BANK OF ISRAEL
Office of the Spokesperson and Economic Information

Bank of Israel

Report to the public of the Bank of Israel's discussions prior to setting the interest rate for August 2007

The discussions took place on July 22 and 23, 2007

6August 2007

General

Before the Governor makes the monthly interest rate decision, discussions are held at two levels. The first discussion takes place in a broad forum, in which the relevant background economic conditions are presented, including real and monetary 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 economic departments of the Bank (the Research, Monetary, Foreign Currency, and Foreign Exchange Activity departments) and economists from various departments who prepare and present the material for discussion.

In the narrow forum, the directors of the economic departments 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
Economic activity continued to grow in the second quarter of 2007. This can be seen from the Bank of Israel's Companies Survey, National Accounts data, and the composite state-of-the-economy index. As economic activity increased, so did the number of employees in most of the principal industries. The Bank of Israel's growth forecast for 2008 is of a modest slowdown in the rate of growth to 4.1 percent.

The Companies Survey of the Bank of Israel
Companies' responses to the Companies Survey for the second quarter of 2007, published on 23 July 2007, show that economic activity continued to expand in 2007:Q2, with expectations in all industries that this would persist in 2007:Q3. The rise in the second quarter occurred in the manufacturing, commerce, transport,

communications and services industries. There was a modest recovery in the level of activity in the construction industry.

Composite state-of-the-economy index

The composite state-of-the-economy index showed an increase of 0.7 percent in June, and the indices for the previous months were adjusted upwards, signaling continued expansion in economic activity. The rise in the index reflected increases in the manufacturing index and the trade and services sales revenue index. These were partially offset by a drop in the foreign trade indices—the goods and services exports index and the imports index both recorded drops in June.

The labor market

According to trend data, the average wage per employee post among Israelis in February–April rose at an annual rate of 5.8 percent, faster than the rate over the previous twelve months. In those months the number of employee posts increased by 1.5 percent, slower than the rate in the previous twelve months. The increase in the average nominal wage in February–April was higher than the rise in productivity in the business sector, which led to a rise in unit labor costs. Data from the Companies Survey also point to a rise in employment in the manufacturing industries, and a marked surge in the services industries.

Foreign trade

In the last few months imports rose rapidly. In 2007:Q2 imports (excluding ships, planes, diamonds, and energy products) rose at an annual rate of 20 percent, seasonally adjusted. The rate of increase in the first half of 2007 was similar to that in the second half of 2006. Seasonally adjusted quarterly data show a 2.2 percent fall in exports in the second quarter (excluding ships, planes and diamonds), following a rise of 34 percent in the previous quarter. The trade deficit rose to $ 1 billion, twice the average monthly deficit in the first half of 2007. At the end of the first half of the year Israel's trade deficit was $ 3.5 billion. The jump in the trade deficit in June resulted from the drop in exports, which continued to exhibit the high volatility they have shown since the beginning of the year.

2. Budget data

Budget performance in the first half of 2007 is consistent with a deficit significantly below the government's target. Buoyant tax revenues and expenditure that was lower than the (seasonally adjusted) budget levels led to a cumulative budget surplus, excluding credit, of NIS 5.6 billion. These figures give rise to a forecast deficit for 2007 of between 1 percent and 1.5 percent of GDP.

3. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) rose by 0.7 percent in June, exceeding forecasters' predictions. Despite the relatively high index, prices in the previous twelve months fell by 0.7 percent. However, since the beginning of 2007 prices have risen by 1 percent, giving an annual rate of 2 percent, consistent with the inflation target. If the components of the CPI are divided into those directly affected by the exchange rate and the price-of-energy component ("imported" items) on the one hand, and "domestic" components not directly affected by them on the other, a marked difference is evident between the paths followed by the two in the past year. According to one of the Bank of Israel's econometric models,[1] prices of the domestic components rose at a higher rate than the upper limit of the inflation target, while the prices of imported items correspondingly fell by more than the reduction in the CPI in the last twelve months.

