Bank of Israel

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

The discussions took place on January 28 and 29, 2006

February 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 various 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

Economic activity continued to increase at the fast rate evident in the first half of 2006. Assessments in the Bank of Israel are that growth in 2007 will persist at close to 5 percent. The outstanding feature of the balance of payments is the significant current account surplus, which is expected to be almost 5 percent of GDP in 2006, with its positive trend predicted to continue in 2007.

Indices of real activity

The Bank of Israel Companies Survey for the last quarter of 2006 indicates that business activity continued to expand rapidly, and that companies' financial managers expect fast growth in the next few months. The Survey reports a rise in activity in the last quarter of 2006 in the manufacturing, construction, and trade and service industries, and a more moderate increase in transport and communications. Activity in the tourist industry remained at a modest level. The Survey reported expectations of a further rapid increase in activity in most industries in the first quarter of 2007

Another indicator that pointed to a rapid rise in activity was provided by the composite state-of-the-economy index, which rose from November to December by 0.6 percent. The indices for October and November—whose low rates of increase when initially reported were one of the few signals of slowing growth in the economy—were revised upwards, to a rise of 0.4 percent in each, following a rise of about 0.5 percent each month from July to September.

Goods imports and exports

Manufactured goods exports (excluding diamonds, ships and planes) rose in dollar terms by 14.4 percent in 2006 compared to 2005, and totaled $ 30.1 billion. Goods imports (excluding diamonds, ships, planes and energy products) amounted to $ 31 billion in 2006, an increase of almost 10 percent over the level in 2005.

The current account of the balance of payments

The current account surplus is expected to reach about $ 7 billion (5 percent of GDP) in 2006, and it is assessed that its positive trend will persist in 2007, with the improvement in the deficit in the goods account making a significant contribution.

The labor market

The rate of unemployment was 8.3 percent of the civilian labor force in October and November. This followed a drop from 8.8 percent in the second quarter of 2006 to 8.3 percent in the third quarter. The nominal wage per employee post in the business sector was about 4 percent higher in January–October 2006 than in the equivalent period in 2005, a rise of 1.3 percent in real terms. The rise in the real wage was lower than the rise in productivity, so that unit labor costs posted a decline.

Negotiations started recently on public sector wage agreements covering the period from July 2005 onwards.

2. Budget data

The total government deficit in 2006, excluding net credit granted, was 0.9 percent of GDP. Most of the drop in the deficit derived from revenues exceeding the original budget estimates by about NIS 12 billion (2 percent of GDP), with about half of the increase in revenues coming from non-recurring sources. The implementation of expenditure was in accordance with the original budget, despite the costs of the war.

The Knesset approved the budget framework for 2007 determined by the government. The budget deficit in 2007 is expected to be below the ceiling set by the government of 2.9 percent of GDP.

3. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) did not change in December, following its cumulative drop of 1.7 percent in September–November. The unchanged CPI in December was slightly higher than the average of the forecasts, and was in line with the seasonal path consistent with the inflation target.

In the last twelve months the CPI fell by 0.1 percent, so that inflation in 2006 was lower than the target. The sharp drop in inflation is to be seen against the background of the strengthening of the shekel against the dollar by 8.2 percent in 2006 and the rapid and heavy impact of changes in the exchange rate on inflation in Israel.

If the components of the CPI are divided into those directly affected by the exchange rate and the price-of-energy component, on the one hand, and "domestic" components not affected by them, on the other, it can be seen that the "domestic" components of the price index rose in 2006 by more than 2 percent, while prices of the "imported" components of the index fell.

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

Inflation expectations to one year ahead derived from the capital market—break-even inflation—continued along their downward path, and in January stood at an average of about 1 percent, after falling to about 1.3 percent in December from 1.5 percent in November. From January to September 2006 these expectations were close to the midpoint of the inflation target range, and since October they have been below the midpoint.

Israeli forecasters' assessments of one-year inflation are close to the midpoint of the target range, and this month the average of their forecasts rose to 1.9 percent.

The average of their forecasts of the Bank of Israel's interest rate in a year's time is 4.5 percent.

Prior to the interest rate decision for February, the *makam* curve was negative, reflecting expectations of a further decline in the interest rate.

The makam and bond markets

In the month prior to the interest rate decision, the five-year CPI-indexed interest rate fell by 0.2 of a percentage point to 3.4 percent, and the 10-year indexed rate fell from 3.6 percent to 3.5 percent. The nominal yield on unindexed 5-year *Shahar* bonds declined from 5.4 percent to 5.3 percent, and on 10-year bonds it declined by 0.1 of a percentage point, to 5.6 percent. The *makam* yield for one year went down in the last month from 5 percent to 4.6 percent.

