BANK OF ISRAEL
Office of the Spokesperson and Economic Information

May 7, 2012

Report to the public on the Bank of Israel's discussions prior to setting the interest rate for May 2012

The discussions took place on April 22 and 23, 2012

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 the public. Other participants in the discussion are the Directors of the Research and Market Operations Departments, 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 Monetary Operations Departments, the two Departmental Directors 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 Bank of Israel Law, 5770-2010, (section 18(c)), the decision on the interest rate is reached by majority vote 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
Indicators of real economic activity that became available this month (between the date of the interest rate decision for April 2012, on March 26th, and the interest rate decision for May 2012, on April 23rd) are consistent with the most recent growth

forecast published by the Bank of Israel, according to which growth in 2012 will be 3.1 percent. National Accounts data for the fourth quarter of 2011 indicate that the state of the real economy is better than it appeared in previous updates. Similarly, company responses to the Bank of Israel's Companies Survey and the Central Bureau of Statistics survey of business trends indicate that current assessments for the situation at the end of 2011 and beginning of 2012 are more positive than assessments in previous periods.

Monthly indices of the economic situation

Indicators of real economic activity that became available this month are consistent with the growth forecast published last month by the Bank of Israel, according to which growth in 2012 will be 3.1 percent, and surveys indicate that concern of a further decline in the rate of GDP growth has eased. National Accounts data for the fourth quarter of 2011 were revised upward, with the GDP growth rate revised to 3.4 percent, similar to its level in the third quarter. The Bank of Israel's Companies Survey indicates acceleration in business sector activity in the first quarter of 2012, and expectations for second quarter activity are positive, primarily in the commerce and business services sectors. The Central Bureau of Statistics survey of business trends for the first quarter indicates that the slowdown in activity is ending, with a significant improvement in March regarding expectations of future activity. The Research Department's index based on Google searches, which serves as an indicator of demand in the economy in the coming months, forecasts demand growth above the trend in recent months. Although the Purchasing Managers Index is still below 50, the boundary between contraction and expansion of activity, it increased in March to 46.3 points, continuing the increase it showed in the previous month, with a positive change in most of its components. The Composite State-of-the-Economy Index increased by 0.2 percent in March. Among its component indices, the manufacturing production index declined by 2.2 percent in February, after an increase of 0.7 percent in January. The trade and services revenue index was unchanged in February after a decline of 1.8 percent in January. There was continued weakness in goods exports, which declined by 1.2 percent in March, following a 0.6 percent decline in February.

The labor market

This month, the Labour Force Survey (for January and February) was published with data calculated using a different method. According to this survey, the unemployment rate was 6.5 percent in February, compared with 6.6 percent in January, and 6.7 percent in the fourth quarter of 2011, in concatenated figures. This contrasts with the unemployment rate of 5.4 percent in the last quarter of 2011 in the survey published using the previous methodology. The participation rate in February declined to 62.2 percent from 62.6 percent in January. The employment rate declined to 58.2 percent in February from 58.4 percent in January. The unemployment rate calculated according to the new method is also lower than that in many other advanced economies. Health tax receipts, which provide an indication of total wage payments, were 4.5 percent higher in March in nominal terms than in March 2011 (excluding the effect of legislative changes); February receipts were 5.5 percent higher than February 2011. Nominal wages increased 0.6 percent in November–January, compared with the preceding three months, and real wages increased 0.1 percent.

2. Budget data

The domestic deficit in the first quarter of 2012 was NIS 0.4 billion, compared with a surplus of NIS 2.4 billion in the first quarter of 2011. The deficit is slightly greater than the seasonal path consistent with the forecast full year deficit of 3.3 percent of GDP, and is considerably greater than the figure required by the target deficit ceiling set by law, of 2 percent. The deviation from the path derives primarily from lower than expected tax receipts in February and March. Likewise, the government's commitments for this year (wage agreements, defense expenditure, etc.) are about NIS 6 billion above the budget's expenditure ceiling. It should be noted, however, that the government has not in the past deviated from the expenditure ceiling, and that the risk of a further increase in the budget deficit from a breach in the budget expenditure framework is much smaller than that arising from a potential decline in government receipts.

3. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) increased by 0.4 percent in March, at the upper bound of the range of forecasts, and above the seasonal path consistent with achieving the inflation target. In recent months, the rate of inflation measured over the previous twelve months has remained stable near the middle of the target range (1–3 percent); in March the figure was 1.9 percent

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

The average of forecasters' inflation predictions, and inflation expectations for the next twelve CPI readings based on over-the-counter CPI futures contracts offered by banks, remained stable at 2.5 percent. One year forward inflation expectations as calculated from the capital markets (break-even inflation) declined from around 3 percent at the beginning of the month to 2.5 percent in the last few days. This was due to the ending of a seasonal bias evident in recent months. Professional forecasters project an increase of 0.9 percent in the CPI for April, and an increase of 0.4 percent for May, relatively high figures, primarily due to seasonal factors. Inflation expectations for the medium term were stable at 2.6 percent, and for longer terms, at 2.4 percent. Expectations for the Bank of Israel interest rate one year from now, based on the Telbor (Tel Aviv Inter-Bank Offered Rate) market, are 2.7 percent, and expectations calculated from the *makam* yield curve are 2.6 percent. The average of forecasters' predictions of the interest rate in one year's time was 2.6 percent, compared with average projections of 2.5 percent last month. Forecasters project that the Bank of Israel interest rate will remain unchanged for the next three months.

The makam and bond markets

Yields decreased in the government bond market, particularly in the unindexed segment, with the decline in inflation expectations for most terms. *Makam* yields were unchanged during the period along the entire curve at an average of 2.6 percent. This was despite a marked exit by nonresident investors at the beginning of the month following the redemption of a bond series and a decline in market expectations regarding additional interest rate reductions by the Bank of Israel.

The yield spread and differential between Israel and abroad

The interest rate differential between Israel and the US is currently 2.25 percent, and 1.5 percent between Israel and the ECB, after the interest rate at the Bank of Israel and the monetary interest rates in the US and eurozone were left unchanged for March. The yield gap between Israeli 10-year government bonds and equivalent 10-year US Treasury securities widened this month by 25 basis points (b.p.) to 270 b.p.; this was due to a sharper decline in yields in the US.

The monetary aggregates

In the twelve months ending in March, the M1 monetary aggregate (cash held by the public and demand deposits) increased by 0.9 percent, and the M2 aggregate (M1 plus unindexed deposits of up to one year) increased by 9 percent.

The credit market

The outstanding debt of the business sector increased in February by 0.6 percent, to NIS 771 billion. The increase in the debt derived primarily from the increase in outstanding bank credit. Total outstanding credit to households declined in February by 0.3 percent, to NIS 365 billion, but within the total the balance of outstanding housing credit increased by 0.3 percent, to NIS 260 billion. Despite a 14 percent increase in new mortgages granted in March (apparently partly due to seasonal factors), total mortgages granted in the twelve months ending in March were 3 percent lower than the amount advanced in the twelve months to February, continuing the decline from the peak level in May 2011. Unindexed floating rate mortgages granted in March constituted 27 percent of total new mortgages. Interest rates on all mortgage tracks declined this month.

The housing market

The housing component of the CPI (representing rents) increased in March by 0.4 percent. In the past twelve months it increased by 4.4 percent. Home prices, which are published in the Central Bureau of Statistics (CBS) survey of home prices but are not included in the CPI, increased in January–February by 0.3 percent, after declining 0.1 percent in December–January. In the twelve months to March, the rate of increase of home prices declined to 3.2 percent, compared with a rate of 4.1 percent in the twelve months to February, continuing the slowdown in the rate of increase in home prices. The ratio of home prices to rents increased by 0.1 percent in January, but remains 3.1 percent lower than the peak level recorded in March 2011.

Activity in the construction industry continues to be strong. There were 44,587 building starts in the twelve months to January, compared with 44,575 in the twelve months to December, and the number of completions was 33,712 compared with the previous month's figure of 33,994. Although in February the number of homes available for sale built by the private sector declined by 3 percent, the decline came after a marked increase in the number of homes available for sale since the second quarter of 2011, the result of a sharp increase in building starts since the end of 2009. Thus, the number of homes for sale is still at the levels of 2003–07.