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

In the wake of the publication of the CPI for June, Israeli forecasters revised their predictions upwards, and on average expect inflation in 2007 and over the next twelve months to reach 2.7 percent. On average they expect that the Bank of Israel's interest rate will rise again this year, and will be 4.2 percent twelve months from now. Break-even inflation (expected inflation derived from the capital market as the difference between the yield to maturity on unindexed bonds and the yield on twelve-month indexed bonds) was 1.9 percent, around the middle of the target range. Market expectations are that the Bank of Israel interest rate will rise by about 40 basis points in the next twelve months. Predictions from the Bank of Israel's econometric models are that in 2007 and 2008 inflation will be within the target range, with a rise in the interest rate by the end of the year.

The makam and bond markets

Since the previous interest rate decision on 25 June, until the current discussion on 22 July, the yield on one-year *makam* rose by 0.2 percentage points. The yields on 10-year unindexed (*Shahar*) bonds and 10-year indexed (*Galil*) bonds remained steady at 5.5 percent and 3.2 percent respectively.

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

At the time of the discussion, the Bank of Israel interest rate was 1.75 percentage points lower than the US federal funds rate. Based on the US yield curve, the US interest rate will remain unchanged till the end of the year. In most countries there is currently an upward trend in interest rates. The gap between the yields on unindexed shekel bonds and US 10-year bonds widened during the last month from 50 to 60 basis points.

The expected real interest rate

The expected real interest rate (the Bank of Israel interest rate *minus* inflation expectations) for one year forward was 1.6 percent, close to its level at the end of June.

[1] For a discussion of the domestic and imported components of the CPI see the Bank of Israel Annual Report 2006, p. 107, and Box 3.2, pp. 128–31.

This followed the sharp drop in June that resulted from the rise in inflation expectations.

The money supply

The rate of increase of the (M1) money supply over the previous twelve months was 16.2 percent: the current-account deposits component rose by 22.8 percent, and the cash element by 7.1 percent.

The econometric models

Various scenarios were examined using the Bank of Israel's econometric models. According to these models, in the scenario with the exchange rate at a level of around NIS 4.24 to the dollar, inflation in 2007 and in the next twelve months is expected to be close to the upper limit of the inflation target. The models also showed that to keep within the inflation target, the interest rate would need to be raised during the third quarter.

4. Capital flows, the foreign currency market, and the share market

The foreign-currency market and capital flows

From the last interest rate decision until the current one, the shekel appreciated by 0.6 percent against the dollar, and depreciated by about 1.9 percent against the euro, while other currencies strengthened against the dollar by more than 2 percent. The negative interest rate differential between the shekel and the dollar in the last month was again a contributing factor to the export of short-term capital by the business sector. Despite these developments, the basic forces acting in support of the shekel—deriving from the current account surplus and nonresidents' investments in the economy—are still evident.

The share market

The leading share indices on the Tel Aviv Stock Exchange rose in the last month, further to considerable rises since the beginning of the year. In the month since the previous interest rate decision, the share indices rose by 3.2 percent, while the stock exchanges in most advanced economies remained steady, and those of emerging markets rose by more than 2 percent. Nonetheless, the level of P/E ratios on the Tel Aviv Stock Exchange is not higher than it was in the past.

5. Israel's financial risk, the sovereign risk premium, and foreign investment house surveys

Israel's risk premium as measured by the five-year CDS spread continued to maintain its stability in June, at around 17 basis points. The foreign investment houses continue to describe Israel's economy in a positive light. They consider that Israel's macroeconomic fundamentals remain strong. Moody's point out that Israel's macroeconomic data are stronger than they have been for many years, and emphasize the importance of lowering the debt/GDP ratio.

