in yields at the end of the period, although volatility was still high and was affected by changes in the risk environment in the world, the crisis in Japan, and recently by the US's own growing debt problems as well.