



**Bank of Israel**

# **MONETARY POLICY REPORT**

July-December 2011

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**Note:** The Monetary Policy Report for the second half of 2011 is the first Monetary Policy Report to be prepared within the framework of the Bank of Israel's Monetary Committee, the forum in which monetary policy decisions are reached. Section 55(a) of the Bank of Israel Law, 5770–2010, mandates the publication of this report after the establishment of the Committee (in October 2011). The first decision by the Monetary Committee was the decision on the interest rate for November 2011, which was published on October 24th. Until that decision, the interest rate decision was made by the Governor of the Bank of Israel, aided by the Senior Monetary Forum—an internal Bank forum, detailed in the reports of the interest rate decisions reached during that period.

## Summary<sup>1</sup>

- **Inflation:** In the second half of 2011 (the period reviewed in this report) the Consumer Price Index (CPI) was unchanged, and on a seasonally adjusted basis increased at a moderate pace of 0.4 percent. The main components that contributed to the increase in the general index were housing (rents) and housing maintenance. The main components moderating the increase were food, education and culture, and transport and communication. The inflation rate, as measured by the change in the CPI, in 2011 was 2.2 percent, near the midpoint of the price stability target range. The largest contribution, 1.2 percent, was the housing component; the CPI excluding housing increased only 1 percent.
- **The global economic environment:** During the second half of 2011, the debt crisis in Europe deteriorated sharply, and led to a slowdown in real activity, and a sharp increase in risk in financial markets world wide. The slowdown in activity in Europe spread to other advanced economies, as well as to emerging economies, and they responded with expansionary monetary policy, primarily through interest rate reductions. In contrast US economic data surprised on the upside. With that, the US rate of growth remains low, compared with the years before the 2007–09 financial crisis.
- **Real economic activity:** The crisis in Europe had a significant negative impact on demand for Israeli exports, and was the main factor in a slowdown in domestic real activity. Likewise, there was a slowdown in the rate of growth of private consumption, with a decline in consumer durables purchases. As a result, the rate of GDP growth slowed from about 4 percent in the first half of the year, to about 3 percent in the last six months of the year. Despite the moderation in the rate of growth, the level of activity was high, and according to most indicators, Israel's economy is near full employment.
- **Financial markets:** Financial markets in Israel were affected by developments in the crisis in Europe, as well as by local factors, primarily the high level of political uncertainty in the Middle East. As a result, during the period reviewed, the general share index declined sharply, by 22 percent in dollar terms, and volatility increased. The decline in the stock market index in Israel was more moderate than in Europe, but sharper than in most other countries. At the same time, for the first time since the recent financial crisis, there was an increase in the yield gap between corporate bonds and government bonds—a development which indicates the market's expectation of a deterioration in the state of domestic companies.
- **Exchange rate:** After an appreciation of about 5 percent in terms of the effective exchange rate in the first half of the year, the trend reversed in the second half, and the shekel depreciated 4.7 percent. The main factors behind the depreciation are a slide to a deficit in the current account of the balance of payments, a decline in the risk adjusted yield gap between Israel and abroad, and the continued operation of regulatory measures.
- **Home prices:** The rate of increase of home prices over the previous 12 months moderated and reached 7 percent by the end of the year. Data for the months September–November show a slight decline in home prices, the first decline in a long time. This development indicates the possibility of a turnaround in the development of prices. Several factors were responsible for the moderation: increases in the monetary interest rate, which occurred until the second half of the year; macroprudential measures in the mortgage market; and steps by the government to increase supply. These factors also had an effect on prices via the public's expectations.

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<sup>1</sup> The Bank of Israel Law, 5770-2010, defines the Bank's objectives as: maintaining price stability (its central goal), supporting the stability of the financial system, and supporting the other objectives of the government's economic policy, especially growth, employment, and the reduction of social gaps, provided that they do not negatively impact price stability over the course of time. Price stability is defined as an inflation rate within a range of 1–3 percent per year.

- **The macroeconomic forecast in the period reviewed<sup>2</sup>:** The slowdown in real activity and in inflation was expressed as well in the forecasts for 2012 which were prepared in the Bank of Israel Research Department during the period reviewed, and which serve as important inputs in interest rate decisions. In the forecast which was published on July 25, 2011, the expected rate of real economic growth in 2012 was 3.9 percent, the rate of inflation was forecast to be 2.6 percent, and these were consistent with a monetary interest rate of 4.3 percent which was forecast for the end of 2012. At the end of the period reviewed, the forecast for 2012 reflected the assessments regarding the worsening of the slowdown in activity and moderation of inflation, and at the same time, the Bank of Israel interest rate reductions which had taken place. In this updated version, the Research Department forecast real activity to grow by 2.8 percent, with the inflation rate at 2.6 percent, and the Bank of Israel interest rate to be 2.2 at the end of the year, lower by about 2 percentage points than the July forecast.
- **Monetary policy:** In the third quarter of 2011, the Bank of Israel stopped the interest rate increases it had carried out since the middle of 2009, and in the fourth quarter the Bank began a policy of interest rate reductions. The Bank of Israel interest rate was lowered by 0.25 percentage points in both October and December, and at year-end stood at 2.75 percent. The Bank continued to reduce the interest rate even after the period reviewed, and in February 2012 it was reduced by 0.25 percentage points. The switch to a policy of interest rate reductions was intended first and foremost to support real activity and reduce the cost of credit in the economy, in light of the slowdown in activity and the concern of a financial crisis in Europe. It was made possible by the moderation in the inflation environment. Concurrent with interest rate policy, the Bank of Israel continued to take regulatory steps in the foreign exchange market and the housing credit market in order to maintain financial stability and support real activity.

<sup>2</sup> The latest forecast in the period reviewed was presented in summary on December 26, 2011, the date of the publication of the interest rate decision for January 2012.

## THE BACKGROUND AND INFLATION

**There is a range of factors that influence the Bank of Israel's monetary policy decisions.**

In managing monetary policy, the Bank of Israel monitors developments in the global environment, in inflation and in real and financial activity in Israel. The Bank continuously monitors market forces and their expected effect on inflation, and sets the level of the interest rate in order to achieve the inflation target within one to two years, while encouraging employment and growth, maintaining stability in the financial markets, and reducing social gaps.

In the third quarter of 2011, the Bank of Israel halted the trend of increasing the interest rate, and in the fourth quarter of the year reduced the interest rate twice. The Bank also reduced the interest rate for February 2012 (after the period surveyed). The interest rate policy was based on economic developments in Israel and around the world, primarily: 1) the marked slowdown in global real activity and a sharp increase in the level of risk in economies world wide, against the background of concern of an outbreak of a financial crisis in Europe and the slide toward a severe recession; 2) moderation in real domestic activity, against the background of the crisis in Europe and moderation of domestic demand; 3) a decline in the actual and expected rate of inflation; 4) expansionary monetary policy of central banks around the world through interest rate cuts and other tools; 5) strengthened forces for depreciation of the shekel; and 6) moderation of the rate of increase in home prices. Following is a description of the main developments in the global and local economies which were the basis for Bank of Israel monetary policy decisions.

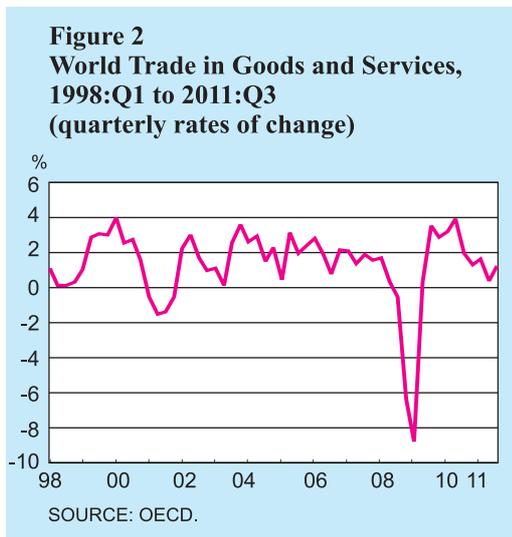
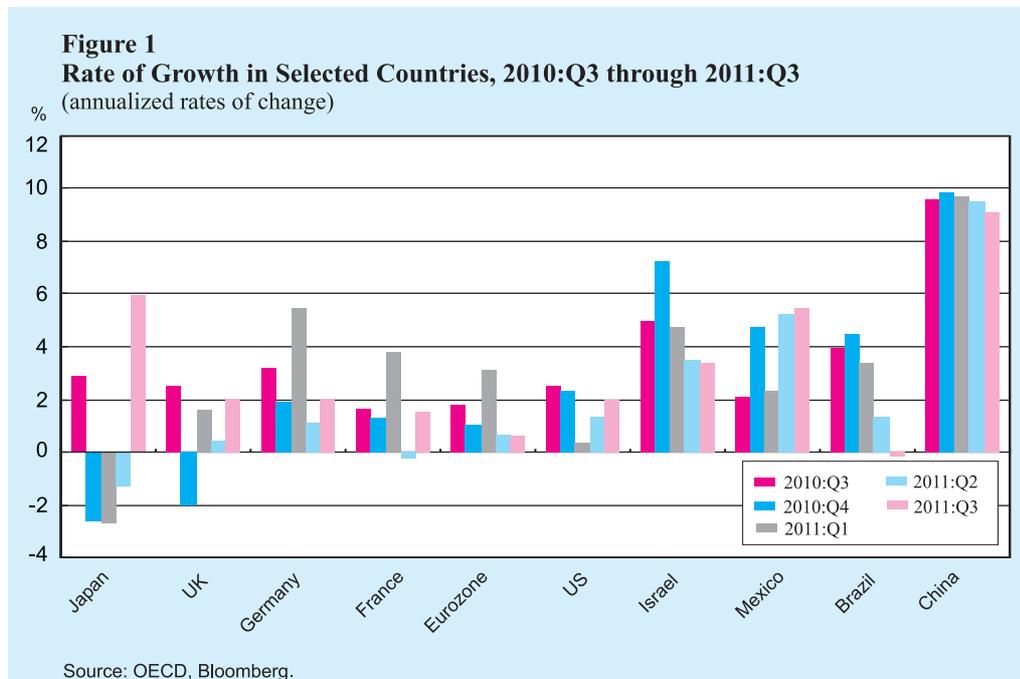
### **a. The global environment**