The moderation in the rate of increase in home prices in recent months comes against the background of the continued increase in the number of building starts, the lagged effect of the changes 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. These moves, together with land marketing efforts by the Ministry of Construction and Housing and the Israel Land Administration, are expected to continue to have a moderating effect on price increases.

The Bank of Israel Research Department assessment (staff forecast)

The Bank of Israel Research Department compiled its quarterly staff forecast last month. GDP growth in 2012 was projected to be 3.1 percent, and 3.5 percent in 2013. The forecast projects an inflation rate of 2.6 percent over the next four quarters and an average interest rate in the first quarter of 2013 of 2.5 percent. The interest rate is forecast to begin increasing in the middle of 2013, under the assumption of a recovery in the global economy.

4. The foreign currency and stock markets

The foreign currency market

From the previous monetary policy discussion held on March 25, 2012, through April 20, 2012, the shekel depreciated against the dollar by about 0.6 percent. Against the euro, the shekel appreciated about 0.45 percent, in line with the trend of the exchange rates of most major currencies against the euro. In terms of the nominal effective exchange rate the shekel depreciated by about 0.25 percent.

The capital market

From the previous monetary policy discussion held on March 25, 2012, through April 20, 2012, the Tel Aviv 25 Index rose by 2.2 percent. This rise offsets some of the underperformance since the beginning of the year, a continuation of the positive trend of the previous month, and in contrast to the general global trend. The decline in the foreigners' share of *makam* holdings continued, and this month their holdings declined to under 4 percent. The trend of money market fund withdrawals halted this month, and there were net new investments of NIS 500 million. Corporate bond mutual funds also attracted net new investments again this month, of around NIS 800 million. The Tel-Bond 20 Index increased by 1.6 percent, and the Tel-Bond 40 Index by 0.8 percent. These returns were part of the positive domestic trend, and also came against the background of an update in Tel Bond indices at the beginning of the month, which increased the weighting of banks in those indices. Tel-Bond yield gaps vis-à-vis government bonds narrowed this month.

5. Israel's sovereign risk premium

Israel's sovereign risk premium as measured by the five-year CDS spread narrowed slightly to 191 basis points, compared with 195 basis points just before the previous interest rate decision.

6. Global economic developments

Following a period of some easing of concerns over the European debt crisis, these increased again this month, with a renewed focus on Spain and to some extent on Italy. Macroeconomic data from around the world continue to indicate a slow recovery in the global economy, with a slight slowdown in growth in the US. The mixed trend in the emerging market economies continued, and the growth rate in China was lower than expected. Against this background, the IMF revised upward its forecast of growth and world trade, reflecting the improvement in the markets since the deterioration in the European debt crisis at the end of 2011. The growth forecast for 2012 was increased by 0.2 percentage points to 3.5 percent, and that for 2013 by 0.1 percentage points, to 4.1 percent; the forecast for world trade was increased by 0.2 percentage points from the previous forecast, to 4 percent in 2012 and 5.6 percent in 2013. Inflation around the world remained moderate, and commodity prices declined this month. Most central banks kept their interest rates unchanged this month.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR MAY 2012

The six members of the Monetary Committee participating in the discussion decide on the appropriate rate of interest for the economy. In the discussion ahead of the decision on the interest rate for May 2012, all Committee members were in favor of keeping the interest rate unchanged at 2.5 percent.

The participants discussed several issues, primarily: developments in inflation and inflation expectations, the assessment of real economic activity, including the housing market; fiscal policy and the budget deficit; global developments, and the risks to the Israeli economy deriving from those developments.

Committee members referred to the CPI data for March, which increased above the average forecast, while the CPI over the past twelve months remained below the midpoint of the inflation target range. Relatively little weight was given in the discussion to the high CPI reading for March, since it was reasoned that, among other things, the seasonally high figure for April was partially brought forward into March due to the relatively early occurrence of the Passover holiday this year. Likewise, it was noted that energy and housing prices which raised the index for March continue to be the dominant factor in the twelve-month increase in the index. In recent months, there have been near zero rates of changes in the rolling twelve-month index excluding housing and energy. In other words, excluding housing and energy prices, there do not appear to be other inflationary demand pressures. Looking forward, to the extent that the declines in global oil prices and prices of agricultural commodities and metals which occurred this month take hold, they are likely to moderate both actual inflation and inflation expectations.

