BANK OF ISRAEL
Office of the Spokesperson and Economic Information

September 12, 2011

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

The discussions took place on August 28 and 29, 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 between the last interest rate discussions and the current ones continue to support the assessment that the economy is still growing, albeit at a slower pace than in previous quarters. The slowdown in growth is mainly due to the moderation of

[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.

global demand, which affects goods and services exports, whereas domestic demand continues to expand.

The National Accounts

The National Accounts data for the second quarter of 2011 show that GDP increased by 3.3 percent and business sector product by 1.9 percent (in annual terms). These figures are broadly consistent with the Bank of Israel's forecast of 4.8 percent growth in 2011. Exports (excluding diamonds) grew at a rate of 0.5 percent in the second quarter, compared with 10.1 percent in the first quarter, and private consumption expanded by 2.3 percent, compared with 7.8 percent in the previous quarter. Private consumption excluding durables, which are relatively volatile, grew at a rate of 4.6 percent, compared with 4.3 percent in the first quarter.

Indicators of real economic activity

The moderation in growth was also reflected in the composite state-of-the-economy index, which rose by 0.2 percent in July, continuing the modest rises in the second quarter. Tax revenues were still below the seasonal path for the fourth consecutive month. Nevertheless, expectations regarding future economic activity, based on the Central Bureau of Statistics (CBS) trends survey and the "Globes" and Bank Hapoalim consumer confidence indices are positive.

The labor market

Labor market data indicate a continued improvement in employment. According to trend data for May, the percentage of unemployed reached 5.7 percent of the civilian workforce. The number of employee posts, seasonally adjusted, increased by 0.6 percent in the three months March–May compared with the previous three months. According to the CBS survey of job vacancies, the number of vacancies increased by 2.2 percent in July. The nominal wage increased in March–May by 1.4 percent (three-monthly rate, seasonally adjusted) compared with the level in the previous three months, while the real wage remained unchanged. Health tax receipts in July, which provide an indication of wage payments in that month, were 6.8 percent higher (initial estimate), in nominal terms, than in July 2010 (excluding the effect of legislative changes).

Foreign trade

Goods exports excluding ships, airplanes and diamonds were unchanged in July, and in the three months May–July fell by 2 percent. The decline was the result of the slower increase in exports by industries of all levels of technological intensity (excluding low-tech industries). Services exports increased by a modest 1.4 percent in June, bringing the increase for the second quarter to 0.7 percent. The increase was led by the growth of exports of other business services (excluding start-ups), which increased at a rate of 5.3 percent in June, similar to the rate in the second quarter.

Goods imports (excluding ships, airplanes, diamonds and energy products) continued to increase, rising by 3.2 percent in July, giving a 5.3 percent increase in May–July. All components of imports increased in the last three months, although the rate of increase in capital goods and raw materials was slower than the rapid rate in the previous quarters.

2. Budget data

Domestic revenues of the government in July 2011 were 3.5 percent lower than the seasonal path of the budget forecast, following the slowdown in indirect tax revenues. Nevertheless, tax revenues from January to July were 5.7 percent higher in real terms than in January to July 2010, and NIS 0.1 billion higher than the seasonal path of the budget forecast (excluding the effect of legislative changes and non-recurring revenues). Government domestic activity in the first six months of the year (excluding net credit) yielded a cumulative deficit of 0.4 percent of GDP, compared with a deficit of 1.2 percent of GDP in the same months last year. Based on government activity to date, it seems that the deficit in 2011 will be between 2.7 percent and 3 percent of GDP (the deficit ceiling specified by law is 3 percent of GDP).

3. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) declined 0.3 percent in July, below the average forecast and below the seasonal path consistent with achieving the inflation target. On a seasonally adjusted basis, the CPI in July fell 0.6 percent. Inflation over the past 12 months, as measured by the change in the CPI, was 3.4 percent, above the upper limit of the target inflation range of 1–3 percent a year.

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

Inflation expectations for the next twelve months, both those calculated from the capital markets and those of forecasters, fell significantly over the past month, and are currently 2 percent and 2.5 percent, respectively. The background to the drop in inflation expectations was a fall in commodity prices, the surprisingly low July CPI reading, expectations of a slowdown in growth, and the protests against the high cost of living. At the same time, forecasts of the Bank of Israel interest rate, both of forecasters and those calculated from the capital markets, fell. Based on the Telbor (Tel Aviv Inter-Bank Offered Rate) market, the Bank of Israel interest rate one year from now is expected to be 3.1 percent, down from 4 percent a month ago, and the average of forecasters' predictions is that it will be 3.6 percent (down from 4.3 percent a month ago). Forecasters expect the Bank of Israel to leave the interest rate for September unchanged.

