BANK OF ISRAEL
Office of the Spokesperson and Economic Information

July 9, 2012

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

The discussions took place on June 24 and 25, 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

Most indicators of real economic activity that became available this month point to a continuation of growth at a moderate rate of around 3 percent on an annual basis.

National Accounts data

The second estimate of National Accounts data for the first quarter indicates that GDP grew by 2.9 percent and that business sector product grew by 2.6 percent, after increases of 3.1 percent and 3.6 percent, respectively, in the previous quarter. Private consumption increased by 3.7 percent, following an increase of 0.2 percent in the previous quarter; investment increased by 7.3 percent, after an increase of 6.9 percent in the previous quarter; and exports increased by 1.6 percent, after a decline of 5.4 percent in the previous quarter.

Monthly indices of the economic situation

Most monthly indicators point to continued growth at a moderate rate—the Composite State of the Economy Index for May increased by 0.2 percent, and the indices for the previous two months were revised upward; the climate indices for May, based on the Central Bureau of Statistics Business Tendency Survey, indicate stability in the growth rate of the business sector; and the Consumer Confidence Indicator calculated by the Central Bureau of Statistics increased moderately in May, following its moderate increase in April. The Purchasing Managers Index declined in May by 2.2 points, but for the second consecutive month the index was above 50 points, the boundary between growth and contraction. The Research Department's index based on Google searches, which serves as an indicator of demand in the economy in the coming months indicates a high probability of acceleration in trade and services revenue in June.

The labor market

Labor market data which became available after the last monetary policy discussion indicate continued improvement in this area. April data from the monthly Labour Force Survey indicate an increase in the participation rate to 63.2 percent and in the employment rate to 59 percent. The unemployment rate in April declined slightly to 6.7 percent. Figures on employee posts for March indicate an acceleration in the trend of increase in the number of employee posts. The forecast for the number of employees, derived from the Business Tendency Survey, is for an increase in employee recruitment in the coming months. Health tax receipts, which provide an indication of total wage payments, were 5.1 percent higher in May in nominal terms than in May 2011 (excluding the effect of legislative changes); in contrast, April receipts were 6.5 percent higher than in April 2011. Nominal wages declined by 0.1

percent in January–March compared with the preceding three months, and real wages declined by 1.1 percent.

Foreign trade

Figures for imports and exports were mixed: data on goods exports (excluding ships and aircraft and diamonds) for May indicate a slight decline in exports compared with the previous month, while services exports (seasonally adjusted) increased in April by about 6 percent compared with March, continuing the increase in the first quarter of the year. Goods imports (excluding ships and aircraft and diamonds) increased in May by about 1 percent.

Budget data

Actual budget expenditure resulted in a domestic deficit from the beginning of the year through May of NIS 2.9 billion, compared with a surplus of NIS 0.7 billion in the corresponding period of 2011. In accordance with the revised growth forecast, the deficit in 2012 is projected to be about 3.7 percent of GDP—above the seasonal path consistent with the Ministry of Finance's revised deficit forecast of 3.4 percent of GDP—primarily due to tax receipts below the path expected for January–May. The government's commitments for this year (wage agreements, defense expenditure, etc.) are significantly above the budget's expenditure ceiling. It should be noted, however, that the government has not in the past deviated from the budget expenditure framework.

2. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) was unchanged in May, below the seasonal path consistent with achieving the inflation target and below forecasts which were for an increase of 0.2–0.3 percent. The surprise in the CPI was due mainly to the food component, which declined by 0.4 percent compared with a forecast for a moderate increase. The rate of inflation over the previous twelve months declined to 1.6 percent, below the center of the inflation target range (1–3 percent).

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

There were declines in most inflation expectations this month. The average of forecasters' projections of the CPI for the next 12 readings declined after the release of the May CPI, from 2.2 percent to 2 percent. Inflation expectations based on over-the-counter CPI futures contracts offered by banks declined, particularly after the May CPI was published, from around 2.3 percent to 1.8 percent. With that, inflation expectations calculated from the capital markets (break-even inflation) remained at their level of the past two months, 2.1–2.2 percent on average. Inflation expectations for medium terms declined as well, by 0.2 percentage points, to 2.4 percent.