#### **(1) Real activity**

**During the six months reviewed, the debt crisis in Europe deteriorated sharply, and a basic assessment that Europe was sliding toward recession crystallized.** In major emerging markets, as well, growth moderated, and in the US, growth settled at a low rate. Likewise, over the course of the period, there was increasing concern of the development of severe difficulties in the financial system, which would deepen the recession, and lead to further deterioration in global growth.

The slowdown in activity came after an extended period of recovery from the financial crisis of 2008 (Figure 1). Toward the end of the year a slowdown developed in growth in emerging markets as well, even though their growth rates were still high,

relative to developed economies. In contrast to developments in Europe, growth of real activity in the US surprised on the upside, though its level remained relatively low, compared with the rate before the financial crisis of 2007–09. The US unemployment rate remains high. As an outcome of the slowdown in Europe, alongside relatively high growth in emerging economies, world trade volume remained relatively stable (Figure 2).



### Europe<sup>3</sup>

Over the course of the second half of 2011, there was a marked slowdown in real activity in the eurozone. GDP contracted by 0.3 percent<sup>4</sup>, in contrast to a positive growth rate of 1.9 percent in the first half. During the course of the period surveyed, basic forecasts were revised downward, and growth in 2012 is now forecast to range between 0.3 percent and negative 0.7 percent. The main risk to the basic forecast stems from the possibility that a severe financial crisis will develop, and will lead to a deeper recession and further deterioration in global growth.

### The US

In the second half of the year, there was a recovery in real activity, and actual data were better than previous assessments: GDP grew 2.5 percent, compared with moderate growth of 0.9 percent in the first half. The full year growth rate for 2011 is expected to

<sup>3</sup> All figures are in annual terms.

<sup>4</sup> The GDP growth rate for the final quarter of 2011 is based on forecasts of international entities.

be 1.8 percent, and similar growth is expected for 2012. At the same time, the unemployment rate declined from 9 percent at the beginning of the period to 8.5 percent toward the end. Despite these positive indications, growth was mostly reliant on public sector demand. Also supporting economic activity were the Federal Reserve's monetary steps, primarily easing in the credit market—making credit cheaper by purchasing medium and long term bonds and increasing its size by providing liquidity to financial markets.

### *Emerging economies*

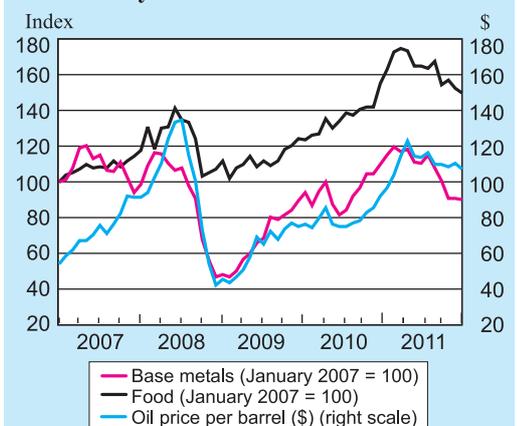
In contrast to most developed markets, in which real activity slackened, emerging markets posted impressive growth in most of 2011. China, in particular, stood out with growth rates of around ten percent. Nonetheless, toward the end of the year, the worldwide slowdown in activity also reached emerging markets, and so forecasts of their economic growth were revised downward.

## **(2) Global inflation**

Despite the slowdown in global activity, inflation rates in Europe and the US were relatively high, but in the second half of the year they moderated somewhat (Table 1). The full year inflation rate in Europe was 2.7 percent, and in the US was 3.0 percent. The main sources of the relatively high inflation rate during the course of the year were commodities and energy, the prices of which increased greatly in the first half of the year, and continued to have an effect in the second half as well. Currently, these factors are offset only partially by a decline in demand, the result of a slowdown in global activity. The relatively high inflation rates also stem from the expansionary monetary policy, of which efforts were focused primarily on stabilizing real and financial activity, with less emphasis on stabilizing inflation.

In contrast to the previous financial crisis, in which energy and commodity prices declined sharply, currently, prices are relatively stable, and are still at a high level (Figure 3) despite the slowdown in real activity. The reason for this is apparently connected to difficulty in supply of crude oil, due to the political uncertainty in the Middle East.

**Figure 3**  
**Price Indices of Base Metals and Food,**  
**and Oil Prices,**  
**January 2007 to December 2011**



SOURCE: Bloomberg.

**Table 1**  
**The CPI and Selected Components in Israel and Abroad**

(percent change)

	Israel						US						Europe					
	2010		2011		2011		2010		2011		2011		2010		2011		2011	
	2010	2011	*I	II*	III*	IV*	2010	2011	*I	II*	III*	IV*	2010	2011	*I	II*	III*	IV*
<b>CPI</b>	2.7	2.2	2.8	6.0	0.0	0.0	1.5	3.0	8.1	4.1	2.1	-2.1	2.2	2.7	4.3	2.3	1.4	3.1
<b>CPI (seasonally adjusted)<sup>a</sup></b>	2.6	2.2	6.0	2.0	-0.8	1.6	1.4	3.0	6.1	1.5	4.8	-0.4	2.1	2.7	3.3	2.0	3.1	2.3
Energy <sup>b</sup>	-0.4	11.0	32.1	4.3	7.8	2.2	7.8	6.6	53.1	20.7	-5.7	-26.0	11.0	9.7	28.5	1.1	6.4	4.7
Food (excluding fruit and vegetables)	2.0	2.3	10.9	7.1	-8.1	0.4	1.5	4.7	8.4	3.6	5.7	1.2	1.5	4.1	4.3	4.1	4.3	3.5
Fruit and vegetables	16.0	-8.1	-15.6	-13.5	-17.8	18.8	1.4	2.3	20.5	-12.6	9.1	-4.5	3.2	1.6	6.7	-0.1	-6.2	6.6
Housing	4.9	5.1	5.2	9.2	11.0	-4.3	0.3	1.9	2.9	3.4	1.8	-0.6	1.3	1.4	1.5	2.2	1.4	0.6
<b>CPI excluding food, energy, and fruit and vegetables</b>	2.5	2.1	0.4	7.0	1.8	-0.8	0.6	2.2	2.0	2.9	2.1	1.8	1.1	2.0	1.3	2.6	1.4	2.6

<sup>a</sup> The estimates of the CPI (seasonally adjusted) for Israel are Bank of Israel calculations. The estimates of the CPI (seasonally adjusted) for Europe do not include tobacco products.

<sup>b</sup> An index made up of several components of the CPI.