The monetary aggregates

In the twelve months up to and including July, the M1 monetary aggregate (cash held by the public and demand deposits) increased by 3.2 percent, and the M2 aggregate (M1 *plus* unindexed deposits of up to one year) increased by 9.3 percent.

The credit market

The balance of business sector debt decreased in June by 0.7 percent, to NIS 748 billion. Outstanding credit to households increased by 0.9 percent in June, to NIS 354 billion. Of the credit to households, outstanding housing credit in June was 12.3 percent higher than in June 2010, at NIS 252 billion; in May it was 13.9 percent higher than in May 2010. The volume of new housing credit granted in the twelve months ending in July was 1.4 percent lower than the previous month (twelve months to June). The share of mortgages at floating interest rates (for all periods) in total new mortgages continued to decline in July, and reached 79 percent, compared with 81 percent in June; Following a Bank of Israel directive that went into effect on May 5, 2011, the share of mortgages at interest rates that vary once in five years or less is expected to continue to fall. The interest rates on CPI-indexed and unindexed floating rate mortgages continued to increase in July, while the interest rates on fixed-interest rate CPI-indexed mortgages declined.

The housing market

Data on building starts and completions show that activity in the construction industry continues to gain strength. The upward trend in starts that started at the beginning of 2008 persists. The number of starts in the twelve months to May reached 42,304, compared with 41,138 in the twelve months to April, and the number of completions was 33,821 in the twelve months to May, compared with the April figure of 34,095. The number of homes sold fell, and in April–June was 7 percent lower than in January–March. The number of homes available for sale continued to increase, and in April–June was on average 5.4 percent higher than the January–March average. Home prices, which are presented in the Central Bureau of Statistics survey of home prices but are not included in the CPI, increased at a monthly rate of 0.7 percent in May–June, after rising at a similar pace in April–May. The annual rate of increase in home prices continues to be high, but declined slightly for the second consecutive month, and in the twelve months ended in June home prices increased by 12.5 percent; compared with a 13.9 percent increase in the May figure. The slowdown in the rate of increase in home prices was affected by 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, together with the continued increase in the number of building starts, and these factors are expected to moderate home price increases in the course of the coming year. The housing price index, which is based mainly on renewed rental contracts and which is included in the CPI, continued to increase, rising by 0.4 percent in July, bringing the increase in the last twelve months to 5.6 percent.

The Research Department assessment (staff forecast)

Following a deterioration in the global economic environment in the past month, the Research Department's staff forecast is somewhat changed compared with last month. The current assessment is that inflation in the 12 months ending September 2012 will be 2.5 percent, and the average interest rate for the third quarter of 2012 will be 3.3 percent. The Research Department forecasts that the inflation rate in 2011 will be 2.7 percent, and that the average interest rate in the fourth quarter will be 3.3 percent. The Department emphasized the primary risks faced by Israel's economy, specifically, the realization of the pessimistic assessments regarding developments in the global economy and their expected impact on demand for Israel's exports and on domestic demand, and negative geopolitical developments.

4. The capital markets

The foreign currency market

From the previous monetary policy discussion held on July 24, through August 26, the shekel depreciated by about 7 percent against the dollar and the euro, and by about 6.6 percent in terms of the nominal effective exchange rate. The shekel's depreciation against the dollar was considerably greater than that of the main currencies against the dollar. This was apparently against the background of a change in market expectations of the path of the Bank of Israel interest rate, which, in contrast to expectations in recent months, are now that the interest rate will not be increased in the near future. The deterioration of the security situation in the south of Israel and other geopolitical risks may also have contributed to the weakening of the shekel.

The share market and the corporate bond market

Between the monetary policy discussions of July 24 and August 26, Tel Aviv Stock Exchange share price indices fell sharply, in line with the general trend in stock markets around the world. The Tel Aviv 25 Index fell by 14 percent, a move similar to that of US stock market indices. Withdrawals from mutual funds specializing in corporate bonds continue. In the last three months, about NIS 10 billion were withdrawn. In contrast, money market funds continue to attract new investment, and in the past three months about NIS 10.8 billion flowed into those funds. This pace is considerably faster than that seen in the period before the Lehman Brothers crisis. The negative sentiment in the corporate bond market can be seen as well in the widening yield spread against government bonds. The yield spread between the Tel-Bond 40 and government bonds widened from 200 basis points to 288 basis points.

