BANK OF ISRAEL
Office of the Spokesperson and Economic Information

7 June 2010

Report to the public on the Bank of Israel's discussions prior to setting the interest rate for June 2010

The discussions took place on 23 and 24 May 2010

General

Before the Governor makes the monthly interest rate decision, 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 these minutes 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 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

Most indicators published in the last month (in the period between the discussions on the interest rate for May on April 26 and the current discussions on May 24) point to the continued expansion of economic activity, with a possibility that the rate of increase is slowing.

Concern mounted this month over the implications of the very large deficits and debts of several European countries for economic developments in Europe and the global economy. With regard to possible effects on Israel's economy, the share of Israel's exports to European countries under market pressure is relatively small (about 5

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percent of exports), but there was nevertheless increased concern that if the crisis were to spread to the whole of the EU, which constitutes an important market for Israel's exports (28 percent of exports), it could have a significant impact on Israel's exports. A decline in demand in Europe, should that occur, together with the weakness of the euro against the shekel, would create difficulties for Israeli firms exporting to Europe and would make Israeli exporters less competitive vis-à-vis European exporters.

National Accounts data for the first quarter of 2010

According to Central Bureau of Statistics (CBS) figures published this month, GDP grew by3.3 percent, annual rate, in the first quarter of 2010, below the Bank of Israel forecast of 3.7 percent. Business sector product increased at a rate of 4.8 percent in the first quarter. The CBS figures show that private consumption increased by 1.6 percent, and public consumption by 8.2 percent, but services exports fell by 7.3 percent, and nonresidential investment declined by 1.5 percent.

The composite state-of-the-economy index

The April composite state-of-the-economy index, published in May, rose by 0.1 percent, following its increase of 0.5 percent in March (each month compared with the previous one). The latest rise, following those in the last few months, strengthens the assessments that the economic recovery is continuing, with some slowdown in its pace .

The increase in April reflects, among other things, a 0.2 percent increase in manufacturing production in March, following its 0.7 percent increase in February; a 1.8 percent increase in trade and services revenue in March, after its decline by 1.3 percent in February; and no change in the services exports index, following its 6.6 percent rise in March. With regard to foreign trade, see below.

The labor market

The gradual improvement in the labor market, as reflected by the increase in employment, continued. In February the number of Israeli employee posts increased by 0.3 percent compared with the number in January (seasonally adjusted). In the three months December 2009 to February 2010 the number increased by 2.6 percent compared with the previous three months (seasonally adjusted, in annual terms).

The nominal wage per employee post in the business sector increased by 1.2 percent in February compared with the January level. In the three months December to February the nominal wage per employee post increased by 6.4 percent compared with the average in the previous three months, and the real wage increased by 3.3 percent (seasonally adjusted, in annual terms).

The monthly unemployment rate according to trend data was 7.3 percent in February, similar to the January level. The monthly data, however, are based on a relatively small sample, so that the figures should be treated with caution.

Foreign trade

Goods exports (excluding diamonds) dropped by about 7.1 percent in April from their March level (in dollar terms, seasonally adjusted). In the three months February–April 2010 these exports expanded at an annual rate of about 22.1 percent (in dollar terms, seasonally adjusted) from their level in the previous three months.

Goods imports (excluding ships, aircraft and diamonds) declined by 3.2 percent in April from their March level (in dollar terms, seasonally adjusted). In the three months February–April these imports increased at an annual rate of 32.2 percent (in dollar terms, seasonally adjusted) from their level in the previous three months.

2. Budget data

An analysis performed by the Bank of Israel Research Department shows that under the assumption of a 3.7 percent growth rate in 2010 in Israel, the budget deficit is expected to be significantly lower than the ceiling of 5.5 percent of GDP. The main reason is that tax revenues are in excess of the forecasts made when the budget was prepared. Excluding the effect of statutory tax changes and non-recurring revenues, tax revenues in January–April 2010 were about 11 percent higher, in real terms, than in the equivalent period in 2009: revenues from direct taxes were about 10 percent higher in real terms, and from indirect taxes, about 11 percent higher.

