



BANK OF ISRAEL

Office of the Spokesperson and Economic Information

December 12, 2011

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

The discussions took place on November 27 and 28, 2011

General

In the process of making the monthly interest rate decision by the Monetary Committee, 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 three members of the Monetary Committee from the Bank—the Governor, the Deputy Governor and the Senior Advisor to the Governor—and the three members of the Monetary Committee from among the public. Other participants in the discussion are 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, which consists of the Monetary Committee and the Directors of the Research and Market Operations Departments, the latter two present their recommendations regarding the interest rate. An open discussion follows, which ends with a vote on the level of the interest rate. According to the new Bank of Israel Law (section 18(c)), the decision on the interest rate is reached by the majority of the members of the Monetary Committee who participate in the voting. If the vote is tied, the chairperson (the Governor) has an additional vote.

A. THE BROAD-FORUM DISCUSSION—THE STATE OF THE ECONOMY

1. Developments on the real side

General assessment

Economic indicators that became available this month support the assessment that in the third quarter and in October the slowdown in the rate of growth of economic activity and of demand continued.

With that, these figures are currently consistent with the Bank of Israel forecast of 4.7 percent growth in 2011. According to National Accounts figures for the third quarter (in annual terms), which were published on November 16, GDP grew 3.4 percent, similar to its growth rate in the previous quarter; business product grew 5.3 percent, compared with 2.7 percent in the previous quarter; private consumption increased by 0.9 percent, compared with 1.3 percent in the previous quarter, gross fixed capital formation increased by 17.8 percent, compared with 9.3 percent in the previous quarter; exports declined 16.9 percent, compared with growth of 1.5 percent in the previous quarter; and imports declined by 7.6 percent compared with a growth of 9.2 percent in the previous quarter.

The composite state-of-the-economy index and monthly indices of the economic situation

The Bank of Israel's Companies Survey and the new Central Bureau of Statistics Survey of Business Trends showed that the slowdown in private sector business activity persisted and even intensified in October. In contrast, the Bank Hapoalim consumer confidence index increased in October, to a level of 50.7—the first time in three months that the figure has been above the 50 point level. Tax receipts in October were 8 percent lower than the forecast seasonal path, a continuation of the slowdown that began in April. The Composite State of the Economy Index for October increased slowly, by 0.1 percent.

The labor market

Labor market data indicate a high level of employment and a low unemployment rate. The trend rate of unemployment declined by 0.1 percentage points in August, and reached 5.6 percent. The number of Israeli employee posts increased by 3.1 percent in June–August, in annual terms, compared with the corresponding period of 2010. The nominal wage rose in June–August by 0.3 percent, compared with the preceding three months, and the real wage increased 0.15 percent in June–August, compared with the preceding three months. Health tax receipts, which provide an indication of wage payments, were 8 percent higher in October (preliminary estimate) in nominal terms than in October 2010 (excluding the effect of legislative changes).

Foreign trade

Foreign trade figures show stability of exports at a relatively low level, and a decline in imports. The stability of exports reflects an increase in exports by high technology industries, which was offset by a decrease in exports by medium high, medium low, and low technology companies. Trend figures show that high technology exports are on a downward path while mixed to high technology industries are on a rising one.

The decline in goods imports comprised all of its components and was prominent especially in consumer goods imports and investment goods imports—the decline in which reflects a marked drop in machinery and equipment imports.

2. Budget data

Government domestic revenues for the year to date through October were 2.7 percent lower than the seasonal path of the budget forecast, primarily due to a continued slowdown in indirect tax receipts, which began in April. The overall government deficit (excluding net credit) in the year to date was NIS 14 billion, compared to a deficit of NIS 16.3 billion in the corresponding period in 2010. Developments in government activity so far indicate that tax revenues will be about 2 percent lower than the budget forecast, and the budget deficit for the year 2011 will be around 3.5 percent of GDP compared with the deficit ceiling set by law of 3 percent of GDP.

3. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) increased 0.1 percent in October, in line with forecasts, and within the seasonal path consistent with achieving the inflation target. The rate of inflation over the past 12 months, as measured by the change in the CPI, continued to settle more firmly within the target range (1–3 percent per year) and is now 2.7 percent.

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

Inflation expectations, as calculated from the capital markets, remained at the same level as in the previous month at around 1.7 percent. With that, after publication of the October CPI, expectations rose slightly to 1.9 percent. Expectations (break-even inflation) for the medium and longer terms also remained steady at an average of 2.3 percent. Forecasters' inflation predictions for the next twelve CPI readings were 2.3 percent on average, compared with 2.2 percent last month. Expectations of the Bank of Israel interest rate one year from now, based on the Telbor (Tel Aviv Inter-Bank Offered Rate) market, remained at 2.7 percent, while the average of forecasters' predictions of the interest rate in one year's time continued to decline, and reached 2.75 percent (compared with 3 percent last month). Most forecasters expect the Bank of Israel to cut the interest rate for December by 0.25 percentage points, and on average they expect the interest rate to be reduced by 0.38 percentage points over the next three months.

The makam and bond markets

Rates declined for most maturities in the unindexed government bond market by up to 10 basis points (b.p.), while the yield curve of CPI-indexed government bonds

declined sharply in short maturities, and increased by up to 15 b.p. for terms to maturity of over 4 years. *Makam* yields increased slightly for maturities of up to 8 months, and declined slightly in longer terms. The yield for one year fell during the period from 2.8 percent to 2.7 percent—against the background of an exit from risk assets and expectations of continued interest rate cuts by the Bank of Israel, and despite the continued exit of nonresidents from *makam*.

The yield gap and interest rate differential between Israel and abroad

The yield gap between Israeli 10-year government bonds and equivalent 10-year US Treasury securities widened to about 270 basis points from 250 basis points in the previous month

The monetary aggregates

In the twelve months ending in October, the M1 monetary aggregate (cash held by the public and demand deposits) increased by 2 percent, and the M2 aggregate (M1 plus unindexed deposits of up to one year) increased by 14.1 percent.

The credit market

The balance of outstanding debt of the business sector increased in September by 1.7 percent, to NIS 781 billion. Outstanding credit to households remained at NIS 359 billion in September, with an increase of 0.8 percent in outstanding housing credit, and a decrease of 1.8 percent in non-housing credit. Of the credit to households, outstanding housing credit rose 11.3 percent in the twelve months ending in September to NIS 257 billion, compared with a 10.9 percent increase in the twelve months to August. The volume of new housing credit granted in the twelve months ending in October was 2.2 percent lower than in the twelve months ending in September—a continuation of consecutive declines since the record high set in May. The share of unindexed floating rate mortgages extended in October was 26.6 percent, after reaching 26.1 percent in August, far lower than the record levels of the first quarter of 2009 of about 75 percent—a decline which was partly due to the limitations imposed by the Bank of Israel on some floating interest rate housing loans . The interest rates on CPI-indexed mortgages—both fixed rate and variable rate—increased in October, while interest rates on variable rate unindexed mortgages declined.

The housing market

Activity in the construction industry continues to be strong. The number of building starts in the twelve months to August reached 43,672, and the number of completions was 33,605, both similar to the numbers in the previous month. The number of homes available for sale continued to increase, and in August–October was on average 8.3 percent higher than in the three preceding months (original data). The Central Bureau of Statistics Survey of Business Trends indicates a decline in activity and in new orders in the industry.

Housing prices reflected in the housing index, which is based mainly on renewed rental contracts and which is included in the CPI, declined 0.3 percent in October, but over the 12 months ending in October they increased by 6.3 percent—compared with an increase of 5.5 percent in the 12 months ending in September—and prices are expected, according to the Research Department forecast, to continue to increase at a similar pace in the coming year. Home prices, which are published in the Central Bureau of Statistics survey of home prices but are not included in the CPI, declined in August–September by 0.2 percent (the first decline since December 2008) after an increase of 0.6 percent in July–August. The annual rate of increase in home prices also moderated—in the 12 months ending in September the rate was 10.5 percent, compared with 12.1 percent in the 12 months ending in August, and this after levels of around 20 percent in 2010.