The makam and bond markets

Yields on local currency government bonds declined sharply by 25–65 basis points (b.p.) across the entire yield curve, though mainly on the short end. The yield curve on CPI-indexed government bonds flattened, with a sharp rise of up to 35 b.p. in short terms and a drop of 5–12 b.p. in the medium to long terms. This was against the background of a sharp drop in inflation expectations for the next two years, from about 3 percent per year last month to 2 percent per year currently. *Makam* yields fell by up to 40 b.p., across the curve, as the yield for one year fell during the period from 3.5 percent to 3.08 percent.

The yield gap between Israel and abroad

The yield gap between Israeli unindexed 10-year government notes and 10-year US Treasury notes widened considerably during the period surveyed, against the background of a steeper decline in the US yields than those on Israeli notes, and at the end of the period stood at 266 b.p. (up from 214 b.p. at the beginning of the period).

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

Israel's sovereign risk premium as measured by the five-year CDS spread rose by 28 basis points, and at the end of the period was 166 b.p.

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

Concern regarding global growth increased this month, in light of the disappointing growth data in the advanced economies. The figures published in the US during the month showed a continued slowdown in growth, and in the second quarter the rate (in annual terms) was only 1 percent, significantly lower than the expected rate of 1.8 percent, and the figure for the first quarter was adjusted sharply downwards, from 1.9 percent to only 0.4 percent. The GDP of the eurozone grew at a rate of 0.2 percent in the second quarter, compared with the expectation of 0.3 percent. The average growth in the eurozone was reduced by the zero growth rates in Germany and France, showing a considerable weakening following their respective rapid growth rates of 1.3 percent and 0.9 percent in the first quarter. Concern over global growth intensified also due to the assessment that the set of tools available for economic policy was depleted, relative to that in 2008. The emerging market economies are still showing strong growth, but it is expected that this will also slow in the near future due to the slowdown in the advanced economies. In light of this assessment, the investment houses reduced their global growth forecasts for the next two years considerably. Following the reduced credit ratings of some eurozone countries, S&P this month announced a cut in the US credit rating, which led to severe reactions in the markets around the world. Moody's lowered Japan's credit rating, and there was concern that France's rating may also be lowered. The European debt crisis is still spreading, and presents a threat to Italy and Spain. Inflation expectations fell steeply this month, in

light of the expected slowdown in economic activity and the fall in commodity prices. Currently the markets do not expect an increase in interest rates by any of the central banks of the large advanced economies, and the Federal Reserve announced that it would leave the interest rate at its near zero level until mid-2013 at least.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR SEPTEMBER 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. In the current discussions on the interest rate for September, all four recommended that the Governor leave the interest rate unchanged at 3.25 percent.

The decision to leave the interest rate for September unchanged is consistent with a monetary policy aimed at returning the rate of inflation to within the 1–3 percent range in the next twelve months, and supporting the growth of economic activity while maintaining financial stability. The direction of future changes in the interest rate depends on the inflation environment, growth in Israel and worldwide, the monetary policies of the major central banks, and the exchange rates of the shekel. At the current interest rate level, monetary policy continues to be expansionary. In light of increasing signs of a significant economic slowdown in the developed economies, possibly even the return to renewed recession, it appears that restoring interest rates in Israel and around the world to normal levels will occur over a longer period of time than was expected several months ago, and possibly will even involve interest rate cuts in countries where it is still possible.

Participants in the discussion dealt with several issues: the inflation environment and inflation expectations, real economic activity, the effect of negative scenarios on the Israeli economy, including developments in the global economy and the geopolitical environment, the exchange rate, and home prices.

With regard to the level of inflation and inflation expectations, the discussion centered primarily on the sharp drop in inflation expectations for the next twelve months calculated from capital markets. It was noted that the source of the drop is the internalization of a new inflation environment as a result of the global slowdown and expectations of its continuation which will be reflected by lower global demand and will moderate inflation pressures. Additional factors which were mentioned as lowering inflation expectations were the July CPI reading, which was lower than all analyst forecasts, and the social protests against the high cost of living.