Government expenditure in April, excluding credit, was lower than the seasonal path consistent with full budget expenditure. In total, since the beginning of the year domestic budget expenditure has been in line with the seasonal path consistent with full expenditure of the budget.

3. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) for April rose by 0.9 percent, slightly more than both the average of the private forecasters' predictions and the Bank of Israel's Research Department forecast which were for an increase of 0.7 percent. The seasonally adjusted index for April increased by 0.2 percent.

The CPI is at the same level as at the beginning of the year. Adjusting for seasonality, the reduction in indirect taxes and the abolition of the water surcharge, inflation since the beginning of the year was 0.9 percent.

In the last twelve months the CPI rose by 3 percent, the upper limit of the inflation target range. Excluding the effect of government actions (i.e., excluding the effects of the changes in VAT, and the increases in taxes on cigarettes and fuel and surcharges), the index rose by 2.6 percent.

The housing component of the CPI increased by 1 percent in April, further to its 0.6 percent increase in March. In the previous twelve months the housing index increased by a cumulative 4.7 percent (see below for a more detailed reference to the housing market).

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

One-year-forward inflation expectations derived from the capital market ("break-even inflation") remained steady during the last month, with the average for April (to April 22) an average of 2.7 percent, the same as the March level.

The Israeli forecasters predict on average that inflation in the next twelve price indices (from May 2010 to April 2011) will be 2.7 percent. They assess that inflation in 2010 measured over the previous twelve months will be 1.9 percent. They expect inflation (over the previous twelve months) to decline gradually to reach 1.5 percent in August, and predict that it will then rise, to reach about 2.7 percent in a year's time.

The Israeli forecasters expect, on average, that the CPI will rise by a total of 1 percent in the three months May to July 2010.

With regard to the interest rate, the Israeli forecasters assess on average that the Bank of Israel's rate will increase in the next three months by a cumulative 0.4 percentage points, and that the rate in twelve months' time will be 3.0 percent.

The slope of the *makam* yield curve indicates that the capital market expects the Bank of Israel interest rate one year hence to be about 2.6 percent.

The makam and bond markets

The yield to maturity on CPI-indexed five-year government bonds declined slightly in May (to May 20) to an average of about 1.1 percent, from about 1.2 percent in April. The yield on 5-year unindexed government bonds declined to an average of about 3.9 percent in May, from about 4 percent in April. The yield to maturity on one-year *makam* remained unchanged in May at its April level of about 2.2 percent.

The interest rate differential and the yield gap between Israel and abroad

Prior to the current interest rate decision, the Bank of Israel interest rate was 1.25–1.50 percentage points higher than the US federal funds rate, and 0.5 percentage points higher than the ECB rate. The yield gap between local currency unindexed ten-year bonds and ten-year US Treasury bonds increased from 117 b.p. on April 26 to 159 b.p. on May 21.

The expected real interest rate

The Bank of Israel interest rate *minus* twelve-months-forward inflation expectations derived from the capital markets in May, prior to these discussions, averaged *minus* 1.2 percent, compared with *minus* 1.1 percent in April.

The monetary aggregates

In the twelve months up to and including April 2010 the monetary base measured by the M1 monetary aggregate (cash held by the public and demand deposits) increased by 15.6 percent; in April it increased by about 2.1 percent. In the last twelve months the M2 aggregate (M1 plus unindexed term deposits of up to one year) increased by 4.1 percent, and in April it increased by 1.2 percent. The rapid increase in M1 in the last year was mainly due to the public's switching from term deposits to demand deposits in light of the low level of the interest rate on term deposits.

The credit markets

The outstanding balance of bank credit to the business sector declined in March by 0.5 percent, after increasing by 0.9 percent in February. Outstanding bank credit to households increased in March by 1.7 percent after falling by 0.4 percent in February.

The housing market

Based on the survey of house prices, housing prices (which are not included in the CPI) increased in March by 1.1 percent, and in the twelve months to March (inclusive) by 21.9 percent, in which period the housing index in the CPI rose by 5.1 percent, due both to the low rate of interest and to the slowness of the response of the supply of housing to higher prices.