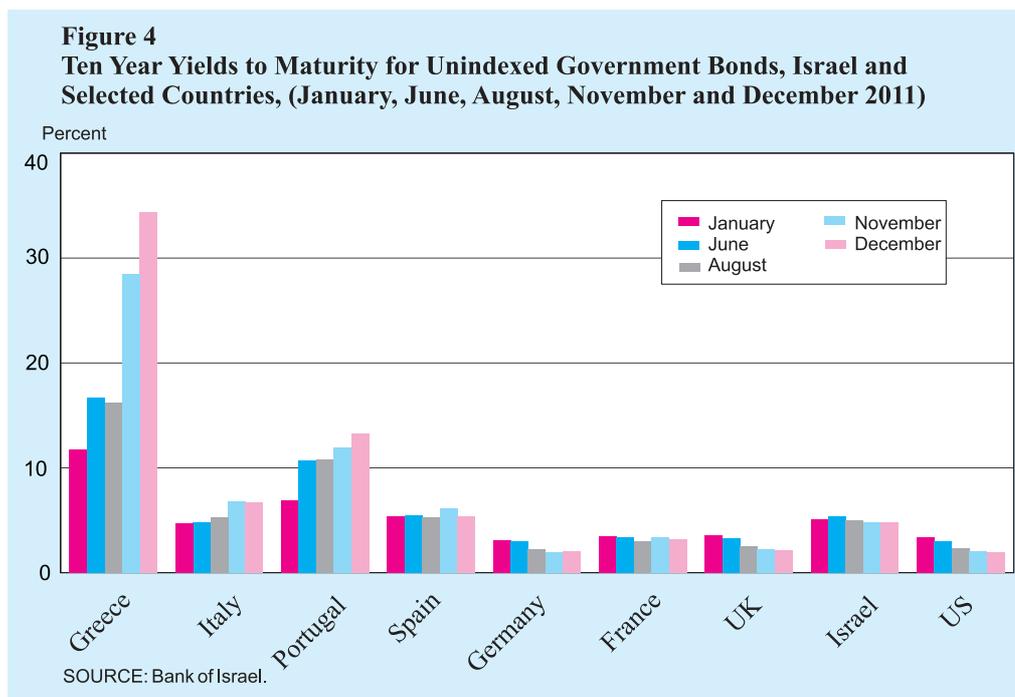
\* In annual terms.

SOURCE: Based on Central Bureau of Statistics, ECB, Eurostat, and US Bureau of Labor Statistics data.

### (3) Financial markets

**In the six months surveyed, the risk level in financial markets around the world increased greatly, primarily in Europe.** The basic source of the increase in risk was the debt crisis in Europe, and the concern of a financial crisis, possibly leading even to the breakup of the euro bloc. However, the increasing risk level over the course of the period stemmed from the lack of success of policymakers to adopt measures which would lead to the end of the crisis. Against the background of a decline in the assessment by the public that adequate steps would be taken in time, the long-term yields on bonds of Greece, Portugal, Italy, and Spain surged and reached record, unsustainable, levels (Figure 4). In Greece the yield on 10-year bonds reached 34 percent, in Portugal, 13 percent, in Spain, 6 percent, and in Italy, 7 percent. The credit default swaps (CDS)<sup>5</sup> spreads in these and other countries also rose steeply (Figure 5).

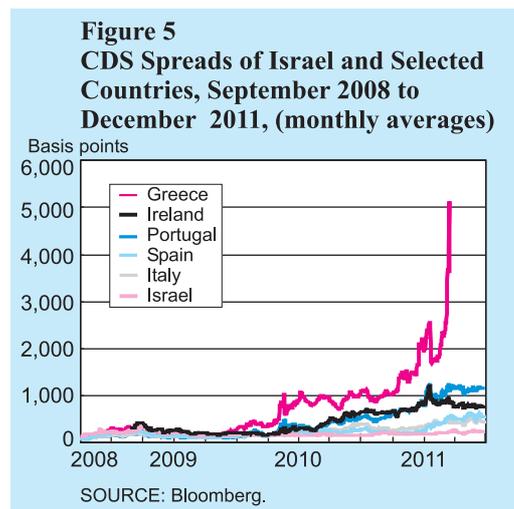
<sup>5</sup> A CDS is a financial instrument for hedging default risks, including of sovereigns. The CDS spread is the monetary premium required by the seller of the CDS for his commitment to repay the debt in the event that the issuer of the debt defaults.



Against the background of the worsening of the crisis and the increase in risk in the second half of 2011, credit rating agencies downgraded the credit rating of Belgium and Hungary. S&P also reduced the rating of the US, mainly because of the difficulties there in reaching agreement on fiscal consolidation. At the beginning of 2012, the credit ratings of other European countries were also reduced: France, Italy, Spain, Portugal, Greece, Austria, Malta, Slovakia, and Slovenia. This step could increase the risk premium required on those countries' government bonds, which itself would make it even more difficult for them to refinance their debt and reduce its burden, and is likely to exacerbate the crisis.

The raising of the risk level was also reflected in share indices around the world (Figure 6): these fell sharply, with an increase in volatility. The decline in Europe was the greatest, with the market plummeting by about a third, while the most moderate decline was in the US, where the share index dropped by only 5 percent. Concurrent with the actual fall in share prices, the volatility indices around the world, including the VIX index in the US (known as the "fear" index) (Figure 7), rose sharply, reflecting concern over further drops in share indices.

Towards the end of the second half of 2011, some measure of calm returned to the financial markets. This was due to decisions on steps to tighten fiscal discipline and on the monetary side to increase liquidity in the financial markets (see below).



## (4) Monetary and fiscal policy around the world

### Monetary policy around the world

Against the background of the slowdown in global economic activity and concern over the financial crisis in Europe, most central banks around the world lowered their interest rates in the second half of 2011. Following the increases in the interest rate in the first half of 2011, the ECB cut the rate twice in the second half of the year, and at the end of the year it stood at only 1 percent. In the US the interest rate had been at a near-zero level since 2009 (Figure 8), and the Fed had declared that it intended to keep it at that level through the end of 2013. The central banks of most advanced and emerging market economies cut their interest rates in the second half of 2011, and even accelerated the pace of the reductions towards the end of the year, when the global slowdown intensified and financial risk increased.

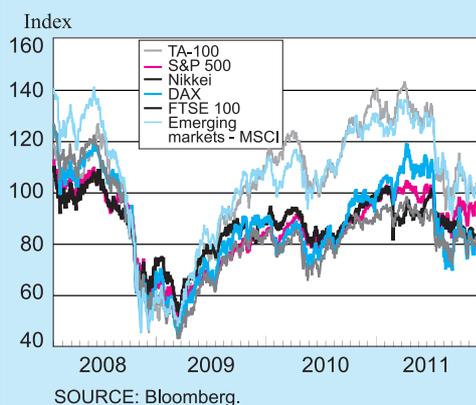
In the US and Europe the central banks employed other monetary tools, in addition to the interest rate, to boost the supply of liquidity and reduce long-term yields. The purpose was to lower the cost of credit, and hence support financial stability and real activity. The Fed started operating a program of selling short-term government securities and buying longer-term ones, to the tune of about \$400 billion (operation twist), and mention is being made of a third quantitative easing program (QE3), which has not yet come about. The ECB purchased about €110 billion of eurozone government bonds.

Towards the end of 2011, when it seemed that the steps taken hitherto fell short of what was required, several central banks, including the Fed and the ECB, took a coordinated step to reduce the interest rate on dollar liquidity swap lines by 50 basis points. The ECB also offered low-interest three-year unlimited (collateralized) loans to private banks, and at the same time eased the collateral requirements (including agreement to accept also bonds of countries in difficulty). Another step decided upon was the establishment of a new €500 billion fund—the European Stability Mechanism (ESM)—to support debt-ridden European countries; this is expected to replace the European Financial Stability Facility (EFSF).<sup>6</sup>

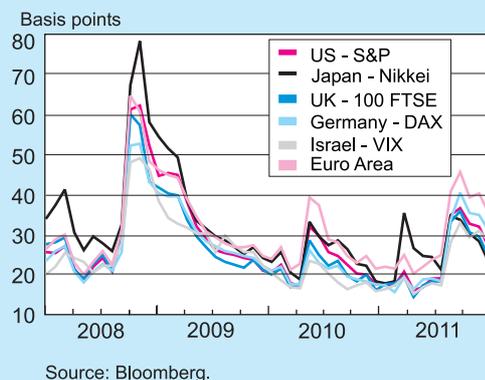
### Fiscal policy around the world

In an attempt to solve the European debt crisis, necessary to return to stable growth, several debt-ridden European

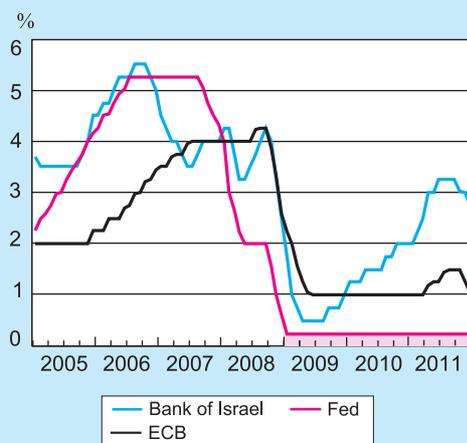
**Figure 6**  
Share Indices Around the World  
(based on dollar prices), 2008–11  
(daily data, September 15, 2008 = 100)



**Figure 7**  
Implied volatility in prices of options  
on stock market indices (VIX), 2008-11



**Figure 8**  
The Short-Term Interest Rate in Israel,  
the US and the Eurozone, 2005–11



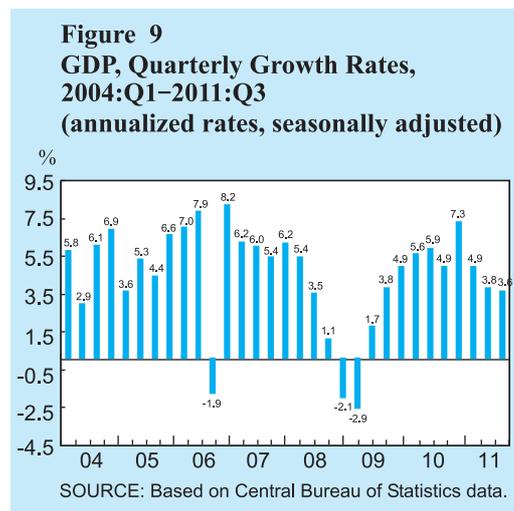
<sup>6</sup> The value of the EFSF was €440 billion at its start, and is currently €250 billion.