With regard to the environment of real economic activity, it was noted that despite a drop in the rate of export growth in the second quarter, local activity is still strong and the probability that the Israeli economy is currently at the beginning of a recession is

low. It was also noted that after the rapid pace of growth in recent quarters, it is not implausible for there to be somewhat of a slowdown. Among other things, continued growth in private consumption excluding durable goods, investment in residential construction which is expected to continue to grow given the continued growth in housing starts, and investment in machinery and equipment were mentioned. It was also mentioned that although in the past year there was a drop in the "Globes" consumer confidence index, its level is not out of line compared with its level during the growth period prior to the global crisis. In addition, it was noted that expectations of future activity, according to the Central Bureau of Statistics survey of business trends and both the "Globes" and "Bank Hapoalim" consumer confidence indices, are positive.

A central point of discussion dealt with future scenarios which are liable to negatively impact the Israeli economy, primarily the negative turnaround in the US and Europe, which led to markets not pricing in an interest rate increase in the next year at the central bank of any major developed market. Among other issues mentioned were the negative sentiment in the world regarding the ability of developed countries to avoid entering a renewed recession, following lower than expected growth figures which were published during the inter-meeting period, downward revisions of future growth estimates, drops in stock markets around the world, as well as the high level of the debt to GDP ratio in a significant number of countries and political limitations which will not allow far reaching changes in fiscal policy. It was noted that one of the indicators of the likelihood of the world returning to recession will be the reaction of stock markets in the world in the coming period. It was noted that in coming weeks a lot of data is expected to arrive, relative to calmer periods, on the nature of possible policy steps in developed markets as a response to the worsening of economic activity. In addition, concern was raised of geopolitical scenarios with possible negative impact on Israel's economy. Despite all these, it was noted that the relatively strong state of Israel's economy at this time would allow it to absorb these shocks with relatively moderate damage.

The exchange rate was discussed in the context of its impact on exports. It was noted that the exchange rate level has a lagged effect, and it is possible that the second quarter slowdown in exports was an effect of the appreciation of the shekel in previous quarters. Likewise, it was noted that export figures, especially services exports–a main source for the slowdown in overall exports–are based on preliminary estimates and there will likely be changes in this area. It was also noted that the recent depreciation, if it continues, is expected to support exports in the future. The exchange rate issue also was raised in the context of its impact on inflation expectations, as it was noted that the linkage between depreciation to the level of prices is regarded as low, and is not expected to create inflation pressures.

On house prices, it was stated that in the case of a change in direction of interest rates, the macro-prudential steps which were taken are expected to continue to moderate demand for homes. With that, it was noted that, should it be necessary, additional steps will be contemplated.

Taking into account the drop in inflation expectations and the moderation in actual inflation, at the same time noting the continued growth in local activity, the geopolitical uncertainty, and against the background of the uncertainty in the strength of the negative turnaround in the global economy and its expected influence on growth in Israel, the four members of the forum recommended leaving the Bank of Israel interest rate unchanged in September. This step is in line with the drive to gradually return inflation to within the target range, taking into account the other issues noted.

Taking all the above points into consideration, the Governor decided to leave the interest rate for September unchanged at 3.25 percent.

In its announcement of the decision, the Bank of Israel emphasized the following points which supported leaving the interest rate for September 2011 unchanged at 3.25 percent:

- Inflation expectations for the next 12 months, both those calculated from the capital market and those of forecasters, fell significantly in the last month and are now 2 percent and 2.5 percent, respectively. The updated forecast of the Bank of Israel Research Department is that inflation will enter the target range toward the end of 2011, compared with the previous outlook which forecast the rate to return to the range in the middle of 2012. The CPI reading for July significantly surprised to the downside, after the four previous readings, seasonally adjusted, were in line with the inflation target range. With that, inflation over the previous 12 months is still above the target range, at 3.4 percent.

- The growth rate in the second quarter was moderate compared with the previous quarter, mainly as a result of moderation of global demand and its effect on exports, while local demand continued to grow. Developments since the previous interest rate decision point to a negative turnaround in the US and eurozone, and together with geopolitical risks, may impact economic activity in Israel. With that, the relatively strong position of Israel's economy currently will allow it to absorb these shocks with a relatively moderate impact.

- The rate of increase in home prices over the previous 12 months continues to be high, though the rate has moderated for the second month; for the 12 months ended in June, the increase was 12.5 percent. With that, the influence of higher interest rates, steps taken by the Bank of Israel in the mortgage market, and steps by the Ministry of Finance regarding real estate taxation, together with the continued increase in building starts, are expected to continue to provide a moderating effect on home prices during the coming year.