Outstanding housing credit increased by 0.9 percent in March, and in the last twelve months by 13.5 percent.

The econometric models[1]

Various scenarios were examined using the Bank of Israel’s econometric models, under the following assumptions: an increase of 4.3 percent in business sector product in 2010 (consistent with the Bank of Israel's forecast of about 3.7 percent growth in GDP); a 4.6 percent increase in business sector product in 2011 (consistent with 4.0 percent growth in GDP); low interest rates around the world that start to increase very gradually in 2011; a moderate increase in prices of imported inputs till the middle of 2010; and an increase of 7.0 percent in world trade in 2010 and of 6.0 percent in 2011.

The baseline scenario of the DSGE (dynamic stochastic general equilibrium) model—which places great weight on expectations and which uses a Bank of Israel reaction function based in part on the smoothing of the interest rate path—gives an increase in the rate of interest to an average of 2.1 percent in the third quarter of 2010, to 2.6 percent in the last quarter of 2010, and to 3.4 percent in the second quarter of 2011. The model also gives an average exchange rate of NIS 3.74 to the dollar in 2010, inflation close to the midpoint of the target range, i.e., 2 percent, in the next twelve months, inflation of 1.4 percent in 2010, and 2.0 percent in 2011.

The error-correction (EC) model gives inflation of 0.9 percent in 2010 and 1.8 percent in 2011, with the Bank of Israel interest rate increasing from an average of 1.3 percent in the first quarter of 2010 to 2.1 percent in the last quarter of the year and to 3.1 percent in the last quarter of 2011. In this scenario the average exchange rate in 2010 is NIS 3.75 to the dollar.

Based on the results of the models, other indicators and economic forces not reflected by the models, the assessment of the Bank of Israel Research Department is that inflation in 2010 will be below the midpoint of the target inflation range. This result is obtained along with an increase in the interest rate during 2010, against the background of the recovery from the recession and the low starting level of the interest rate.

4. The foreign currency market and the share market

The foreign-currency market

During the period from April 26 to the current discussions (May 21), the shekel weakened against the dollar, with the exchange rate rising from NIS 3.72 to the dollar to NIS 3.82, a depreciation of 2.8 percent. In this period the shekel appreciated by 3.5 percent against the euro, from NIS 4.96 to the euro to NIS 4.78. Measured by the nominal effective exchange rate of the shekel, calculated as the trade-weighted

[1] The Bank of Israel uses econometric models to test various scenarios. Due to their nature, including the fact that their results naturally depend on certain assumptions about relevant variables, the scenarios should be viewed as one input among several in the discussions on the interest rate. In the abnormal conditions prevailing in the global financial markets since the outbreak of the worldwide financial crisis, and bearing in mind that the models do not directly reflect such events, the weight that can be attached to the forecasts derived from the models is reduced.

average shekel exchange rate against 28 currencies (representing 38 of Israel's trading partners), the shekel appreciated by about 1.3 percent.[2]

The share market

The Tel Aviv 25 share price index on May 21 was about 8.9 percent lower than on April 26. The Dow Jones index fell by about 9.1 percent in that period.

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

Israel’s risk premium, as measured by the five-year credit default swap (CDS) spread, increased slightly between the previous and the current interest rate discussions, from 1.09 percentage points to 1.13 percentage points (in the course of the period it reached 1.25 percentage points). The CDS spreads of the emerging market economies also increased, and the differences between countries widened.

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

In the month between the previous interest rate discussions and the current ones, concern mounted over the budget deficits and debts of several European countries, leading to sharp changes in financial markets. The reversal in the financial markets occurred with the downgrading of the sovereign credit ratings of Greece, Portugal and Spain. Financial market traders became more risk averse, and bond and CDS spreads widened in several countries in Europe. In the currency markets the euro weakened very considerably against the dollar.