**countries decided on severe fiscal restraint. In contrast, the US pursued an expansionary fiscal policy intended to encourage real economic activity.** To receive economic aid to overcome the crisis, European countries were required to operate severe austerity programs, which would probably escalate the slowdown in their economic activity for an unknown period, and could even destabilize them politically. The hope was that in the long term stable growth would be achieved, by switching resources to the private sector and reducing the risk premium required on real and financial investments. The alternative, i.e., not introducing austerity programs, would probably exact a far higher price—economic collapse of the debt-ridden countries and the breakup of the eurozone, which would severely impact on the entire global economy. With these considerations in mind, towards the end of 2011 the European governments announced the first steps towards increased fiscal discipline, and even decided on the first principles regarding sanctions on countries that would violate it.

The US, in contrast, continued with its expansionary fiscal policy in the second half of 2011, intended to encourage real economic activity. However, the burden of the relatively high gross public debt, about 100 percent of GDP in 2011 (compared with only 60 percent prior to the financial crisis) and the heavy deficit in 2011, will make it difficult to continue with fiscal expansion, as will the recent downgrading of the credit rating of the US.

### b. Real economic developments in Israel<sup>7</sup>

**The rate of economic growth in Israel slowed in the second half of 2012. This was mainly due to the significant decline in exports that resulted from the crisis in Europe, as well as domestic factors such as the erosion of the public’s financial assets and pessimism about future growth.** Following rapid growth in 2010, the pace of economic activity started to moderate in the first half of 2011, and became even more notable in the second half (Figure 9 and Table 2). GDP grew at an annual rate of 4.4 percent in the first half of the year and slowed to 3.4 percent in the second half.<sup>8</sup> Despite this slowdown in the growth rate, Israel’s economy was in a relatively good situation: real activity was at a high level, and most indicators suggested that the economy was approaching a state of full employment.



<sup>7</sup> Data in this section are in seasonally adjusted annual terms.

<sup>8</sup> Fourth quarter data are based on Research Department assessments.

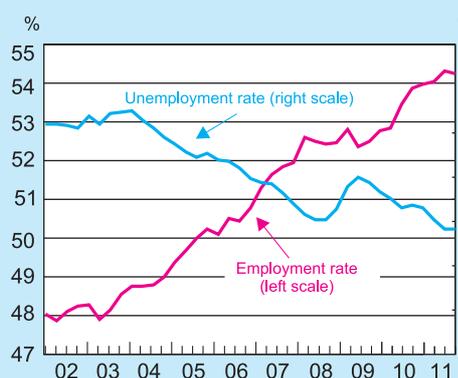
**Table 2**  
**GDP, Imports and Uses, 2009-2011:Q3**

(volume change from previous period, percent, seasonally adjusted, in annual terms)

	2009	2010	2010: Q2	2010: Q3	2010: Q4	2011: Q1	2011: Q2	2011: Q3
GDP	0.8	4.8	5.9	4.9	7.3	4.9	3.8	3.6
Business sector output	0.3	5.8	7.2	4.9	8.6	5.3	3.0	4.9
Imports excluding defense imports, ships, aircraft and diamonds	-12.2	9.5	14.3	-0.6	13.7	21.3	5.8	-2.6
Private consumption	1.4	5.3	8.2	1.3	10.2	6.7	-0.2	1.8
<i>of which:</i> Private consumption excluding consumer durables	2.5	4.5	4.8	2.2	7.0	4.1	2.8	2.5
Public consumption	2.4	2.5	1.8	6.6	5.8	2.8	-3.5	8.0
<i>of which:</i> Public consumption excluding defense imports	3.9	2.2	2.5	5.9	6.1	3.2	-3.9	8.9
Gross domestic investment	-7.0	4.0	-14.8	8.0	22.7	51.8	18.0	3.6
<i>of which:</i> Fixed investment	-4.1	13.6	29.1	16.0	25.5	19.6	14.5	13.5
Exports excluding diamonds	-10.2	10.7	17.9	2.9	1.3	9.3	7.9	-0.5
<i>of which:</i> Exports excluding diamonds and start-ups	-9.7	10.6	18.8	1.5	0.2	12.3	6.0	1.6

SOURCE: Based on Central Bureau of Statistics data.

**Figure 10**  
**The Employment Rate and the Unemployment Rate,<sup>a</sup>**  
**2002:Q1 to 2011:Q3**  
**(seasonally adjusted)**



<sup>a</sup> Unemployment rate - percent of labor force (aged 15-64);  
Employment rate - percent of working-age population.

SOURCE: Labour Force Surveys of the Central Bureau of Statistics.

Exports declined by about 5 percent in the second half of the year, after increasing by about 7 percent in the first half. However, investment in fixed assets increased at a relatively high rate, so that the negative effect on GDP was only a moderate one. However, the rapid increase in investments in the second half of the year does not necessarily indicate that investors expected an economic boom, but may reflect mainly the implementation of previous investment decisions.

Expectations of a slowdown in activity and the erosion of the value of the public's financial assets due to the fall in security prices were reflected in the moderation of private consumption. Its rate of increase fell to 3.3 percent in the first half of the year, and to 1.2 percent in the second half. The decline was due mainly to a contraction in the demand for durables, which have a high import component: when consumers expect a slowdown in activity in the future they increase their current savings to keep their consumption stable even in a recession. The increase in the rate of interest in the first half of the year also encouraged saving. Expectations of a slowdown in activity were also reflected in the Globes consumer confidence index and in the Google index,<sup>9</sup> which serves as an indicator of real activity in real time. Both these indices declined steeply in the second half of 2011, reflecting the public's assessment of a higher probability of a recession.

<sup>9</sup> See Tanya Suchoy (2009), "Query Indices and a 2008 Downturn: Israeli Data," Bank of Israel Discussion Paper Series 2009.06.

The drop in purchases of durables in the second half-year contributed to the 5 percent drop in imports, following their 13.5 percent increase in the first half. The decline in raw material imports also contributed to the overall fall in imports.

**The rate of unemployment reached an unprecedentedly low level, and most indicators support the assessment that in the current conditions in the labor market, the economy is close to full employment. Nevertheless, there are no pressures for increases in the real wage in excess of the increase in labor productivity.** The unemployment rate continued to decline in the second half of the year, and at the end of the year it reached its lowest ever recorded level of 5.6 percent (Figure 10). Despite the low unemployment, the real wage was stable, as it has been in the last few years (Figure 11).

The concept of full employment plays an important role in the analysis of the relation between unemployment and inflation, but due to conceptual and measurement difficulties, we cannot obtain an accurate assessment of the level of unemployment consistent with full employment. Nevertheless, the current low level of unemployment could well be expected to cause significant pressures for an increase in wages. The lack of such pressures so far is apparently the result of a combination of structural and demand factors. The former include globalization and potential competition from abroad for Israel's products, and an increase in the rate of participation in the workforce by populations characterized by low participation rates—a phenomenon which increases the flexibility of the supply of labor in the economy. On the demand side, the threats posed by the crisis and the recession abroad have led to a high level of uncertainty regarding the growth rate of the economy in coming years, and as a result, regarding the continuation of the upward trend in the demand for labor which characterized the economy in recent years.