The moderation in home prices comes against the background of the continued increase in the number of building starts, the lagged effect of the increase in the interest rate, measures introduced by the Bank of Israel affecting mortgages, and steps taken by the Ministry of Finance in real estate taxation. The effect of these moves is expected to continue and be evident going forward.

The Bank of Israel Research Department assessment (staff forecast)

According to the Research Department's end of September staff forecast, inflation over the four quarters ending in the third quarter of 2012 will be 2.3 percent, and the average interest rate for 2012 will be 3 percent. GDP growth for 2011 is forecast to be 4.7 percent, and 3.2 percent in 2012. The assessment is based on, among other things, the lowered International Monetary Fund (IMF) forecast for global growth and world trade.

4. The foreign currency and share markets

The foreign currency market

From the previous monetary policy discussion held on October 23, through November 25, the shekel depreciated by about 3.8 percent against the dollar, in line with the general strengthening of the dollar world wide. The shekel was essentially unchanged against the euro (appreciation of 0.1 percent). The shekel weakened by about 2 percent in terms of the nominal effective exchange rate. The rate of participation by nonresident investors in foreign currency trading was 30 percent in November, compared with the average of 35 percent since the beginning of 2011.

The capital market

From the previous monetary policy discussion held on October 23, through November 25, the Tel Aviv 25 Index declined by 8.3 percent, more than stock market indices in advanced economies unconnected with the debt crisis. The Tel-Bond 20 Index

declined by 1.4 percent, and the Tel-Bond 40 Index declined by 2.1 percent. Withdrawals from mutual funds specializing in corporate bonds continued this month, although at a slower pace than that in the previous month.

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

Israel's sovereign risk premium as measured by the five-year CDS spread increased this month to 215 basis points from last month's 160 basis points.

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

The debt crisis in Europe is deepening and spreading to additional countries. There is growing concern of a severe impact on the global economy. Austerity measures announced by several European countries have not succeeded, to date, to calm the markets. Yields on government bonds of Italy and Spain have reached high and apparently unsustainable levels. The banking sector around the world, specifically in Europe, is under pressure due to its exposure to bonds of countries in difficulty. Last month credit rating companies made further cuts in the rating of European countries, and warned of the credit rating outlook of other countries and of banks around the world. Macroeconomic figures published this month in the US were relatively favorable, and were generally better than expected. Data published in Europe were weaker, and many forecasters and investment houses expect that Europe will slip into a recession that is likely to deteriorate in light of the austerity measures announced in several countries. Inflation around the world is starting to moderate, and commodity prices that fell sharply are expected to reduce it further, but the increase in oil prices this year, constitutes a burden on the already weak global economy. Against the background of these developments, the ECB made a surprise cut in the interest rate this month, and the markets are pricing in interest rate cuts in other economies.

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

Participants in the discussion dealt with several issues. The major issues were the assessment of real economic activity, economic developments world wide and the risks they pose to the Israeli economy, housing prices, inflation and the foreign exchange market.

Regarding real economic activity, participants agreed that economic indicators that became available this month support the assessment that in the third quarter and in October the slowdown in the rate of growth of economic activity and of demand continued. The sharp decline in exports of goods and services was also mentioned, as well as the moderate growth of private consumption. Additionally, one committee member remarked that the continued decline in financial markets is liable to reduce domestic demand. With that, it was noted that the level of domestic activity remains

high, and its moderation is a result of the worsening crisis in Europe, which is expected to continue to have a negative impact in the future, if the crisis worsens.

A central topic of discussion was the uncertainty around the European crisis, and its effect on economic activity in Israel. Participants in the discussion agreed that the probability of the crisis in Europe worsening has increased since the previous discussion, and they noted, among other things, that yields on government bonds of Italy and Spain have reached high levels.