The EU responded by announcing a package of emergency measures intended to ease the pressures in the financial markets and the financial sector, and to prevent the spread of the crisis to other countries. The IMF created a rescue plan for Greece that supported a reduction of the budget deficits (from 13.6 percent of GDP in 2009 to less than 3 percent in 2014). The ECB bought government bonds of several European countries on the secondary market, introduced additional expansionary monetary measures, and reactivated dollar swaps between central banks (as a result of a shortage of dollar credit).

Pressure mounted for a change in budgetary policy in countries with large public debts and/or large budget deficits. In Spain and Portugal fiscal measures were introduced to reduce budget deficits. The EU formulated proposals to tighten surveillance over EU members with regard to macroeconomic imbalances and impaired competition.

[2] The weight of the dollar in the effective exchange rate is about 25 percent, and that of the euro, about 33 percent.

Economic developments in the US, Japan, and the large eurozone countries continue to indicate that the exit from the crisis is proceeding and that they are returning to economic growth. Among the advanced economies, the recovery in the US is stronger than that in Japan and much stronger than that in Europe. Global growth is spearheaded by China and India.

Expectations regarding interest rates around the world derived from the conduct of financial market traders are that the increases in interest rates by the central banks in most advanced economies will start later than expected last month. The Fed is expected to increase its interest rate in the second half of the year, and the ECB is expected to increase its rate after the Fed. As stated, the ECB reintroduced several special policy measures in order to conduct a more accommodative monetary policy.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR JUNE 2010

In the narrow-forum discussion, four members of management make recommendations to the Governor regarding the appropriate rate of interest for the economy. In the discussions on the interest rate for June, all the participating members of management recommended that the Governor hold the rate unchanged at 1.5 percent.

As was stated in the report of the previous interest rate discussions, the Bank of Israel's policy is to continue with the gradual process of bringing the interest rate back to a more "normal" level that reflects the recovery in economic activity, and that is required to place inflation firmly in the target inflation range. The gradual nature of the process is expressed by the fact that the Bank does not change the interest rate every month, but only in light of the inflation environment, expectations of growth in the global economy, and the interest rates of the major central banks, while taking into consideration the exchange rate of the shekel.

In the discussion, participants noted that data that became available in the month since the previous interest rate discussions indicate that real activity is continuing to expand, with some indications that the rate of expansion has slowed somewhat. Participants referred particularly to the increase in uncertainty regarding global developments and their implications for Israel's economy. The greater uncertainty resulted from the outbreak of the debt crisis in Greece and fears that it would spread to other countries in Europe. Participants discussed the various channels via which the debt problem in several European countries affects the global environment: the exposure of banks around the world to countries facing debt difficulties, the liquidity problem in European financial markets, the essential fiscal consolidation in several European countries that is likely to reduce demand in the short term, and the decline of demand in Europe due to the weakness of the euro.

As far as Israel's economy is concerned, it was noted that Israel's exports to European countries with debt problems are relatively modest, but if the crisis should spread and become more severe it could reduce Europe's demand for Israel's exports. Furthermore, the weakness of the euro against the shekel makes Israel's exports to Europe less profitable and has an adverse impact on exporters' competitiveness vis-à-vis European competitors.

Participants in the discussion observed that the econometric models used by the Bank indicate that inflation (over the previous twelve months) is expected to be below the midpoint of the target inflation range in 2010, and is expected to remain within the target range over the course of the next twelve months. This assessment, consistent with those of the private Israeli forecasters, also shows the interest rate increasing in the next year. One-year forward inflation expectations derived from the capital market remained at the same level as in the previous month, in the upper part of the inflation target range. The reductions in commodity prices, and oil prices in particular, (in the month since the previous interest rate discussions) are expected to moderate the inflation environment.

The timing of increases in the interest rate in Israel relative to those in the leading economies round the world affects the shekel exchange rate. Participants in the discussion noted that as a result of concern over the debt crises in several European countries, the increases in interest rates that were expected to take place in the next few months in Europe and most advanced economies will be delayed, and the ECB is not expected to increase its interest rate in the next half year.