Expectations for longer terms were stable at 2.5 percent. Expectations for the Bank of Israel interest rate derived from the Telbor (Tel Aviv Inter-Bank Offered Rate) market and as calculated from the *makam* yield curve indicate a 0.25 percentage point decline in the interest rate during the next three months. Most forecasters predict that the Bank of Israel interest rate for July will be reduced by 0.25 percentage points.

The makam and bond markets

In the unindexed bond curve, yields declined 20–30 basis points along most of the curve, which steepened. A similar trend was observed on the CPI-indexed bond curve, with declines of 10–20 basis points. *Makam* yields declined by about 20 basis points along the entire curve, with one year yields at 2.19 percent during the period.

The yield spread and differential between Israel and abroad

The yield gap between Israeli 10-year government bonds and equivalent 10-year US Treasury securities was stable this month, with a slight decline of 4 basis points, to 271 basis points. Israel's sovereign risk premium as measured by the five year CDS spread declined by about 20 basis points this month to 170 basis points, similar to developments in many emerging economies.

The monetary aggregates

In the twelve months ending in May, the M1 monetary aggregate (cash held by the public and demand deposits) increased by 2.5 percent, and the M2 aggregate (M1 plus unindexed deposits of up to one year) increased by 6.9 percent.

The credit market

The outstanding debt of the business sector increased in April by 0.5 percent, to NIS 790 billion. The increase in the debt derived primarily from the increase in the CPI and the depreciation of the shekel. These factors increased the balance of CPI-indexed debt and of foreign currency denominated debt. Company responses to the Central Bureau of Statistics Business Tendency Survey indicate that companies in nearly all industries sense an easing in the credit constraints they face, except for the construction and hotels industries, where firms reported that the credit constraint became more severe, although the constraint was reported to be moderate. Total outstanding credit to households increased in April by 0.2 percent, to NIS 368 billion, within which the balance of outstanding housing credit was NIS 263 billion. Total mortgages granted in the twelve months ending in May were 1.7 percent lower than those advanced in the twelve months to April, continuing the decline from the peak level in May 2011. Unindexed floating rate mortgages granted in May constituted 28 percent of total new mortgages. Interest rates on indexed mortgage tracks declined by

0.1 percent this month on average, and interest rates on unindexed mortgages were unchanged.

The housing market

The housing component of the CPI (representing rents) increased in May by 0.3 percent. In the twelve months ending in May it increased by 3.8 percent, compared with an increase of 4.6 percent in the twelve months to April. Home prices, which are published in the Central Bureau of Statistics survey of home prices but are not included in the CPI, increased in March–April by 1.4 percent, after remaining relatively stable in December–March. In the twelve months to April, home prices increased by 2.2 percent, similar to the rate in the twelve months to March.
Activity in the construction industry is strong compared with its levels in the past decade. Although building starts are below the record level of the middle of 2011, they remain high and are expected to continue to be reflected in an increased inventory of homes. There were 43,770 building starts in the twelve months to March, compared with 44,817 in the twelve months to February. In February–April, the stock of vacant homes available for sale remained stable at 20,500, after a trend of increase in the past year—reflecting a decline in building starts at the same time as an increase in homes sold.

The Bank of Israel Research Department assessment (staff forecast)

The Bank of Israel Research Department updated this month its macroeconomic forecast for 2012 and 2013. The forecast for the primary variables was revised downward, though only slightly so. Projected GDP growth in 2012 was unchanged at 3.1 percent. In light of the decline in the global growth forecast, the forecast for 2013 for Israel declined slightly to 3.4 percent from 3.5 percent in the previous forecast. (The Research Department also presented a scenario in which the interest rate remained unchanged. Under this scenario, the forecast was for 3.3 percent growth.) According to the staff forecast, the inflation rate over the 4 quarters ending in the second quarter of 2013 is expected to be 2.4 percent. The Research Department forecasts that following the current interest rate reduction, the interest rate will remain unchanged until at least the end of 2013, while the previous forecast projected that the interest rate would begin to increase toward the end of 2013. The current forecast was influenced not only by the deterioration of the economy in Europe, but also by domestic data for the first half. The Research Department noted that the main risk to the forecast is a deterioration of the financial crisis in Europe.