Another issue discussed was home prices, and the fact that these had fallen in August–September, the first decline since December 2008. The continued increase in the number of building starts was also referred to. Members of the Committee were of the opinion that the limitation imposed by the Bank of Israel on some mortgages reduces the effect of a cut in the Bank's interest rate on the average rate of interest on mortgages, so that the limitation is expected to continue to exert a moderating effect on home prices. One member stated that he was not concerned about a continued rise in home prices, but just the opposite, a too rapid drop in their prices.

In the discussion of the foreign exchange market it was stated that since the previous monetary policy discussion held on October 23, through November 25, the shekel had depreciated by about 3.8 percent against the dollar and reached NIS 3.79. If the exchange rate continues around this level, it will help exports. The point was made that a cut in the interest rate could contribute to the further weakening of the shekel, and thus perhaps increase inflation to some extent in the future.

The main considerations in favor of leaving the interest rate unchanged were: domestic activity which remains buoyant, as seen in, inter alia, the low unemployment rate and the increase in investments; the recent shekel weakness which supports exports; and concern that reducing the interest rate will halt the moderation in the rate of increase in home prices. With regard to the uncertainty regarding how the European crisis will develop and how it will affect Israel's economy, the Bank of Israel would have the tools and the ability to respond quickly and effectively to such developments.

The main arguments in favor of a quarter-percentage-point cut in the interest rate were the continued slowdown in the growth of real economic activity, the persistent decline in the financial markets that is expected to dampen domestic demand, the assessment that the risk of Europe slipping into a recession had risen, the significant slowdown in the global economy, which is already affecting the Israeli economy, and the fact that steps have to be taken before the crisis deteriorates, due to the lagged effect of changes in the interest rate on real economic activity.

The six members of the Monetary Committee who participate in the discussion decide on the appropriate rate of interest for the economy. In the discussions on the interest rate for December, four members of the Committee voted in favor of reducing the

interest rate by 0.25 percentage points, while the two other members of the Committee voted in favor of leaving the interest rate unchanged.

In announcing the decision, the Bank of Israel emphasized the following points that led to the decision to lower the interest rate to 2.75 percent for December 2011:

- The debt crisis in Europe is becoming more severe and is spreading to other countries, and there is growing concern over its potentially strong impact on the global economy. Yields on government bonds of Italy and Spain have reached high and apparently unsustainable levels. In light of the weak economic data published in Europe, the risk of Europe sliding into a recession and a significant slowdown in the global economy has risen. These negative developments are already affecting the Israeli economy, and their effect is expected to intensify.
- Economic indicators that became available this month support the assessment that in the third quarter and in October the slowdown in the rate of growth of economic activity continued. Most of the slowdown in the domestic economy resulted from the easing in global demand and its effect on exports, and also to some extent from the slackening of domestic demand.
- Inflation forecasts for the next twelve months as calculated from the capital market, those of the forecasters and that of the Bank of Israel are all close to the midpoint of the target inflation range. Actual inflation over the last twelve months is within the target range, and is expected to remain there over the next year.
- The persistent negative trends in Europe led to a cut in the ECB interest rate and to cuts in interest rates in other countries, and resulted in the markets not pricing in an increase in the interest rate in the coming year in any of the major advanced economies. According to the announcement by the Federal Reserve, the interest rate in the US is expected to remain at its almost zero level till the middle of 2013 at least, and the Fed and the ECB are continuing with their quantitative easing measures.
- Home prices increased by 10.5 percent in the twelve months ending September, compared with 12.1 percent in the twelve months to August. In August–September home prices declined for the first time since December 2008. The continued increase in the number of building starts, the delayed effect of the increase in the interest rate, measures introduced by the Bank of Israel affecting mortgages, and steps taken by the Ministry of Finance in real estate taxation are all expected to continue to moderate home prices during the coming year. It should be noted that the limitation imposed by the Bank of Israel on some housing loans at variable interest rate reduces the effect of a cut in the interest rate on the average rate of interest on mortgages.

