BANK OF ISRAEL
Office of the Spokesperson and Economic Information

June 11, 2018

Report on the Bank of Israel's discussions prior to deciding on the interest rate

The discussions took place on May 27 and 28, 2018.

General

The Monetary Committee sets the interest rate in a process that includes two discussions—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 the real and financial-monetary developments in Israel's economy, and developments in the global economy. Participants in this discussion include the members of the Monetary Committee, senior representatives from the various departments of the Bank, and economists from the economic departments (Research and Market Operations), who prepare and present the material for discussion.

In the narrow forum—which consists of the Monetary Committee and the Director of the Research Department—the Research and the Market Operations Departments present their views of the main considerations that should guide the setting of the monetary policy. An open discussion on monetary policy follows, which ends with a vote on the level of the interest rate. According to Section 18(c) of the Bank of Israel Law, 5770–2010, 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 summary view of the economic situation available at the time of the Committee's discussion is presented in the notice regarding the interest rate decision, which was published on May 28, and in the data file that accompanied the notice.

THE NARROW-FORUM DISCUSSION

The members of the Monetary Committee participating in the discussion decide on the appropriate rate of interest for the economy. After the discussion, it was decided to keep the interest rate unchanged at 0.1 percent. Five Committee members supported the proposal to keep the interest rate unchanged, and one Committee member supported increasing the interest rate to 0.25 percent.

The discussion focused on several main issues: (1) real economic activity; (2) inflation, (3) the global environment and the exchange rate, (4) the housing market.

Main points of discussion

In their discussion on economic activity, the Committee members discussed National Accounts data for the first quarter of 2018 indicating growth at a solid pace of 4.2 percent in annual terms. Several activity indicators, such as the Composite State of the Economy Index and the Business Tendency Survey, show the economy continuing to grow at an adequate pace that is in line with the potential growth rate. In contrast, there has been a prolonged decline (over four quarters) in residential construction. The Committee members discussed growth of exports (primarily the services component, but also the goods component) and said that it contributed to a more balanced composition of growth. The Committee referred as well to labor market data, which continue to indicate a tight labor market—record high employment and participation rates, a low in unemployment, and business sector wages returning to increase at a more rapid pace after some slowing in preceding months.

The Committee noted that the inflation environment is still low, adding that it has been on a trend of some growth in recent months: core inflation indices are slightly above actual inflation, and expectations derived from the various sources have been on an upward trend and are nearing the target range. The Committee referred to both the GDP deflator and wages being on an upward trend; this supports actual inflation and is likely to create a dynamic of increases, which is expected to support the return of inflation to within the target range. The Committee members noted that certain factors can delay the return of inflation to the target at this time, including (1) the decline in oil prices—in recent days there was a decline, and if it continues it is likely to slow inflation, and (2) increased competition—competition has been enhanced, among other reasons, because online purchases of consumer goods have expanded markedly in the past decade. The Committee assessed that these factors do not reflect weakness in demand. In addition, they observed that should the shekel begin to appreciate again, it will slow the increase in inflation.

In their discussion on the global economy, the Committee members said that high levels of activity continue in most economies, despite some weakness seen in recent activity indices. Likewise, they referred to the US Federal Reserve being expected to continue the path of increasing the federal funds rate, while the decline in the inflation rate in Europe and in Japan is expected to push off the decision to withdraw from their accommodative monetary policy.

The Committee members noted that the exchange rate continues to stay relatively stable since the beginning of the year (though it appreciated slightly since the last interest rate decision) and most were of the opinion that the shekel is still over-appreciated. A discussion developed regarding the forces acting to weaken the shekel, including the continued rise in the US interest rate, a process that worked, among other things, to reduce hedging activities among institutional investors, and the forces acting to strengthen it, including growth in exports.

With regard to the housing market, the Committee noted that housing market data continue to show that the increase in home prices has halted, against the background of the increase in supply in recent years, and in the past 6 months (for which data were published) prices declined. The Committee members said that investment in residential construction declined in response to moderation of demand. In parallel, there appears to be some acceleration in the rate of increase of rents.

As noted, five Committee members were of the opinion that the interest rate should be kept at its current level. These members claimed that the inflation environment remains below the lower bound of the target range and that the interest rate should be kept at its low level to support its entrenchment within the target range. They added that if the interest rate rises before inflation is entrenched within the target range, it is liable to delay the entrenchment of the inflation environment and ultimately to slow the path of interest rate increase. One of the Committee members was of the opinion that the interest rate should be increased to 0.25 percent, claiming that the low inflation rate does not indicate weakness of demand, and that the low interest rate is not in line with the parameters of the economy.

Participants in the narrow-forum discussion:

Members of the Monetary Committee:
Dr. Karnit Flug, Governor of the Bank and Chairperson
Dr. Nadine Baudot-Trajtenberg, Deputy Governor
Mr. Andrew Abir, Director of the Market Operations Department
Prof. Reuben Gronau
Prof. Moshe Hazan
Prof. Zvi Hercowitz

Other participants in the narrow-forum discussion:
Michael Gurkov, Economist in the Research Department
Ilan Sociano, Assistant to the Secretary of the Monetary Committee
Yoav Soffer, Bank of Israel Spokesperson
Prof. Michel Strawczynski, Director of the Research Department