3. The foreign currency and stock markets

The foreign currency market

From the previous monetary policy discussion held on May 23, 2012, through June 21, 2012, the shekel depreciated against the dollar by about 1.2 percent, and depreciated by 0.3 percent against the euro, in line with the trend of most currencies against the dollar and euro. In terms of the nominal effective exchange rate the shekel depreciated by about 0.9 percent.

The capital market

From the previous monetary policy discussion held on May 23, 2012, through June 21, 2012, the Tel Aviv 25 Index increased by 2.7 percent, in line with the worldwide trend. The Tel-Bond 20 Index declined by about 1.1 percent, and the Tel-Bond 40 Index declined by about 1 percent. This was part of the negative domestic trend, which was reflected in, among other things, a widening in Tel-Bond yield gaps vis-à-vis government bonds and in increased yields of holding groups. The trends in mutual funds continued—net new investments in money market funds, and withdrawals from corporate bond mutual funds.

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4. Global economic developments

There was an additional deterioration in economic developments in Europe this month, along with further signs of a slowdown in the global economy's growth rate. In Europe, purchasing managers indices as well as indices of manufacturing, employment, and sales indicate a slowdown. The unemployment rate in the EU reached a record 11 percent; Spain's unemployment rate of over 24 percent was notably poor. In the US, most economic figures indicate a slowdown, reflected primarily in the labor market and in personal consumption expenditure. The Tech Pulse Index continued to indicate a recovery, and a slight recovery was seen in the real estate market. In the large emerging market economies—China, India, and Brazil—data continued to emerge indicating a marked slowdown in growth rates. Investment houses revised downward their growth forecasts for major economies in the world. Against the background of the crisis in Europe, there was a steep increase this month in yields on Spain's sovereign bonds to over 7 percent. Globally, the inflation environment is expected to remain low in advanced economies, and to continue to moderate in developing economies that are experiencing a marked slowdown in growth. Commodity prices continued to decline this month as well, a trend which was prominent primarily in oil prices, which declined by about 15 percent. Against the background of these developments, central banks again extended various easing plans. The Fed extended its Operation Twist, in which it sells short term securities and buys long term bonds to replace them, until the end of the year. The Bank of England also reported the implementation of aid programs for the real and financial sectors. The ECB adopted various expansionary measures as well, and there are expectations for additional significant measures by the EU at the end of the month. At the same time, a decision was reached on a €100 billion loan to Spain via the European Stability Mechanism (ESM), with the aim of injecting capital into that country's banking system. Against this background, stock market indices rose around the world and there was a decline in the yield on Spain's sovereign bonds. Interest rate reductions continued in several countries.

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

1. Main points of discussion

The six members of the Monetary Committee participating in the discussion decide on the appropriate rate of interest for the economy. After the discussion on the interest rate for July 2012, five Committee members voted in favor of reducing the interest rate by 0.25 percentage points, and one Committee member voted to leave the interest rate unchanged at 2.5 percent.

The discussion focused on (1) the effects on, and the risks to, the Israeli economy deriving from the state of the global economy, and of Europe in particular; (2) the level of inflation in Israel and inflation expectations, (3) Israel's fiscal policy, and (4) the housing market.

Committee members noted that despite the decline in the risk of an immediate crisis which would derive from Greece's exit from the eurozone, several indicators became available which pointed to a deterioration in the global situation. Within this framework, it appears that growth rates in several countries around the world, even those outside Europe, declined. Global growth forecasts at a number of investment houses were revised downward. Members also expressed concern that even without a significant deterioration in the crisis, several advanced economies will find it difficult to return to a growth path over the next year or two. There are market expectations for interest rate reductions in other countries, besides those that already lowered rates this month, and for further monetary easing plans. Monetary Committee members assessed that a continued decline in growth rates in the world is liable to have a negative impact on Israel's economic growth, primarily via a possible blow to exports.

Committee members assessed that in recent months the economy has continued to grow at an annual rate of around 3 percent. One member said that data that became available this month indicate that the growth rate continued in the second quarter as well. With that, concerns were raised about the continuation of the current rate of growth due to the decline in growth rates of business sector product, and concern for continued growth of exports.