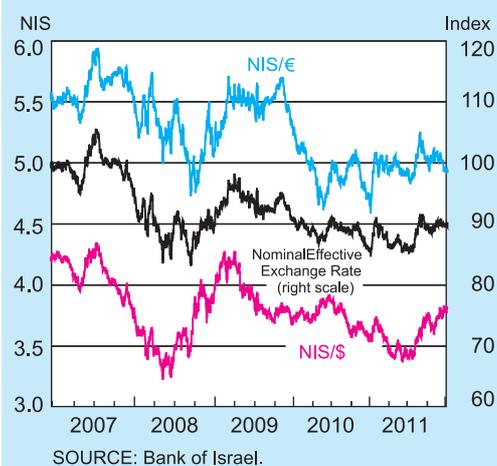
### c. The exchange rate

The exchange rate changed direction in the second half of 2011. After a trend of appreciation of the shekel in the first half of the year, and in particular in the second quarter, the effective exchange rate showed depreciation of 4.7 percent in the second half of the year (Figure 12). This weakness of the shekel derived mainly from its 12 percent depreciation against the dollar, whereas against the euro it remained steady. Since the beginning of 2011 the effective exchange rate of the shekel weakened by 4.8 percent, similar to the depreciation against the euro. Against the

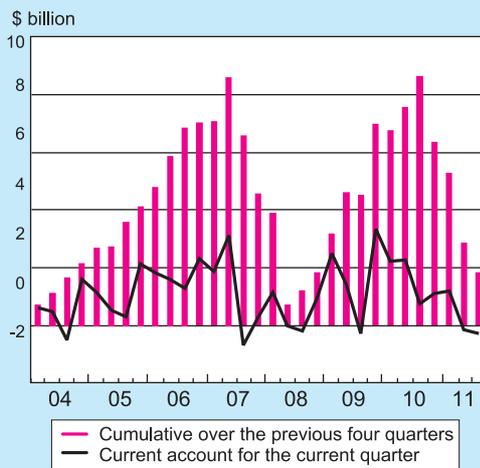
**Figure 11**  
The Real Unit Cost of Labor per Unit of Gross Product in the Business Sector in Israel, and the Real Wage 1997:Q1-2011:Q2



**Figure 12**  
The NIS/\$, NIS/Euro Exchange Rates and the Nominal Effective Exchange Rate, 2007–11 (Index, Jan 1, 2007 = 100, daily data)



**Figure 13**  
**Current Account of Balance of Payments**



Source: Based on Central Bureau of Statistics data.

dollar, the shekel depreciated more significantly, by 7.7 percent.

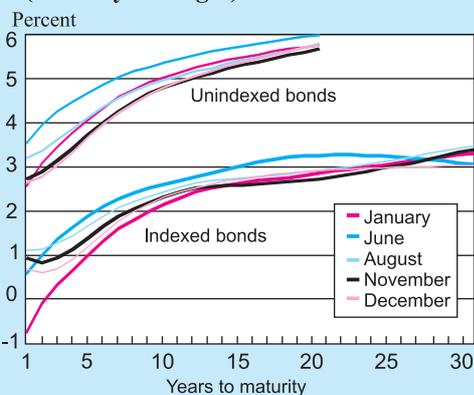
Several external and internal factors acted to weaken the shekel in the second half of the year. The main causes deriving from global developments were the drop in demand for Israel's exports and the increase in oil prices, which led to a deficit in the current account of Israel's balance of payments (see Figure 13). The main domestic factors include the contraction of the interest rate differential between Israel and abroad, which resulted from the cuts in the interest rate in Israel and which were expected to continue (based on market data and according to forecasters); the rise in Israel's risk premium with the greater political uncertainty both in the Middle East in general, and in Israel; and the continued implementation of regulatory measures intended to make it less worthwhile for foreign investors to invest in short-term shekel financial assets, particularly *makam* (the contraction of the effective interest-rate differential confronting foreign investors).

#### d. Financial developments

**In the second half of 2011, share price declines worsened.** In light of the marked rise in financial market risk around the world, share price indices in those markets dropped at an accelerated pace, and their volatility increased (Figure 6). The greater risk derived from the increased concern over a financial crisis in the eurozone, and its possible spread into other countries—a crisis that would be liable to result in a global recession. Although there was a uniformly downward trend in the global markets, there were differences in its intensity in different countries, which can be explained by their different situations and specific risks. Thus, in Israel, the general share price index dropped by 22 percent in the second half of 2011 (after falling by 5 percent in the first half), similar to the rate of decline in the emerging market economies (measured in dollar terms). The fall in Israel was steeper than those in the US, the UK and Japan, where declines of 8–10 percent were recorded, but was more moderate than in the eurozone, where the market lost a third of its value due to the increased severity of the debt crisis. The strong reaction of the domestic market compared with those in most other countries may be attributed to two main factors: the increased political uncertainty in the Middle East, and a correction after the faster increase in share prices in Israel than in the advanced economies.

Short-term risks (up to one month) that are reflected in volatility indices (VIX)<sup>10</sup> pointed to a significant rise in the risk level at

**Figure 14**  
**Yield Curves of Indexed and Unindexed Government Bonds, January, June, August, November and December 2011 (monthly averages)**



SOURCE: Bank of Israel.

<sup>10</sup> Based on Bank of Israel calculations.

the beginning of the second half of the year in most countries, particularly in Europe (Figure 7). In the final quarter of 2011 the risk indices around the world eased back to some extent, but not in Israel, apparently because here the risk level was relatively low already at the beginning of the second half of the year.

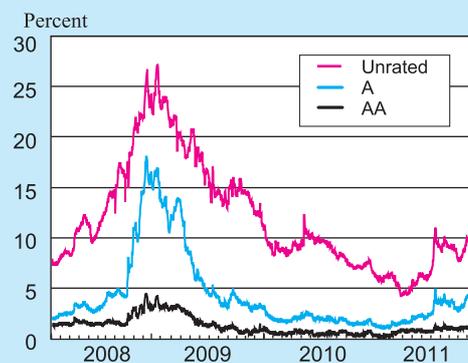
**Nominal and real yields on government bonds declined in the second half of 2011 along the entire yield curve.** Until November, the nominal yield curve declined along its entire length, with the main reductions being in the short and medium terms. The downward trend in yields for all terms was consistent with declines also in the US and Europe (in Germany, the UK and France). In the last two months of the year the decline in short-term nominal yields continued to fall, while long-term yields increased moderately, reflected in a steepening of the curve (Figure 14).<sup>11</sup> The movement of the real yield curve over the course of the second half of the year was similar to those of the nominal yield curve, though with different intensity.

The fall in nominal and real short-term yields in Israel in the last two months of the year may be attributed mainly to the two cuts in the interest rate by the Bank of Israel in the last quarter of the year, while the concurrent increase in long-term yields apparently reflects a rise in the risk level in the financial markets because of the deterioration of the European crisis.

**The yield gap between corporate and government bonds rose to a different level in the second half of the year.** For the first time since the outbreak of the financial crisis in 2008 the yield gap between corporate bonds and CPI-indexed government bonds widened significantly (Figure 15): the gap between the latter and unrated corporate bonds was twice as large as it was at the end of the first half-year, and was about 10 percentage points at the end of the year. The increase in the gap between government bonds and the bonds of more secure companies (rated A) was more modest, an increase of 1.8 percentage points, and at the end of the year the gap was about 4 percentage points. The gap vis-à-vis AA-rated companies widened by only 0.2 percentage points, to reach about 1 percentage point at the end of the year.

The increase in the yield gap reflected an increase in the risk premium on corporate bonds required in light of the market expectation of a greater slowdown in real activity of domestic companies because of the crisis in Europe. The premium is higher for companies assessed to be more likely to run into difficulties and to default. Most of the increase in the risk premium can

**Figure 15**  
**The Yield Gap between CPI-Indexed Corporate Bonds, by Rating, and CPI-Indexed Government Bonds, 2008–11**  
**(daily data)**

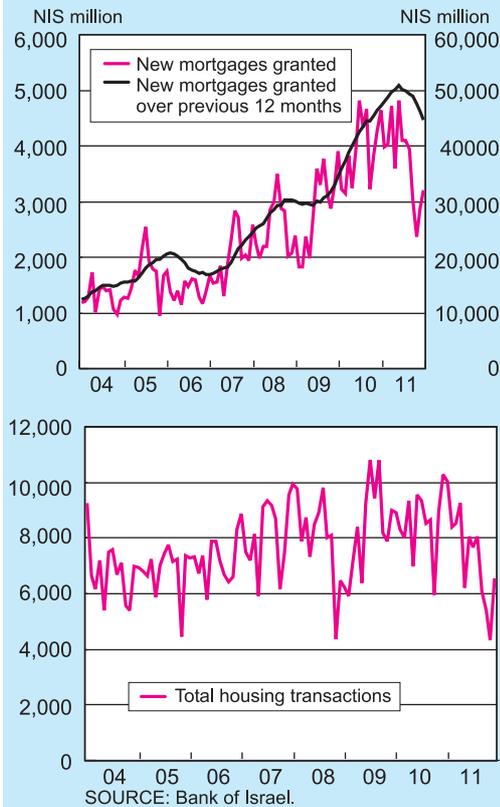


<sup>a</sup> Corporate bond yields are a weighted average of yields of CPI-indexed bonds, excluding structured bonds and convertibles; government bond yields reflect "Galil" bond yields.

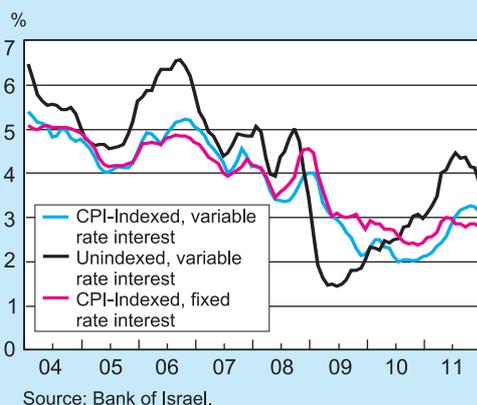
SOURCE: Based on Tel Aviv Stock Exchange data.