- The negative turnaround in the US and in Europe resulted in markets not pricing in an increase in interest rates by central banks of any of the major developed markets over the coming year. Likewise, the US Federal Reserve announced this

month that it will leave the fed funds rate at its near-zero level until at least the middle of 2013.

The Bank of Israel stated that it will continue to monitor developments in the Israeli economy and the global economy and in 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 assets markets, including the housing market.

The decision was reached and announced on August 29, 2011.

Participants in the narrow-forum discussion:

Prof. Stanley Fischer, Governor of the Bank of Israel
Dr. Karnit Flug, Deputy Governor of the Bank of Israel
Mr. Andrew Abir, Director of the Market Operations Department
Dr. Michel Strawczynski, Head of Macroeconomic and Policy Division and Acting Director of the Research Department
Dr. Edward Offenbacher, Member of Management and Head of the Monetary and Finance Division, Research Department
Mr. Eddy Azoulay, Chief of Staff to the Governor
Dr. Yossi Saadon, Advisor to the Governor and Bank of Israel Spokesperson
Ms. Esti Schwartz, Monetary Committee Secretary
Mr. Daniel Nathan, Economist, Research Department

Appendix: Major Global Economic Developments

Global

A downward revision of US growth figures for the past three years, a cut in the credit rating of the US, stagnation in core economies in Europe, and concerns of an expansion of the debt crisis to Italy and Spain (which led to European Central Bank (ECB) intervention in the market) significantly increased concerns of a double dip recession and led to an unsettled market. Stock market indices registered sharp drops and bond yields in major developed markets fell significantly, as in the US they reached historic lows. The EMBI Index increased significantly. Investment houses lowered growth forecasts for the US and for the global economy for the next two years, and some raised the probability of a double dip recession to as much as 50 percent. With concerns for a slowdown in the global economy and a sharp drop in inflation expectations around the world, investors today are not pricing in interest rate increases in the coming year at any central bank of major developed markets.

The US

US Commerce Department figures published during the month point to a continuing slowing of US growth, as second quarter growth was only 1 percent (significantly lower than the 1.8 percent forecast). The figure for the first quarter was revised sharply lower, from 1.9 percent to only 0.4 percent. In addition, the revision by the US Commerce Department of figures for the prior three years shows that GDP is currently only $13.5 trillion (not $14.3 trillion) and in effect is still lower than the level on the eve of the crisis in 2008. While macroeconomic data published during the month were mixed, (unemployment, retail sales, and building starts actually surprised to the upside), the negative figures were especially bad and indicated that the US economy is near recession levels. The University of Michigan consumer confidence index fell in August to its lowest level since 1980, private consumption contracted for the first time since September 2009, and according to the Fed's Beige Book, most districts registered a slowdown in growth. The Federal Open Market Committee (FOMC) said that economic growth this year is considerably slower than the committee's forecast, and that a general slowdown was seen, especially in the labor market and in real estate. The FOMC noted the "temporary" weakness in food and energy prices (which negatively impacted consumer purchasing power) and the disaster in Japan which impacted the supply chain. In addition, in light of their forecast for a more moderate growth rate in coming quarters than they previously estimated, and a rise in the level of downside risks, the committee decided to leave the fed funds target rate at 0–0.25 percent at least through the middle of 2013, while the market is pricing in the next rate hike only in early 2014. Investment houses lowered the average forecast for the US in 2011 from 2.53 percent to 1.74 percent, and for 2012 from 3 percent to 2.14 percent.

Democrats and Republicans succeeded only at the last minute to reach an agreement on raising the debt ceiling for the US, with a commitment to wide ranging budget cuts, and managed to avoid a technical default. However, despite the deal, S&P cut the credit rating on US debt to AA+, and left their negative outlook, with a 33 percent chance of lowering the rating further in the next six months to two years, if the US does not carry out the budget cuts to which it committed, or if debt level rises. S&P said that the US needed an even sharper cut than was decided upon–a cut of 4 trillion,

and they lowered their level of confidence in the ability of politicians to deal with the financial challenges. It can be assumed that upcoming elections are likely to continue the "paralysis" of the leadership there in its ability to deal with the crisis. In light of that, it currently appears that most of the ability to respond to the economic slowdown can only come from the monetary side, through the Federal Reserve. After Fed Chairman Ben Bernanke did not announce an additional quantitative easing plan at an annual symposium at Jackson Hole, Wyoming (where he previously had announced QE2), there are increasing assessments that he will announce an additional quantitative easing plan with the monetary policy decision announcement in September. During the month, yields on US bonds fell to historic lows, with the yield to maturity on a 10-year Treasury note falling to an intra-day level of only 1.97 percent. They have since risen to about 2.25 percent, after Chairman Bernanke said that the economic situation is not severe enough to immediately announce an additional quantitative easing program, and that the Fed has enough tools to move the economy forward.