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

Before the current interest rate decision, the Bank of Israel interest rate was 75 basis points lower than the Federal Reserve rate. US capital market data indicate a strong probability of no change in the US federal funds rate in the coming months.

The gap between the yields on 10-year unindexed shekel bonds and US bonds of the same term contracted significantly during the last month from 104 basis points to 73 basis points.

The expected real interest rate
As the previous cut in the Bank of Israel interest rate, for January, was greater than the drop in inflation expectations, the expected real interest rate for one year forward fell in January from a level of 3.9 percent to about 3.6 percent.

The money supply
The money supply (M1) increased by 7.3 percent in 2006. This is a modest rise compared with the rates in previous years. In 2005 the money supply increased by 24 percent.

The econometric models[1]
The various scenarios that were examined using one of the Bank of Israel's econometric models showed that in the scenario that included a cut in the interest rate and the consequent nominal depreciation of the shekel, inflation would return to within the target range in the last quarter of 2007. The elements in the model acting to lower the interest rate derive from the appreciation of the shekel against the dollar in the last three quarters, and the low rate of inflation in the last quarter of 2006. According to the model, these factors are conducive to low rates of price increases also in the first quarter of 2007.

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

Capital flows
In the month since the last interest rate decision, the downward trend of the NIS/$ exchange rate (i.e., the strengthening of the shekel against the dollar) halted. Nevertheless, the underlying conditions of the current account surplus and nonresidents' investments in the economy constitute basic forces for real appreciation.

As mentioned above, the positive trend in the current account surplus is expected to continue in 2007, and to rise to more than 5 percent of GDP.

The foreign-currency market and the share market
During the last month the shekel weakened a little against the dollar. At the time of the previous interest rate decision the exchange rate was around NIS 4.22 to the dollar, and in the days prior to the current decision, around NIS 4.24. The shekel strengthened against the euro in the last month, from NIS 5.55 to the euro at the time of the previous interest rate decision, to NIS 5.48 in the days prior to the current decision.

The Tel Aviv 100 share price index rose by about 4 percent in the period from the beginning of the year to 28 January.

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

[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.

Israel's risk premium as measured by the five-year CDS spread went down from 23 basis points at the time of the last interest rate decision to 20 basis points currently, similar to the reduction in CDS spreads in other emerging-market economies. The yield gap between 10-year *Shahar* bonds and US government bonds of the same term contracted from the time of the previous interest rate decision to date by about 30 basis points.

The foreign investment houses continue to describe Israel's economy in a positive light, and commend its strong macroeconomic performance. Specifically, they emphasize the buoyant rate of growth, the current account surplus, and the extent of direct investment, all of which are expected to continue along the positive trend in 2007. They also note in their reviews that since Israel is less exposed to speculative activity than are other emerging markets, it is less vulnerable to a possible rise in risk aversion among foreign investors.

Most of the investment houses expect the shekel to continue its strong performance, although a possible deterioration in the geopolitical situation in the region or a greater-than-expected slowdown of growth in the US economy that would affect emerging markets in general and Israel in particular still constitute risk factors.

6. Global economic developments (full details in the Appendix)

Global growth is expected to remain high in 2007, and according to the IMF forecast is expected to reach 5 percent, compared with 5.1 percent in 2006. The latest figures of the US economy indicate a "soft landing" (a moderate slowing of economic growth).

Economic data from other regions of the world show limited reaction to the expected US slowdown. Growth in Europe has been sustained and is becoming more robust, the emerging markets are continuing to show a favorable picture, while China and India are maintaining their impressively rapid growth. Japanese growth remains moderate.

Most of the world's leading central banks are expected to have a tightening bias. The path of the interest rate in the US depends on growth and inflation there, and the Fed is not expected to change the interest rate in the near future. The Bank of England raised the interest rate at its meeting in January. The ECB and the Bank of Japan are expected to further raise their interest rates in the next few months.

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

The inflation rate in the last twelve months was significantly below the target range, and stands at –0.1 percent. The inflation estimates and expectations to twelve months ahead are lower than the midpoint of the target range. Inflation expectations derived from the capital market stand at about 1.0 percent, and the average of the forecasts of private economic forecasters are about 1.9 percent.

In the three months from September to November 2006 the CPI fell by a total of almost 2 percent, and the index for December remained unchanged. The participants in the discussion stressed that the low rate of inflation was expected to continue in the first quarter. The assessment was that the rate of inflation viewed retrospectively over twelve months for the first quarter would be negative, and only in the second quarter would the monthly CPI inflation figures rise to rates in line with the target inflation path. Given the negative rate of inflation, viewed over the previous twelve months, in recent months, inflation is expected to remain below the target range for most of 2007. The aim of achieving the inflation target for 2007 was stressed in the discussion, as well as the Bank of Israel's equal treatment of a deviation from the target, whether it had undershot or overshot it.