The reduction in the interest rate together with the recent weakening of the effective exchange rate of the shekel are expected to help Israel's economy deal with the difficulties confronting it.

The Bank of Israel will continue to monitor developments in the Israeli economy and the global economy and in financial markets. The Bank will use the tools 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 assets markets, including the housing market.

The decision was reached and announced on November 28, 2011.

Participants in the narrow-forum discussion:

Members of the Monetary Committee

Prof. Stanley Fischer, Governor of the Bank of Israel, Chairperson

Prof. Alex Cukierman

Dr. Karnit Flug, Deputy Governor of the Bank of Israel

Prof. Reuben Gronau

Prof. Rafi Melnick

Mr. Barry Topf, Senior Advisor to the Governor on Monetary Policy Issues

Other participants in the narrow-forum discussion:

Mr. Andrew Abir, Director of the Market Operations Department

Prof. Nathan Sussman, Director of the Research Department

Mr. Eddy Azoulay, Chief of Staff to the Governor

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

Mr. Daniel Nathan, Economist, Research Department

Ms. Esti Schwartz, Monetary Committee Secretary

Appendix: Main Global Economic Developments

Europe

The deepening debt crisis is spreading in the direction of important European countries and it appears that the measures being taken so far by European governments are far from sufficient to prevent this from happening. The beginning of the month was characterized by a certain amount of optimism following the agreements reached regarding Greece's debt. These included a 50-percent haircut on the debt to the banking sector, a significant increase in the European Financial Stability Facility (EFSF) to one trillion euro and a demand that the banks increase their capital reserves. However, following the declaration by Greek Prime Minister Mr. Papandreou that a referendum would be held on the austerity measures, confidence in the program was undermined and optimism was replaced with fear. At the G20 meeting, the donor countries, led by China, would not commit themselves to

participation in the fund and requested clarifications regarding its operation and the austerity programs. Meanwhile, Germany and France did not manage to agree between them on the powers of the fund and how it would operate.

The concern in the markets is currently focused on Italy and Spain, which together account for about 28 percent of the euro bloc's GDP. The yields on their 10-year bonds rose to about 7 percent, and in France yields and the CDS spreads also rose, though not to the same extent. These countries are continuing to borrow even at high rates, but it is clear that this cannot continue in the long run. A critical junction will be reached already at the beginning of 2012 when Italy will have to recycle about 150 billion euro of debt (out of a total of about 300 billion in the whole of 2012). Italy and Spain are considered too big to fail, but on the other hand they are almost too big to save. As time goes on, the price of rescuing them gets higher and the chances of it happening gets slimmer. Although the ECB is continuing to purchase the bonds of the countries in distress, and since August has purchased about 110 billion euro (bringing the total to close to 200 billion), the rate and volume of purchases is far from sufficient and there are increasing calls for the ECB to begin acting with more determination and on the same scale as the Bank of England, the Fed, and the Bank of Japan. On the other hand, various governments, led by Germany, Austria and the Netherlands, are opposed to the purchasing of bonds and suggest that focus be placed on austerity programs. Nonetheless, it is worth noting that even if a change in approach is adopted in the euro bloc which leads to the purchase of significant quantities of bonds of Portugal, Ireland, Italy, Greece and Spain (PIIGS), this may be effective only in the short run. In the medium run, the weaker countries will have to make major and painful fiscal adjustments and will need to carry out structural reforms to restore their competitiveness, while the euro bloc as a whole needs to strengthen its fiscal cohesion and improve its budget control.