Europe

Like in the US, figures published during the month in Europe were mixed, but the weak numbers were quite bad, as even Germany (which until today has pushed the entire eurozone higher) showed signs of weakness. The Purchasing Managers Index (PMI) and retail sales in the eurozone surprised on the upside, but industrial production, the ZEW Index (in the eurozone and Germany), and primarily weak second quarter growth added to the markets' pessimism. The eurozone grew 0.2 percent in the second quarter, compared with forecasts of 0.3 percent, with Germany and France lowering the average growth for the eurozone with 0.1 percent and 0 percent second quarter growth, respectively, after strong growth of 1.3 percent and 0.9 percent respectively in the first quarter.

The debt crisis is deepening and threatens Italy and Spain as well. It is pushing the leaders of the countries to turn to the market with calming messages. Internal disagreements in Italy regarding the extent of fiscal cuts, which led to concern that the ECB will not agree to purchase its bonds, and a warning from Moody's of a lowering of Spain's debt rating, raised the yield on ten year notes belonging to the two countries to record levels of over 6 percent. In order to "placate" the ECB, and calm the markets, Italy's Prime Minister Berlusconi succeeded in passing though his government an austerity plan which includes sharp fiscal cutbacks of €20 billion next year and an additional €25 billion in 2013, and a legislative decision to work toward a balanced budget by 2013. These steps were strongly criticized at home because of the negative impact on growth, but they did allow the "opening shot" by the ECB in purchasing tens of billions of euros worth of Italian and Spanish government bonds, lowering the yields to the range of 5 percent.

During the month, pressure on the eurozone came from France, the second largest economy in the eurozone, with rumors of a possible rating downgrade, which led to a jump in the CDS spread for France to 185 basis points (higher than Israel's). In addition to those rumors, the exposure of French banks to Greece, Spain, and Italy led to sharp drops in share prices of French banks. Like Berlusconi, French President Nicolas Sarkozy moved to calm the markets and committed to lowering the deficit from 7.1 percent of GDP last year, to 3 percent of GDP by 2013, "unrelated to

economic developments", and won ratification of the perfect credit rating by the three leading rating agencies. In Greece, too, the aid plan remains delayed after Finland's demand to receive collateral led to a similar demand from other countries in the eurozone. Since Greece cannot provide collateral against all the debt, it remains to be seen how the issue will play out.

The emerging markets

In China, retail sales, exports, and imports beat preliminary forecasts and raised hopes that the Chinese economy will compensate for moderating growth in the US and Europe. At the same time, inflation continues to increase and rose this month to 6.5 percent, the highest level since June 2008. With that, estimates are that inflation will fall in coming months. Investment houses lowered growth forecasts for China for this year from 9.1 percent to only 8.9 percent, and from 9 percent to 8.7 percent for 2012, against the background of the influence of the slowdown in the US and Germany on China's manufacturing sector.

The capital markets

Markets reacted sharply to the situation in the US and Europe, calling to mind the collapse of 2008. The reaction was expressed in steep drops in indices not seen since the Lehman Brothers crisis. Government bond yields fell sharply. Between the previous monetary policy meeting and August 24th, US stock indices fell 13 percent, and European indices fell by up to 22 percent. The MSCI World Index fell 13 percent and the EMCI Emerging Markets Index fell 15 percent. Bond markets posted steep drops in yields, with the return on 10 year notes in the US dropping from 2.96 percent to 2.29 percent (and intra-day even hit 1.97 percent), while in Germany they fell from 2.83 percent to only 2.26 percent. Against expectations of a slowdown, the price of a barrel of Brent crude oil fell significantly, by 7.5 percent, to $109 per barrel (and West Texas crude fell even more sharply, by more than 14.5 percent to $85 per barrel). The price of an ounce of gold jumped during the month to a record $1,897, though in recent days it fell back significantly to only $1,750. The commodities, excluding energy, index increased 1 percent and the agricultural commodities index increased 5.8 percent.