Prior to the interest rate decision for February, the expectation derived from the capital market was of a reduction in the interest rates during the coming year following the recent drop in inflation. Private forecasters expected the Bank of Israel interest rate to be around 4.5 percent at the end of 2007.

According to the scenarios derived from the econometric models, subject to a reduction in the interest rate, there is a relatively high probability that inflation would revert to the target range in the last quarter of 2007. The return to within the target inflation range and the rate of interest required for this depend to no small degree on the future changes in the exchange rate.

In the month prior to the current interest rate decision the financial indicators in Israel continued to strengthen. In the international financial markets Israel’s country risk premium, as measured in the 5-year CDS market, continued to decline. The yield gap between 10-year *Shahar* bonds and US government bonds of the same term continued to narrow, and in the past month narrowed considerably.

The strengthening of the shekel, which acted to push inflation down, expresses several positive developments reflecting the reduction in Israel's country risk premium. In 2006, the growth in the current-account surplus stood out, and this is expected to grow further in 2007. Fiscal discipline was also impressive. Despite the hostilities in the north and the associated government expenditure, the budget deficit for 2006 totaled about 0.9 percent of GDP, lower than the budget ceiling. In 2007 too the budget deficit is expected to be lower than the ceiling approved by the Knesset of 2.9 percent of GDP. These developments contribute to the growing confidence of foreign investors in Israel’s economy, reflected by the amount of foreign investment.

As in the past, the participants stressed the relatively strong and rapid effect that the exchange rate has on inflation in Israel. The shekel's strengthening against the dollar in previous months had contributed significantly to the low inflation figures. However in contrast to recent months when the shekel had strengthened against the dollar, the shekel/dollar exchange rate at the time of the discussion was similar to the rate at the time of the previous month's interest rate discussion.

The data on real activity continue to indicate that the economy is still enjoying a high rate of growth. Assessments presented in the discussion pointed to growth of 5.0 percent in 2006 and a similar rate in 2007. The rate of unemployment stabilized in recent months and stands at 8.3 percent. No inflationary pressures from the labor market are evident at this stage, and the real wage has edged up by only a moderate amount, lower than the rise in productivity such that unit labor costs remain on the downward trend of the past two years.

All the participants favored a reduction of 25 basis points in the interest rate for February. Referring to the factors allowing a reduction in interest rate for February, in addition to the starting point of inflation being lower than the target, the further drop in Israel's country risk premium was noted. This reduction in risk premium, together with the current-account surplus and the foreign investment in the economy, constitute a factor acting to strengthen the shekel. Furthermore, the responsible budget policy was also noted as a factor that reduced inflationary pressures, as the low budget deficits reduce the (net) pressure of government demand for funds in the economy.

In considering forces that could tend to increase inflation, participants focused on the rapid growth rate of the economy and the associated narrowing of the output gap. These act over time to increase pressure on prices, and it was noted that there were already indicators reflecting this pressure on domestic prices. However, recent data show no inflationary pressures from rising unit labor costs.

It was also noted that a reduction in the interest rate for February would add to the cumulative interest rate reduction of 1 percentage point in the three months prior to this decision. After a cut in the interest rate of 25 basis points for February, the Bank of Israel interest rate would be 1 percentage point below the US Federal Reserve rate, and this at a time when the indications from most leading central banks worldwide are for a rise in short-term interest rates.

Some participants noted that after a 25 basis point reduction in the interest rate for February, they thought it likely that the process of interest rate reductions would be coming to a close. Most of the participants were of the opinion that it was preferable at this stage to give no indication regarding interest rate decisions for the coming months.

In conclusion, in light of the highly favorable background conditions, in terms of falling country risk premium, levels of current-account surplus in the balance of payments, and the inflow of foreign investment into Israel, the departmental directors participating in the discussion considered a reduction in the interest rate of 25 basis points for February was consistent with achieving the inflation target for 2007. The participants emphasized the importance that the Bank of Israel attaches to the inflation target, and stressed that the reduction in this month's interest rate was a step intended to increase the probability that price rises return quickly to a rate consistent with the target inflation.

All the departmental directors participating in the discussion recommended reducing the interest rate for February by 25 basis points, and after considering their recommendations, the Governor decided to reduce the interest rate by 25 basis points. The Bank of Israel interest rate for February will therefore be 4.25 percent.

The decision was made and published on January 29, 2007.