<sup>11</sup> The development of nominal long-term yields abroad was not uniform among countries that are not directly involved in the debt crisis, such as the US, Germany, France and the UK.

**Figure 16**  
**Total new mortgages granted in the previous 12 months, new mortgage monthly volume, and total housing transactions based on betterment tax and purchase tax, December 2003–November 2011**



**Figure 17**  
**Interest Rate on New Mortgages Granted, 2004–November 2011**



be traced to real estate companies and to very highly leveraged business corporations that are more sensitive to increased uncertainty and to a fall in the supply of credit.

**In the second half of the year a downward trend in new mortgages was evident.** The fall in demand for homes in the second half of 2011 resulted in a decline in transactions and in new mortgages granted, viewed on both a monthly and an annual basis (Figure 16). The fall in demand for homes can be explained by the public's expectation of a fall in house prices in the future, in light of steps on the supply side taken by the government, and the increase in the average rate of interest on mortgages following measures introduced by the Bank of Israel (Figure 17).

#### **Credit to the business sector**

The annualized pace of expansion of credit to the business sector has been characterized recently by relative stability, and is around two percent.<sup>12</sup> The expansion stemmed primarily from non-bank credit, while bank credit is not growing, and its rate of increase is lower than that of GDP. Since the financial crisis of 2007–09, the ratio of credit to the business sector-to-GDP has been in a declining trend. The decline of this ratio continued in the first half of 2011, but in the second half it increased slightly to 91 percent.

#### **e. Inflation and inflation expectations**

##### **Development of actual inflation**

In the second half of 2011, the CPI was unchanged (Figure 18), and on a seasonally adjusted basis it increased 0.4 percent (an annual rate of only 0.8 percent).<sup>13</sup>

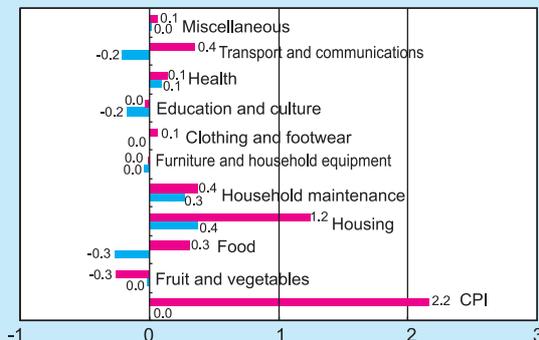
The development of the main components in the general index was not uniform over the course of the half year (Figure 18): the most significant contribution to the increase of the general index, 0.4 percent, was the housing (rents) component. Other components with important contributions to the increase in the CPI were household maintenance, at 0.3 percent, and health, at 0.1 percent. The significant contribution by the household maintenance component came primarily from an increase in electricity rates as a result of the halt in supply of natural gas from Egypt. The main factors contributing toward a reduction in the CPI were food, at 0.3 percent, and education, culture, and entertainment, and transport and communications, both of which contributed 0.2 percent. Other components had an even smaller effect.

<sup>12</sup> Data as of October 2011.

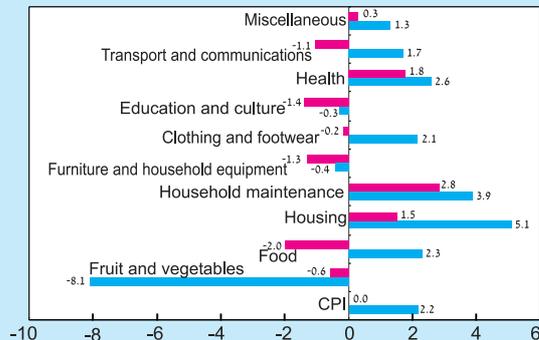
<sup>13</sup> Seasonally adjusted CPI data are based on Bank of Israel calculations.

Figure 18

**Contribution of the Components of the CPI to the Changes in the CPI in the Previous 6 and 12 Months (percentage points)**



**Changes in the Components of the CPI in the Previous 6 and 12 Months (percent)**



Legend: In previous 6 months (pink bar), In previous 12 months (blue bar)

SOURCE: Based on Central Bureau of Statistics data.

### The effect of the social protest on prices in the second half of 2011

Several indicators show that the social protest acted to moderate several components of the CPI.

#### Food prices<sup>14</sup>

Affected by the social protest, food prices (excluding fruits and vegetables) declined 8.1 percent in the third quarter of 2011 (Table 1)—the first decline in a long time—despite a marked depreciation of about 17 percent (in annual terms) that quarter. In the fourth quarter, there was only a slight increase in food prices. This development is the opposite of the trend of increasing food prices worldwide: prices increased 5.7 percent in the US and 4.3 percent in Europe during this period.<sup>15</sup> The significant decline in food prices in Israel in the second half cannot be explained by declines in agricultural commodities in the world during the previous quarters, nor by seasonal factors.<sup>16</sup> Review of the components of the food index shows that the decline encompassed most sections, but the greatest change was in dairy products, the price of which declined 20 percent. (For example, the price of cheese declined 32 percent, and the price of

<sup>14</sup> All variables are in annual terms.

<sup>15</sup> Data are in dollar terms and euro terms, respectively.

<sup>16</sup> Based on a Bank of Israel analysis.

yogurt declined 25 percent.) These data indicate that the decline in prices was largely a result of the social protest; this was seen in companies' lower markups on domestically produced items, markups which reflect monopolistic power, but was also seen in prices of imported goods.

### Housing component

For the first time after a long period, the housing component declined, unexpectedly, during the last three months of the year, by a cumulative 1.1 percent. This decline apparently stemmed from moderating forces on rent levels, influenced by a parallel decline in home prices, but apparently also from the effect of the social protest and its future repercussions, reflected primarily in expectations.

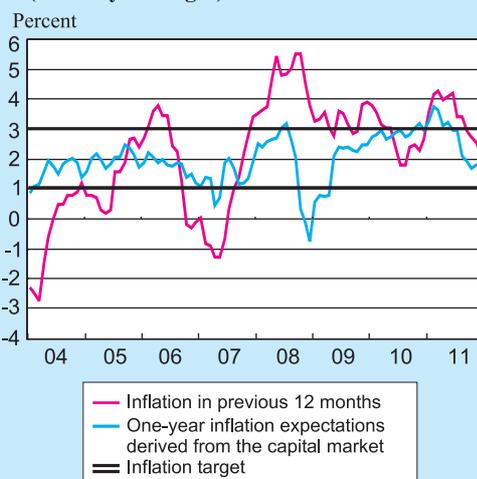
Despite the declines in prices in the domestic market that we have seen in recent months, it is difficult to know at this stage if the effect of the social protest on price levels in the economy will persist, and spread to other sectors, or if it will dissipate with time, and the economy will return to its state just prior to the protest. The continuation of the process depends primarily on the continued implementation of the Trajtenberg Committee recommendations in the areas of competition and prices.

### Communications prices

Prices of communications services declined in the second half at the greatest pace in many years, 1.5 percent. This decline stemmed primarily from declines in tariffs for landline telephony and the Internet; the declines in mobile communications are not yet reflected in the data. The declines, both actual and expected, of communications services indices are attributed to increased competition in the sector, among other things through the permitted entrance of other operators. Although the decision to allow other operators was taken before the social protest, it is consistent with the principles of the protest, some of which were to increase competition in the domestic market.

**The development of the year over year inflation rate was not uniform over the course of 2011:** The year over year inflation rate at the beginning of the year was 2.7 percent, increased to 4.2 percent by the middle of the year (Figure 19), but moderated over the course of the second half and reached 2.2 percent by the end of the year. The main reason for the moderation in inflation over the course of the second half is the slowdown in real activity, but there was also the effect of the decline in inflation expectations, which reflected expectations of moderation in economic activity

**Figure 19**  
**Inflation in Previous 12 Months,**  
**Inflation Expectations and Inflation**  
**Target Range, 2004–11**  
**(monthly averages)**



SOURCE: Based on Central Bureau of Statistics data.

over the coming year as well. The social protest, as noted, also had a moderating effect on inflation.

**The housing component (primarily representing rents) made the greatest contribution to the increase of the general index.** The most significant contribution to the development of the inflation rate in 2011, particularly in the second half, was the housing component. Its rate of increase over the past 12 months continued to be high throughout 2011, at 5.1 percent, similar to its pace in 2010. The rate of inflation excluding housing was only 1.0 percent in 2011, and in the second half of the year was even negative 0.4 percent.

An analysis by the Bank of Israel<sup>17</sup> shows that the main component of the high rate of increase of the housing component in 2011 is the shortage of homes, reflected in the increase in the ratio of population to the stock of homes. Another factor in the increase in rents is the increase in home prices in the first half of the year, which stemmed primarily from the low interest rate in the economy. Measures on the supply side by the government, and the acceleration in building starts in the past year, are expected to reduce the housing shortage, reduce prices, and thus moderate the pressure on rent levels.