Special emphasis was placed in the discussion on the rapid increase in housing prices in the last year, with the Supervisor of Banks participating in the discussions of this issue. It was noted that housing prices, according to the house price survey, continued to increase at the beginning of 2010 following their rapid rise in 2009. Participants in the discussion were of the view that there was no "bubble" in the housing market, but in order to prevent undesirable developments in the future it was important to moderate the pressures for increases in housing prices. The point was made that house prices affect rentals, which are included in the CPI, so that house prices have an effect on the index. In addition, a continuation of recent rapid increases in housing prices would be likely to have a negative impact on the stability of the financial sector.

Based in part on the analysis of the situation by the Banking Supervision Department, and in part on the discussion within the forum, which concluded that in light of the changing situation in the global economy, it would not be appropriate to raise the interest rate, participants recommended that macro-prudential tools be used concurrently with the announcement of the interest rate for June. In this context, to support financial stability, the Supervisor of Banks decided to publish draft guidelines—on the same day as the announcement of the June interest rate—for consultation with the banks, on the development of risks on housing loans, with a requirement for an additional provision for housing loans with a high loan-to-value ratio.

Taking into consideration the various points made in the discussion, the Governor decided to keep the interest rate for June unchanged at 1.5 percent, and the Supervisor of Banks published a requirement for banks to make an additional provision for housing loans with high loan-to-value ratios.

In its announcement of the decision, the Bank of Israel stressed the following background conditions that led to the decision to leave the interest rate unchanged for June:

- The inflation environment: the CPI rose by 3 percent in the last twelve months, and over the last three months it was unchanged. Excluding the effect of indirect-tax reductions and the removal of the water surcharge, inflation in the last twelve months was 2.6 percent. Inflation over the previous twelve months is expected to decline in the next few months, and the annual rate for the whole of 2010 is expected to be slightly below the midpoint of the range. One-year-forward inflation expectations derived from the capital market stood at 2.7 percent in May. The Israeli forecasters also expect, on average, that CPI inflation in the next twelve months will be 2.7 percent. These expectations and forecasts are accompanied by expectations of gradual increases in the Bank of Israel interest rate.

- Data published this month, and in particular data on business sector product in the first quarter of 2010 and labor market data, continue to support the assessment that economic activity is on a rising trend, although there are signs of a slowing in the rate of increase in activity. There was growing concern that the debt crises in some European countries would cast a cloud over the recovery in the advanced economies, and would thus have a negative impact on economic activity in Israel.

- Interest rates of the central banks of the leading advanced economies are very low, and are expected to remain so longer than originally anticipated. In addition, the ECB reintroduced some of the special instruments of monetary accommodation.

- In light of the continued rapid increase in housing prices and the steep rise in housing credit, due partly to the low level of interest, and in order to moderate these trends and to support financial stability, the Supervisor of Banks issued draft guidelines for consultation with the banks regarding the development of risks on housing loans, and imposing additional provisions for housing loans with a high loan-to-value ratio.

The Bank of Israel will continue to act to achieve its objectives of price stability, the encouragement of employment and growth, and support for the stability of the financial system.

The decision was made and published on May 24, 2010.

Those participating in the narrow-forum discussion:

Prof. Stanley Fischer, Governor of the Bank of Israel

Prof. Zvi Eckstein, Deputy Governor of the Bank of Israel

Dr. Karnit Flug, Director of the Research Department

Mr David Elkayam. Acting Head of the Monetary and Finance Division, Research Department

Ms Irit Mendelson, Assistant Director of the Market Operations Department

Mr Rony Hizkiyahu, the Supervisor of Banks

Dr. Ohad Bar-Efrat, Advisor to the Governor and Head of the Information and International Affairs Division

Mr. Eddy Azoulay, Chief of Staff to the Governor

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

Appendix: Major Global Economic Developments

US

In the month since the previous interest rate discussions the data on the US economy continued to be positive. In the first quarter of 2010 GDP increased at an annual rate of 3.2 percent, compared with expectations of 3.3 percent. The composition of growth was encouraging: The private sector contributed 3.6 percentage points to the growth rate, while the public sector reduced it by 0.3 percentage points—an indication of the strength of the recovery in the private sector. The weakness of the public sector, however, points to a different problem, that whereas the government is taking significant expansionary fiscal measures to boost the economy, the local and municipal authorities are having to cut their budgets heavily, and this more than offsets the expansionary policy.