Those present at the 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
Dr. Ben Z. Schreiber, Deputy Director of the Foreign Exchange Activity Department
Dr. Ohad Bar-Efrat, Advisor to the Governor and Head of International Affairs
Mr. Gaby Fiszman, Chief of Staff to the Governor

Appendix: Major Global Economic Developments

U.S.

The macroeconomic date published this month were generally positive and attested to stronger than expected economic activity in the fourth quarter of 2006. The investment houses revised their growth forecasts upward for the fourth quarter from 2.1 percent to 3 percent, regarded as the US potential growth rate.

Private consumption remained strong despite the fear of a moderating effect of the slowdown seen in recent months in the housing market. Retail sales were surprisingly good and at the same time the consumer confidence index remained high.

The growth outlook for the first quarter of 2007 remains subject to upside risks mainly due to the background of the positive momentum already established so far this year. The investment houses expect growth in 2007 to slow down during the year to below the US potential growth rate.

The risks of continued inflationary pressures, particularly from the labor market, remain against a background of continued increases in average hourly earnings and an unemployment rate that stands at 4.5 percent. However, the Fed expects inflationary pressures to moderate over time, against a background of falling energy prices and the expected decline in the growth rate to below its potential. Investment houses also expect, on average, that inflation will fall to 2 percent at the end of the last quarter of 2006 and to below 2 percent in the second quarter of 2007.

The positive data on US economic activity led the investment houses to change their forecasts for when the Fed will begin cutting its discount rate. Until now they had estimated that the Fed would reduce its rate by 25 basis points by the first quarter of 2007 but they now believe this will occur only in the third quarter. At the same time, in the past month we have witnessed the convergence of the market regarding its forecast for the Fed; Fed funds futures price in a 25 basis point cut in the Fed rate only by the end of the year, compared to a 50 basis point cut, seen in last month's futures.

Europe

Economic data published recently point to self-sustaining and broadening growth in the euro area, with domestic demand still the main driver of growth. Various confidence surveys remain at very high levels and point to robust growth. At the same time, data on European consumer confidence continue to show private consumption on a recovery path against a background of a continuously falling unemployment rate and further improvement in the labor market. The global economy remains strong and continues to provide support to the European export sector.

Germany stands out as particularly strong compared to the other countries in the euro area, and is expected to continue leading growth in Europe in 2007. The investment houses expect growth in Europe to ease to 1.4 percent in the first quarter of 2007, and then to accelerate again to a rate of 1.9 percent as early as in the second quarter.

The rate of inflation remained unchanged in December at 1.9 percent in annual terms. Developments in oil prices and the effect of rising indirect taxation will continue to play an important role in setting the inflation path at the beginning of 2007. The European Central Bank expects inflation to hover both this year and next around 2 percent, the bank's inflation target. The investment houses expect similar movements. The outlook for price developments remains subject to upside risks, stemming in particular from a stronger than anticipated pass-through of oil price increases in 2006. At the same time the continued rapid growth in money supply and in private sector credit constitute a factor of risk for price stability in the medium and long term.

As expected the ECB left its interest rate unchanged at 3.5 percent this month. However the bank did signal to the market its intention to raise rates at its meeting in March and not in February as the market had factored in. As a result, the market now prices in a certain rise of 25 basis points in March and a further rise after that by the end of the year. The investment houses expected similar developments in the ECB interest rates.

Japan

Japan's central bank expects the economy to continue growing at a moderate pace. Exports are expected to grow further, supported by the favorable global environment, and domestic demand is expected to expand supported by increased company profits and a modest rise in household income. The investment houses expect, on average, growth of 2.3 percent in the fourth quarter of 2006, to be followed by further growth in the first half of 2007.

The rate of price increases on domestic products slowed down against a background of falling prices of oil and commodities globally. However the rate of rise in core inflation remains on a positive trend.

Against a background of moderate growth figures and low inflation, the Bank of Japan left its interest rate unchanged this month at 0.25 percent. For the first time since March 2006, its interest rate decision was not unanimous, and opinions of the central bank board were divided principally over the strength of private consumption. The governor of the Bank pointed out that he required more data on consumer expenditure and inflation in order to decide the correct time to act. Nevertheless, the Bank still tends towards tighter money. The investment houses expect a rise of 25 basis points in the interest rate in the first quarter of 2007.

The emerging markets

The economies of the emerging markets continued to exhibit buoyancy, with further improvement in the last month. The background to this improvement was provided by their positive domestic data and the more positive global environment, as well as the high level of market liquidity. The growth process in the emerging markets, which has benefited from the inflow of foreign investments and the increase in world trade, is likely to become based more on domestic demand. Economists are of the opinion that if the emerging market economies make good use of their current account surpluses to invest in development and their infrastructures, their rate of growth is likely to increase further and thus continue to contribute to the global economy in the next few years.