US

Overall, the macroeconomic data for the US continues to be positive, and the upward trend that began in June has gained strength. The positive results were primarily in the areas of production, consumption and employment. Thus, manufacturing output grew by 0.7 percent in October (compared with analysts' expectations of 0.4 percent), retail sales grew by 0.5 percent (expectations were 0.3 percent) and factory orders grew by 0.3 percent, despite expectations of a decline. With regard to employment, there was improvement in the figures for first-time applications for unemployment benefits, the supply of jobs and productivity levels. In addition, the net financial position (NFP) figures were encouraging, if one includes upward revisions of the figures for previous months. Particularly important was the pleasant surprise in some of the confidence indices of consumers, investors, small businesses and contractors (as well as other data in the construction industry). The improvement in these indices, which were particularly weak in recent months, may be a sign that consumer and investor confidence in the economy is returning. In their announcement of the Leading Economic Indicators, the Conference Board also highlighted the improvement in private consumption, production, construction and employment and claimed that the

economy “has managed to overcome the fluctuations in the financial markets that were the result of the debt crisis in Europe.” In addition, many investment houses have raised their growth forecast for the fourth quarter by about 0.5 percent on average, to levels exceeding 3 percent. Nonetheless, the level of most indicators remains low and the rate of recovery is far from sufficient to enable the economy to deal with the challenges it faces. A downward revision of growth figures to 2 percent for the third quarter (compared with expectations of 2.5 percent) led Fed chairperson Ben Bernanke to again stress the downside risks in his interest rate announcement, in which he also stated that the improvement in employment would be “frustratingly slow”. He also repeated his assessment that the interest rate would remain low until mid-2013 and announced the continuation of the Operation Twist program.

Emerging economies

The performance of the large emerging economies continues to be relatively strong, although they are also experiencing a noticeable slowing of growth, which is mainly evident in forward-looking indicators. Thus, the rate of growth in manufacturing production fell in each of Brazil, Russia, India and China (known as the BRIC countries) and in Brazil the index even indicated a contraction of 1.6 percent. China’s exports grew at their lowest rate in two years and its trade surplus shrank; even its retail sales were somewhat disappointing. The World Bank expects a “soft landing” for China, with growth of 9.1 percent this year and 8.4 percent next year. However the main problem for China remains the overheating of its economy, which is manifested in inflation and the fear of bubbles in real estate, credit and investment which would endanger the banks. China’s CPI fell to 5.5 percent this month (from 6.1 percent) as expected and there were small declines in housing prices; in particular the producer price index (PPI) fell more than expected, to 5 percent. All this indicates some reduction in price pressures from the prices of goods; however, the 21.7 percent average increase in wages in most districts of China and the renewed rise (beyond expectations) in the volume of loans to the private sector indicate that the risk has not disappeared. In its first review of the Chinese banking system, the IMF reported a significant improvement, but warned that there are a number of risks with non-negligible probabilities, particularly those related to credit provided to poorly functioning local governments and projects, and that there is increased risk in China’s real estate sector. The IMF called on the government to increase its supervision of the banks and to improve its evaluation of risk, consistent with the warning by a bank regulator in China who stated that the banks are liable to incur major losses because of the construction industry. The Nomura Bank estimated the probability of a “hard landing” for the Chinese economy at about 30 percent and claimed that the main risk lies in the combination of overinvestment with a real estate bubble, an inefficient monetary policy and debt-laden government banks.

The capital markets

In the financial markets, concerns regarding the debt crisis and a possible return to recession still predominated this month and even strengthened in intensity. For the

month as a whole, stock exchanges declined by five percent in the advanced economies and by one percent in the emerging economies and the various market volatility indices changed very little. However, the behavior of the markets was not uniform throughout the period. Thus, during the first half of the period, stocks rose by up to 10 percent in the emerging economies and up to 6 percent in the advanced economies, while the VIX volatility index declined; however, since then the stock markets have mainly fallen. In particular, the stock markets in the PIIGS countries, led by Italy, have recorded sharp declines in share prices while the yields on government bonds and also CDS spreads have risen (again) to record levels. From a longer-run perspective, the stock markets in the emerging economies have fallen by about 22 percent since the beginning of the year, compared with 13 percent in the advanced economies (and a 6 percent drop in the S&P index), in spite of the fact that the emerging economies have outperformed the advanced ones.