6. Global economic developments

Global economic activity remains strong, against the background of rapid economic growth in markets around the world. The emerging Asian markets continue to constitute an important source of momentum to the global economy, while the effect of the relative slowdown in the US economy remains relatively muted. Global inflation stayed relatively moderate, but the rise in oil and basic food prices, together with the reduction of the output gap in the advanced economies, increases the chances of a higher rate of global inflation. Against this background it is more probable that the upward trend of interest rates will continue in many central banks throughout the world. **(See Appendix for more details.)**

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR AUGUST 2007

In the light of the developments since the previous interest rate decision (25/6/07), the discussion focused on two possibilities: raising the interest rate by 25 basis points or leaving it unchanged.

The major arguments for raising the interest rate by 25 basis points to 3.75 percent were:

- The expected rapid growth this year and next, and with it the further contraction in the output gap (the difference between the actual output of the economy and the output it could reach at full capacity) are reflected in inflation in local prices, as estimated by the Bank of Israel's econometric models, which continue to rise by a rate of more than 3 percent. Until the middle of May this year, this rise in local prices was moderated by the fall in the prices of imported goods and products whose prices are directly affected by the exchange rate, mostly as a result of the strengthening of the shekel. In the absence of this moderating factor, the consumer price index is rising at a far higher rate.
- Factors acting to push up inflation in recent months are expected to bring inflation back to within its target range during 2007, and to raise it close to the upper boundary of the range in 2008. These factors strengthen the need to raise the interest rate, given the time lags inherent in the effects of interest rate policy.
- Recently, the probability of a rise in the global inflation rate has increased following a sharp rise in the prices of oil and basic foods. These are likely to raise import prices and this will constitute an additional factor in pushing up prices in the economy.
- Given the trend of raising interest rates in the world against a background of an increasing probability of a rise in the global inflation rate, the positive interest rate gap between other countries and Israel is likely to rise, and to affect the movement of short-term capital. This tends to weaken the shekel and thus contributes to higher inflation, and in addition could be a factor leading to financial instability.

In the discussion, the following points were raised in favor of leaving the interest rate unchanged:

- Assuming that the exchange rate were to remain around its level at the time of the discussion, inflation would be likely to stay within its target range, even without an increase in the interest rate. Furthermore, underlying factors that act to strengthen the shekel, such as the surplus in the current account of the balance of payments, continue to operate. Therefore it was not viewed as necessary to raise the interest rate at this juncture.

Participants discussed the need for continued financial stability in the economy, and in this context stressed the importance of maintaining budgetary discipline.

Three department directors recommended raising the interest rate by 25 basis points while two recommended leaving the interest rate unchanged. The Governor decided to raise the interest rate for August 2007 by 25 basis points to 3.75 percent.

The decision was made and published on July 23, 2007.

Those present at 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
Dr. Edward Offenbacher, Director of the Monetary Department
Mr. Barry Topf, Director of the Foreign Currency Department
Mr. Balfour Ozer, Director of the Foreign Exchange Activity Department
Mr. Yossi Saadon, Bank of Israel Spokesperson

Appendix: Major Global Economic Developments

U.S.
Recent macroeconomic data indicate accelerated economic activity in the US in the second quarter, and according to assessments of the investment houses, growth is expected to reach an annual rate of 2.9 percent, close to the US economy's potential rate assessed at 3 percent a year. The Purchasing Managers Indices in the manufacturing and services sectors reached their highest levels in a year. The manufacturing sector is supported by the growth registered in export orders against a background of a strong global economy and the depreciation of the dollar in the past year. Retail sales data for June show that private consumption, which began to moderate in the first quarter, continues to slow down. Orders for durable goods also fell relatively sharply. The Consumer Confidence Index for July saw a relatively sharp rise which is likely to signal a future recovery in private consumption. Various indicators of activity in the housing market show a continuation in the weakening trend

and most investment houses believe that the slowdown in the housing market will continue.