Participants noted that inflation over the previous 12 months is below the center of the target range of 1–3 percent per year, and that the surprise in the CPI for May led to a relatively sharp decline in expectations for inflation in the coming 12 months.

Committee members discussed the increase in the government's deficit for 2012, and the need for measures to reduce expenditure ahead of the 2013 budget in order to ensure the credibility of fiscal policy and continued decline in the debt to GDP ratio. Within this framework, the importance of tax rate increases was emphasized. At the same time, the rate of growth of government expenditures derived from the automatic pilot needs to decline in order to meet the expenditure rule. The tax and expenditure measures are required to improve the ability to deal with possible crisis developments. Although an indirect tax increase will apparently increase the price level in the economy, the increase in prices is expected to be a one-time phenomenon.

The increase of 1.4 percent in the index of home prices for March-April, the increase in new mortgages granted in May and the slight decline in building starts (which remain at a high level) were considered in a discussion regarding the effect of monetary policy on the housing market. The assessment in the discussion was that due to the weakness of the pass-through mechanism from the Bank of Israel interest rate to the housing market following the last macroprudential step taken, which led to a decrease in the weight of the variable rate component in a mortgage, and despite the interest rate reduction, an additional macroprudential measure is not required at this time.

After the discussion, the six Monetary Committee members voted on the interest rate for July 2012. The main argument in favor of reducing the interest rate was its contribution to strengthening the Israeli economy's ability to deal with the impact of potential negative consequences from the global economy, by maintaining the rate of inflation near the center of the target range. In contrast, the Committee member who recommended leaving the interest rate unchanged felt that despite the risks to growth seen from developments abroad, growth is still stable, while there are marked risks to the stability of growth stemming from fiscal policy. Until the budget picture becomes clear, it is appropriate, from his perspective, to wait with an interest rate reduction.

2. The main factors influencing the decision, as published in the interest rate announcement of June 25, 2012:

The decision to reduce the interest rate for July 2012 by 0.25 percentage points to 2.25 percent is consistent with interest rate policy that is intended to entrench the inflation rate within the price stability target 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. The interest rate reduction will contribute to strengthening the Israeli economy's ability to deal with the impact of potential negative consequences from the global economy.

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

- Following the May CPI, actual inflation over the previous 12 months is below the center of the inflation target range, and inflationary pressures are not evident. Various inflation expectations for the coming 12 months are around the center of the target range, after inflation expectations of forecasters and those based on over-the-counter CPI futures contracts were revised markedly down. Prices of commodities, particularly oil, declined sharply—a continuation of their declines in the previous two months.

- Most indicators of real economic activity in Israel which became available this month point to continued moderate growth at an annual rate of about 3 percent, a rate similar to that of the first quarter. After the reduction in the interest rate for July, the Research Department staff forecast for GDP growth in 2012 remains 3.1 percent and the forecast for 2013 was revised to 3.4 percent.

- This month macroeconomic data around the world indicated a further slowdown in growth, and projections of international organizations were revised downward. The level of economic risk in the world due to developments in Europe remained high, and with it the concern over negative effects on the domestic economy.

- Interest rates in the major economies remain low, and markets are not pricing in any increases in interest rates this year by any of the leading advanced economies' central banks. Several central banks even reduced interest rates this month. Against the background of recent developments, the Fed announced the continuation of its easing plans, and there are increasing market assessments that several central banks will take additional easing steps.

The Bank of Israel will continue to monitor developments in the Israeli and global economies and in financial markets, particularly in light of the increasing uncertainty in the global economy. 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, and in this regard will keep a close watch on developments in the asset markets.

The decision was reached and announced on June 25, 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. Tal Biber, Head of Dealing Unit, Market Operations Department
Prof. Nathan Sussman, Director of the Research Department
Mr. David Zaken, Supervisor of Banks
Dr. Yossi Saadon, Advisor to the Governor and Bank of Israel Spokesperson
Ms. Ziv Naor, Economist in Research Department
Ms. Esti Schwartz, Monetary Committee Secretary