Regarding real economic activity, Committee members referred to new data published in the past month. In their assessment, the picture which emerges from the range of figures is mixed, and along with positive indicators, primarily from company surveys regarding expectations of future activity, there have also been several negative figures published. With that, Committee members still assess that the data which became available are consistent with the recent 3.1 percent growth forecast for 2012 published by the Bank of Israel. The forum also dealt with Labour Force Survey data, which are now based on a new methodology, and indicate an unemployment rate of 6.5 percent in February—a slight decline from January and from the first quarter of 2011—as well as a decline in the participation rate and in the employment rate. Committee members emphasized that the findings and new methodology of the survey need to be studied, and that its reliability has not yet been established.

Regarding the housing market, Committee members noted that looking over the past twelve months, there has been some moderation in the increase in the housing component of the CPI (based on rents) and in home prices (based on the CBS survey), and the increase in the latter has even halted. With that, in recent months there has been a recovery in the volume of new mortgages granted and in the number of transactions in the housing market. The Committee is following developments in the housing market, and will continue to monitor the market and will consider taking steps if necessary.

The forum also discussed fiscal policy and the budget deficit. The members of the Committee spoke of the importance of maintaining fiscal discipline and continuing with the process of reducing the debt/GDP ratio. They noted that at this time developments in fiscal policy and the deficit are having no evident effect on inflation.

Another issue discussed was the global environment and the risks posed by it to the Israeli economy. Committee members referred to concerns which continued to be raised in regard to the debt crisis in Europe, particularly in Spain, the loss of momentum in the US and the mixed data regarding emerging economies, after a period of relative calm and expectations for recovery. Committee members noted that if the new developments persist, it will make exports, and thus economic growth, more difficult. Forum members noted that it is still too early to determine whether there is a change in the trend.

In light of the range of factors, the Monetary Committee decided unanimously to keep the interest rate for May unchanged at 2.5 percent. In announcing the decision, the Bank of Israel said that leaving the interest rate for May unchanged at 2.5 percent is consistent with interest rate policy that is intended to entrench the inflation rate within the price stability range of 1–3 percent a year over the next twelve months, and to support growth while maintaining financial stability. The path of the interest rate in the future depends on developments in the inflation environment, growth in Israel, the global economy, monetary policies of major central banks, and developments in the exchange rate of the shekel.

In its announcement, the Bank highlighted the following main considerations underlying the decision:

- The CPI increased by 0.4 percent in March, at the upper bound of the range of forecasts. For the third consecutive month, inflation over the previous twelve months is near the midpoint of the target inflation range, and in March was 1.9 percent. The housing and energy components of the CPI continued to contribute significantly to inflation. Inflation expectations for the coming year are around 2.5 percent. The relatively high figure derives primarily from the continuing increase in energy prices despite some decline in recent weeks, and from expectations that the housing (rent) component in the CPI will continue to increase at a relatively high rate. There do not appear to be other domestic inflationary demand pressures. Expectations for the Bank of Israel interest rate in the coming months are stable.

- Indicators of real economic activity that became available this month are consistent with the growth forecast published last month by the Bank of Israel, according to which growth in 2012 will be 3.1 percent. Based on various surveys, companies' expectations for future activity are slightly more positive than in previous surveys.

- After a period of relative calm over the debt crisis in Europe, concerns of a renewed worsening increased this month. Global macro figures continued this month to indicate a slower rate of recovery in the global economy, with some slowing in growth in the US and China. With that, this month the IMF revised upward its global growth and world trade forecasts slightly, while emphasizing the risks to the recovery process.

- Interest rates in major economies remain low, and markets are not pricing in an increase in the interest rate this year by any of the central banks of large advanced economies. The Fed has declared previously that it intends to maintain the federal funds rate at its near-zero level at least until the end of 2014.

The Bank of Israel will continue to monitor developments in Israel's 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 the asset markets, including the asset markets.

The decision was reached and announced on April 23, 2012.

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. Ynon Gamrasni, Economist in Research Department
Ms. Tsila Billet, Assistant to Monetary Committee Secretary