In contrast, labor market data for June point to a continuation in the positive trend of recent months. The unemployment rate remains at 4.5 percent, and at the same time both the number of employed and the level of wages increased.

In recent months the core inflation rate has moderated although it remains close to the upper limit of the range that the Fed seems comfortable with, which puts the risks to the inflation outlook on the upside, particularly in light of the high manufacturing capacity utilization, pressures from the labor market, and the rise in energy prices. As expected, the Fed left its federal funds interest rate unchanged this month at 5.25 percent. The investment houses and capital markets estimate that the Fed rate will remain unchanged until the end of the year. Yields on 10-year US bonds stood, prior to the interest rate discussion, on 22/7/07 at 4.95 percent.

Europe

Recent economic data for Europe indicate that the growth rate remained high in the second quarter too. Purchasing Managers Indices for the services and manufacturing sectors show that activity is strong in the euro zone in general and in the three major economies in particular. European consumer confidence data remain positive and are expected to continue supporting private consumption, currently in a positive trend, against a background of further improvement in the labor market and further reduction in the unemployment rate this month to 7 percent, the lowest level in 25 years. Strong global growth continues to support European exports and corporate investment is expected to remain high in the light of positive financial conditions, continued high profitability, structural changes in balance sheets and increased corporate efficiency. The investment houses expect, on average, that rapid growth will continue in the second half of the year, and estimate that growth for 2007 will reach 2.7 percent.

Inflation over the previous twelve months remained at 1.9 percent in June. (The inflation target ceiling is 2 percent). The ECB noted the threat to price stability in the medium term in the light of a further rise in manufacturing capacity utilization, an improvement in the labor market, the probability of upward pressures on wages, and the rise in oil prices. The investment houses expect 2007 will end with high inflation, close to the target boundary. As expected, the ECB decided to leave the interest rate unchanged at 4 percent, while signaling that it intended to raise the interest rate at its September meeting.

Japan

The rate of growth of the Japanese economy is expected to weaken in the second quarter of 2007 after reaching the rate of 3.3 percent in the first quarter, in annual terms. However, the Japanese economy is expected to continue growing moderately, boosted mainly by the activity of the companies sector and continued growth in exports. Household income continued to rise moderately, supporting private consumption. Data on industrial production is expected to show improvement, against a background of growth in demand, both domestic and abroad, supported by the strong global economy. The investment houses on average expect growth in 2007 to reach 2.6 percent.

The underlying inflation rate over the past 12 months in Japan fell in May by 0.1 percent, further to similar falls in the three preceding months. According to the Bank of Japan, CPI inflation is expected to stay at around zero in the short term, but to switch to a positive trend in the long run. As was expected, the Bank of Japan did not change the interest rate this month, leaving it at 0.5 percent. The Governor of the Bank said that the Bank prefers to be more confident regarding the growth forecast before raising the interest rate. The investment houses and financial markets expect that the central bank will raise the interest rate by 25 basis points by the end of the year.

The emerging markets

In the last month too the emerging markets continued to present a positive picture, against positive domestic data which indicate continued firming of domestic demand, the positive global environment, the increase in world trade, as well as the high level of liquidity in those markets. The greater-than-expected deceleration in the US economy, developments in prices of energy and commodities, the geopolitical risks and the large positions held by investors in the emerging markets, remained the major risk factors in future global developments.

In China, growth for 2006 was revised upward from 10.7 percent to 11.1 percent. Growth remained at 11.1 percent for the first quarter of the current year. In addition, since the beginning of the year, foreign currency reserves grew at the central bank by $266 billion, and now total about $1.3 trillion. This increase was registered following a sharp expansion in the trade account surplus since the beginning of the year, and an increase in nonresidents' direct investments. As a result, the rate of appreciation of the yuan accelerated and the daily fluctuation band of the currency against the dollar may be widened. Against the background of all these developments, there is growing expectation of a rise in the interest rate in China.