**The rate of increase of home prices moderated over the course of the second half of the year.** Although home prices are not included in calculating the CPI, they do have an impact on inflation through their effect on rents. Home prices are important as well from the perspective of financial stability and real activity, particularly of the construction industry, as a sharp decline in home prices is likely to impair the stability of the banks and to have a negative impact on supply in the construction sector, as occurred in the US and other countries.

The annual rate of increase of home prices moderated over the course of 2011, as well as in the second half, from an increase of about 15 percent at the end of 2010, the rate of increase declined to 12 percent at the beginning of the second half, and reached 7 percent by the end of the year. Consistent with these developments, the ratio of home prices to rent levels continued to increase over the course of the year, though at the end there are some indications of a moderate decline of this ratio (Figure 20).

In the final quarter of the year, for the first time in a long while, home prices declined. The decline, 1.5 percent, indicates the possibility of a turnaround in their development. It appears that this is the result of steps to moderate demand through monetary policy, steps that the government has recently taken to increase

**Figure 20**  
**Owner-Occupied House Prices and**  
**Rents, CPI-Adjusted**  
**2000 to December 2011**  
**(Index, January 2005 = 1)**



<sup>17</sup> This analysis is based on a research paper by Weitzman Nagar and Guy Segal (2011), "What explains the developments of home prices and rents in Israel, 1999–2010", Bank of Israel.

supply—along with expectations that the policy will continue in the future, and possibly pressures of the social protest as well.

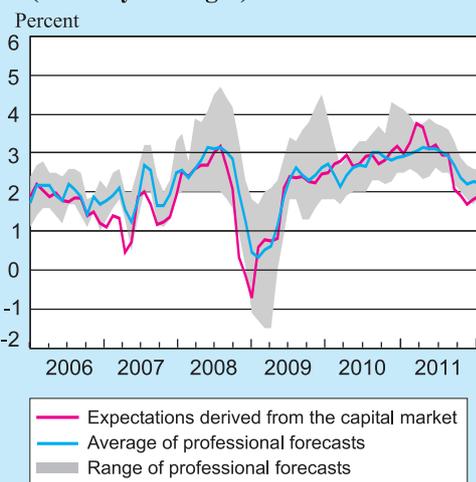
It follows from the Bank of Israel analysis noted above (Footnote 17) that the primary factor in the moderation of the increase in home prices over the course of 2011 is the increase in the monetary interest rate through the beginning of the second half of the year, and the limitation imposed on the share of a mortgage loan based on the prime rate. The strong impact of the changes in the monetary interest rate reflected the considerable weighting of unindexed (prime), floating rate interest mortgages taken out at the time. Nonetheless, the limitation, imposed by the Bank of Israel, on the floating rate (up to 5 years) component's share of a mortgage to one third of the total loan, reduced the transmission from the monetary interest rate to home prices, and increased the transmission from long term, indexed, interest rates. The moderation in the rate of inflation, and particularly in the increase in home prices—possibly even their decline—allows the Bank of Israel to reduce the interest rate in order to diminish the slowdown in real activity.

**Expectations of inflation over the next 12 months declined during the second half, to the middle of the target range.** Great importance is attached to the examination of capital market expectations, and forecasters' expectations, since they serve as an indicator of company decisions regarding the prices of their products, and thus have an effect on the rate of inflation in the economy. At the beginning of the second half, inflation expectations derived from the capital markets were 3 percent, at the upper limit of the target range (Figure 21). In August, expectations declined markedly, to the middle of the range, 2 percent. They continued to decline at a moderate pace through October, when they reached 1.7 percent; by the end of the year, they returned to the middle of the target range. The concurrent declines of inflation expectations and of the expected Bank of Israel interest rate in a year from now indicate that for the coming year, the market assigns considerable weight to the decline in demand and the slowdown in domestic real activity, which stemmed primarily from the global slowdown. Also contributing to the decline in inflation expectations were moderating forces which came against the background of the social protest and the expected implementation of the Trajtenberg Committee recommendations.

Professional forecasters' projections of inflation and the interest rate over the course of the second half of 2011 were similar to those of the capital market (Figure 21).

**Expectations for medium and long terms were at the**

**Figure 21  
Inflation Expectations for the Next Year Derived from the Capital Market and According to Professional Forecasters, 2006–11<sup>a</sup>  
(monthly averages)**



<sup>a</sup> As of April 2007, expectations for 1 year are based on 1 year makam rates compared with the entire real yield curve (which takes into account every series of indexed bonds).

SOURCE: Based on professional forecasters' reports and capital market data.

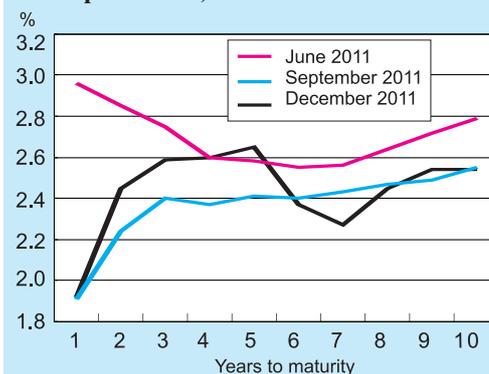
**limits of the target range throughout the half year reviewed.**

Inflation expectations declined, for all terms, and reflected a decline of the inflation environment as viewed by the public (Figure 22). The expected rate of inflation in the 2–3 year range was 2.8 percent at the beginning of the second half of 2011, and declined to 2.5 percent by the end of the year. Inflation expectations for the coming 4–6 years and 7–10 years began the half at 2.6 percent and 2.7 percent, respectively, and at the end of the year they declined to 2.6 percent. It should be noted that these expectations, as derived from the capital market, include an inflation risk premium, so that the real expectations of the public are lower.

## 2. MONETARY POLICY

**In the half year reviewed, there was a turnaround in monetary policy compared with the first half of the year: In light of the slowdown in growth in Israel’s economy—against the background of Europe’s slide toward recession and the concern of a financial crisis, which would lead to an additional slowdown in global growth—the Bank of Israel halted, in the third quarter of 2011, the trend of interest rate increases, a trend which had begun in mid-2009, when the interest rate was 0.5 percent.** In the middle of the half year reviewed, signs of a slowdown in the Israeli economy were noted, against the background of a worsening of the slowdown in global real activity, and a significant increase in the risk of a financial crisis and global recession. As such, the Bank of Israel reduced the interest rate twice, by 0.25 percentage points each time, for October and December, and at the end of the year the interest rate was 2.75 percent. Against the background of the intensification of the slowdown and the high level of uncertainty, the Bank of Israel reduced the interest rate in the beginning of 2012 as well, by 0.25 percentage points. The interest rate reductions were facilitated by a moderation in the inflation environment: the actual annual rate of inflation declined from 4.2 percent at the beginning of the half year to 2.2 percent at its conclusion, and all indicators—including inflation expectations derived from the capital markets and those of forecasters, as well as assessments by the Bank of Israel Research Department—pointed to a decline in expected inflation. Under these economic conditions, the Bank of Israel’s interest rate reduction was intended to support domestic real activity, while maintaining inflation within the target range. The reduction in the interest rate also had a moderating effect on medium and long term bond yields, though it was not as great as

**Figure 22**  
**Long Term Forward Inflation**  
**Expectations, June-December 2011**



Source: Bank of Israel

the effect of the decline in yields on bonds with similar maturities abroad. The decline in yields for medium and long terms made it a bit easier for companies to raise funds in the half year reviewed, and is likely to reduce the costs of large scale recycling of debts expected in 2012.

One of the important inputs which the Bank of Israel uses in setting the monetary interest rate is the Research Department's staff forecasts. These forecasts, which are based on a wide range of data sources on the global and domestic economy, are compiled with the aid of a macroeconomic model developed by the Research Department, and also reflect the views of the economists working on them.

During the period reviewed, the forecasts of the rate of growth of GDP in 2012 were lowered, primarily due to the expected decline of global demand for Israeli exports, and also following an expected decline in domestic demand. In the beginning of the second half, the GDP growth forecast for 2012 was 3.9 percent, in the middle of the period it was reduced to 3.2 percent, and by the end of the period it declined further, to 2.8 percent. As a result of the expected slowdown in the rate of growth, the forecast rate of inflation in 2012 was also reduced, from 2.6 percent at the beginning, to 2.2 percent in the middle, and to 2.1 percent by the end. The forecasts for activity and for the inflation rate are based on the combined effects of current monetary policy, expected policy in the future, and the current rates of economic growth and inflation. The forecasts in the period reviewed are in line with an expected decline in the monetary interest rate, which is intended to support economic activity while maintaining price stability. The forecast Bank of Israel interest rate at the end of 2012 was reduced from 4.3 percent at the beginning of the half to 2.25 percent at the conclusion.