The main change noted in the announcement of the Fed interest rate decision was the comment that the labor market had started to improve, and indeed the employment data were particularly encouraging. The number of employee posts increased more than expected, and the number of hours worked per post also increased. The Chairman of the Fed, in his address, stated that he expected that the banks would soon start lending to small businesses, due to the improvement in those businesses' situation.

The CPI data for March and for the first quarter of 2010 were very low. As a result of the reductions in commodity and fuel prices and the strengthening of the dollar, no inflationary pressures are expected in the near future. The Fed Chairman's adherence to the expression promising "exceptionally low levels of interest for a long time" led to a delay in the timing of the expected path of increases in the interest rate in the US.

Europe

The crisis in Greece, against the background of high budget deficits and public debt in several European countries, made it an urgent necessity to find a solution for Greece and dominated the difficult problems facing the eurozone. Solutions to the structural problems of some European countries would have been simpler to find if they had the possibility of devaluing their currencies and cutting their labor costs, or if the eurozone were subject to one uniform fiscal authority. Different commentators saw the crisis either as posing a threat of the break-up of the eurozone or as the opportunity to create fiscal uniformity.

The main points of the rescue plan announced by the EU were the establishment of an extensive loans mechanism, intended for countries in difficulties, and the injection of liquidity by means of actions by the ECB. The President of the ECB stated that this was the most difficult crisis since the WW2, and stated that they needed a strong sense of direction.

Despite everything, the European macroeconomic data published this month were generally good, with a positive surprise in the form of Germany's and Europe's GDPs, manufacturing production, orders from factories, and employment data, and even confidence indices (apparently dating prior to the increase in the severity of the crisis). However, it appears that these indications relate to the past, whereas Europe's economic future currently depends entirely on the success of the EU rescue plan.

UK

The new government declared an immediate program of cuts in budget expenditure. Manufacturing production came as a positive surprise with the sharpest increase for seven years, and various confidence indices continue to indicate expansion. The fact that the UK has an independent currency and an independent interest rate policy is likely to improve its competitive position and to support the economy.

In its interest rate announcement, the Bank of England kept unchanged both its interest rate and its bond purchase program, and stated that the risks that could endanger growth had increased slightly, and that the Bank did not rule out the continued purchase of assets in the context of its quantitative easing.

Japan

The data on Japan's economy were also encouraging. Production, consumption, construction activity, the various confidence indices and the composite indices all showed a continuation of the trend of improvement (and most were better that the forecasts), and there was even some improvement with regard to the deflation. The export sector in particular was notable, with a significant increase in sales, resulting from the improvement in world trade and the weakness of the yen in the previous months.

The disappointing GDP figure for the first quarter, the reduced demand expected from Europe, together with the strengthening of the yen, all these are expected to have a negative impact on Japan's production and exports, and were among the factors that led to the Bank of Japan's announcement on the urgent need to broaden the basis of growth. The Bank of Japan increased its growth forecast from its January level, and now expects stronger growth than the long-term trend (particularly in 2011). However, it seems that there are risks to the realization of this forecast, especially the implications of the European debt crises, both via the drop in European demand and due to the unease expected to be felt by the markets with regard to countries with heavy debts.

The emerging markets

The macroeconomic data of the emerging market economies continue to be buoyant, particularly those of East Asia and Latin America. That said, however, the capital markets of the emerging markets were adversely affected by the European crisis as were the advanced economies, with the East European indices showing an even stronger negative impact. The main route of the contagion was the increased risk aversion and the growing dependence of the emerging markets on global growth and world trade, which are likely to suffer.

Some East European countries, with Hungary at the top of the list, have a worrying debt profile, and are likely to be harmed by the increase in attention being paid to the subject of debt.