In the interest rate decisions over the course of the half year reviewed, the Bank of Israel faced a dilemma regarding the magnitude and frequency of interest rate cuts. On the one hand, realization of the risk of a relatively severe hit to real activity, with a decline in the inflation rate—primarily the worsening of the recession in Europe, leading even to a global recession—would indicate that a more significant reduction in the interest rate would already have been required, in order to provide timely support for domestic demand, while maintaining moderate inflation and financial stability. This is because monetary policy has lagged effects on real activity. In contrast, in the case of the occurrence of the main forecast of a less sharp slowdown in activity, an overly expansionary monetary policy would lead to a significant and extended deviation of actual inflation and

of inflation expectations from the upper bound of the target range<sup>18</sup>, with a negative impact on the credibility of the central bank. Beyond that, such a step would likely have brought about a renewed increase of home prices, which remain high. In the conditions which existed in the economy, i.e., an inflation environment which was moderate, but not low, and considerable uncertainty regarding the situation of real economic activity in the world in general, and in Israel in particular, the Bank of Israel implemented cautious policy to balance these two risks—a measured reduction of the interest rate.

Aside from the interest rate, monetary policy made use of additional tools, in order to meet the targets set by the Bank of Israel law – primarily price stability, support for real activity, financial stability, and reduction of social gaps. The steps taken in the foreign currency market were intended first and foremost to moderate the volume of capital flows and reduce the risk of sharp changes in the exchange rate. In 2011, these steps led a moderation in the forces acting toward appreciation of the shekel, which supported exporters and financial stability. The Bank of Israel also continued macroprudential policy in the housing market, in order to maintain the stability of the financial system and avoid a blow to the construction sector.

In the half year reviewed, directives which were imposed on the foreign currency market and housing market in the first half of 2011 remained in place<sup>19</sup>: in the foreign currency market, there was a reserve requirement on nonresident transactions in foreign currency derivatives, and they were required to report transactions in *makam* and short term debt securities; in the housing market, the share of the variable interest rate component of a mortgage was limited to one third of the total loan.

In the second half of 2011, the Bank of Israel did not intervene in the foreign currency market<sup>20</sup>, in light of the assessment that the path of the shekel's depreciation is in line with basic economic forces – the slowdown in economic activity and in inflation; this was in contrast to the situation in the first half of the year, when there were strong forces working toward shekel appreciation, and the Bank of Israel intervened in the market, and even enacted, as noted, regulatory measures. Likewise, the cancellation of the tax exemption on nonresidents' investments

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<sup>18</sup> Based on Research Department assessments.

<sup>19</sup> For details on the measures, please see the Monetary Policy Report for the first half of 2011.

<sup>20</sup> There was a one time purchase in July.

in *makam* and short term bonds was implemented.<sup>21</sup> Although this step has only a small effect in reducing the effective interest rate spread that nonresident investors see, because of tax treaties between Israel and other countries, it signals to the public that policy makers are determined to take additional steps, and even harsher ones, in order to moderate forces of appreciation, should they strengthen.

**Fiscal policy maintained the expenditure path set in the budget for 2011. The decline in tax revenues as a result of the slowdown in activity was reflected in a deficit which was somewhat above the ceiling set by law.** In the beginning of the half year reviewed, there was a decline in direct tax revenues collected, in addition to the trend of a decline in indirect tax collection, which had already begun in the first half of the year. After high tax revenues in the first half of 2011, total revenues in the period reviewed were lower than the seasonal path forecast in the budget, and in real terms were lower by about one percent than the corresponding period of the year before. The moderation in tax collection reflected a slowdown in real activity. Since government expenditures from the beginning of the year were also a bit lower than the path consistent with full performance of the budget, the government deficit totaled 3.3 percent of GDP – only about 0.3 percentage points above the ceiling set.

Maintaining fiscal discipline in recent years led to a high level of credibility, and provided monetary policy some maneuvering room in dealing with the consequences of the global crisis on the economy. As such, it enabled reaching the targets with high efficiency.

The risk of an increase in the deficit for 2012 stems primarily from the possibility of deterioration in real activity in the domestic market, which will lead to a shortfall of tax revenues relative to budget projections, from the possibility of increased defense expenditures against the background of a deterioration in the geo-political situation, and from increased expenses related to the social protest. The government should avoid having overall expenditure deviate from the ceiling set by law, even in the case of these risks transpiring.

<sup>21</sup> The decision was reached by the Ministry of Finance together with the Bank of Israel.

**Appendix Table 1**  
**The Domestic Assets Markets, (rates of change)**

	07/11	08/11	09/11	10/11	11/11	12/11
<b>Yields to maturity (monthly average, percent)</b>						
3-month <i>makam</i>	3.2	3.1	2.8	2.7	2.7	2.6
1-year <i>makam</i>	3.5	3.2	3.0	2.8	2.8	2.6
Unindexed 5-year notes	4.5	4.1	3.9	3.8	3.7	3.7
Unindexed 20-year bonds	5.9	5.8	5.8	5.7	5.7	5.8
CPI-indexed 1-year notes	0.5	1.1	1.0	1.1	0.9	0.7
CPI-indexed 5-year notes	1.7	1.7	1.6	1.4	1.4	1.2
CPI-indexed 30-year bonds	3.2	3.5	2.9	3.0	3.4	3.0
Yield gap between government bonds and:						
private bonds rated AA–AAA <sup>a</sup> (percentage points)	1.1	1.4	1.6	1.4	1.6	1.6
private unrated bonds excluding real estate <sup>a</sup> (percentage points)	12.4	13.9	15.4	16.3	15.1	
<b>Stock market (percentage change during the month)</b>						
General share price index	-0.8	-9.5	-6.1	7.1	-3.2	0.1
Tel Aviv 25 index	0.0	-7.5	-4.8	5.2	-4.5	0.3
<b>Foreign currency market (percentage change during the month)</b>						
NIS/\$	0.4	3.7	4.3	-2.9	5.2	0.7
NIS/€	-1.0	5.0	-1.9	0.0	0.1	-2.2
Nominal effective exchange rate	0.3	3.7	0.0	-1.0	2.1	-0.5
<b>Risk measures derived from the trade in NIS/\$ options on the Tel Aviv Stock Exchange (monthly averages, percent)</b>						
Implied volatility	10.2	12.0	11.7	10.4	11.1	10.7
Probability of depreciation greater than 3%	8.4	11.9	12.0	8.6	12.4	11.7
Probability of appreciation greater than 3%	1.7	3.9	3.1	2.5	2.5	1.9

<sup>a</sup> The calculation has changed from previous reports to CPI-indexed bonds, excluding convertibles, with a yield of up to 60 percent and a duration longer than six months.

The gaps between each series of corporate bonds and Galil bonds with the corresponding duration.

SOURCE: Bank of Israel.

**Appendix Table 2**  
**The Inflation Environment and Interest Rates**

	(monthly averages, percent)					
	07/11	08/11	09/11	10/11	11/11	12/11
<b>Inflation environment (percent)</b>						
Monthly change in CPI	-0.3	0.5	-0.2	0.1	-0.1	0.0
Forecasters' predictions of monthly CPI (average of forecasts prior to publication of CPI)	0.4	0.2	0.4	0.0	0.1	0.2
12 month change in CPI	3.4	3.4	2.9	2.7	2.6	2.2
One-year inflation expectations derived from the capital market	3.0	2.1	1.9	1.7	1.8	1.9
Forecasters' one-year inflation predictions	2.9	2.7	2.4	2.2	2.2	2.3
<b>Inflation expectations for various terms</b>						
Short term (second and third years forward)	2.8	2.5	2.3	2.3	2.4	2.5
Medium term (fourth to sixth years forward)	2.6	2.5	2.4	2.6	2.4	2.5
Long term (seventh to tenth years forward)	2.7	2.5	2.5	2.7	2.6	2.4
<b>Interest rates and interest rate differentials</b>						
Bank of Israel interest rate	3.25	3.25	3.25	3.00	3.00	2.75
Short-term interest rate differential between Israel and the US (prior to decision on the next month's rate)	3.00	3.00	3.00	2.75	2.75	2.50
Short-term interest rate differential between Israel and the eurozone (prior to decision on the next month's rate)	1.80	1.75	1.75	1.50	1.73	1.69
Forecasters' predictions of change in monetary interest rate for next month (prior to the decision)	0.0	0.0	-0.1	0.0	-0.2	-0.1
Forecasters' predictions of interest rate a year hence	4.3	3.9	3.4	3.0	2.9	2.6
Long-term (10-year) nominal interest rate differential between Israel and US	2.3	2.7	2.9	2.6	2.8	2.8
Long-term (10-year) real interest rate differential between Israel and US	2.0	2.3	2.4	2.1	2.4	2.4

<sup>a</sup> Inflation expectations are measured by the difference between yields on local currency unindexed and indexed bonds. These expectations include an element of risk premium, which rises with the length of the term to which the expectations relate.  
 SOURCE: Based on Central Bureau of Statistics data and private forecasters' reports.

