Bank of Israel

Report to the public of the Bank of Israel's discussions prior to setting the interest rate for August 2006

The broad-forum discussion took place at the Bank of Israel on 23 July 2006, and the narrow-forum discussions on 23 and 24 July 2006

General

The process by which the Governor makes the monthly interest rate decision consists of discussions at two levels; the first in a broad forum, and subsequent discussions in a narrower forum. In the broad forum the relevant background economic conditions are presented; these include real and monetary-financial developments in Israel's economy, and developments in the global economy. Participants in this discussion include the Governor, his deputy, the directors of the various economic departments in the Bank (the Research Department, the Monetary Department, the Foreign Currency Department, and the Foreign Exchange Activity Department), and economists from the different departments who prepare and present the material for discussion.

In the narrow forum, the department heads present their recommendations regarding the interest rate decision, and following a discussion of the possible courses of action, the Governor makes his decision.

A. THE STATE OF THE ECONOMY

1. Developments on the real side

General

In assessing the state of the economy on the real side, attention was paid to the situation before the outbreak of hostilities in the north and the initial assessments of its affect on activities.

The state of the economy prior to the outbreak of fighting in the north: The latest National Accounts data for the first quarter of 2006, together with current data on economic activity, point to continued rapid growth: an increase of 6 percent in GDP (in annual terms) and an increase of 7.7 percent in the business product[1]. This growth was led by an increase in domestic demand.

According to the Bank of Israel's Companies Survey, all industries reported a continued rise in activity in the first quarter, with the manufacturing, commerce, business services and hotel industries reporting relatively strong growth in activity

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[1] In the most recent revision of the National Accounts, the Central Bureau of Statistics changed the definition of GDP to make it conform to the accepted international definition. According to the previous definition, GDP increased in the first quarter by 6.3 percent (in annual terms).

while transport and communications and construction saw more modest growth. The leading index of the Companies Survey pointed to a high likelihood of further expansion of activity in the third quarter of 2006. It should be noted that this leading index was based on companies' expectations for the coming quarter, surveyed before the outbreak of fighting in the north.

Initial assessments of possible implications of the hostilities in the north on the state of the economy: The fighting in the north brought about the cancellation of almost all tourist activities in the area at the height of the summer season, and to the partial or complete shutdown of most industries in the north. From past experience, in such circumstances foreign tourism is generally affected fastest and more sharply and recovers slowly after an improvement in the security situation. As a measure, a drop of 50 percent in incoming tourism in the third and fourth quarters of 2006 would lead to a contraction in GDP of 0.4 percent. Assuming that the fighting will continue for a month, and given that about 15 percent of business sector activities is in the north—with part of this shut down either completely or in part—we can estimate that the loss of GDP, beyond the affect on tourism, will be about 0.5 percent. An escalation of the fighting could affect real activities also through an indirect affect on major macro variables such as investment and private consumption. Exports could also be affected, beyond the damage to the export of tourist services. However a fast and successful completion of the fighting would result in relatively minor damage to the economy.

Indicators of economic activity

The composite state-of-the-economy index rose by 0.7 percent in June, prior to the outbreak of fighting in the north. The manufacturing production index showed a continuing positive trend. The increase in the composite index was a result mainly of increases in the manufacturing production index and the index of trade and services revenue. This was partly moderated by a fall in the import of goods.

Foreign trade and balance of payments data

Foreign trade figures for the export of goods (excluding diamonds, in current dollars) point to a continued positive trend for exports, a trend that began in recent months after some slowdown in the export of goods in the second half of 2005. Imports of goods (excluding diamonds, fuel, ships and planes) showed a continuation of a moderately increasing trend led by the imports of raw materials. Imports of investment goods showed no rising trend. This was apparently due to the fall in imports of security goods which are partly registered as imports of investment goods. Furthermore, the rate of increase that began in recent months in the imports of consumer products, was less than 5 percent (in annual terms).

Labor market data

Labor market data for March and April point to a rise of almost 5 percent in wages per employee post, compared to a rise of 5.3 percent in the business sector in the parallel period last year. This rise was led by the business services, banking and manufacturing industries. Given that the business sector registered the same rise in wages (compared to the parallel period of last year) in January and February, the rise in wages is not seen as a result of one-off payments such as bonuses or payments prior to privatization, but expresses a rise in employee wages in these industries. In public services the rise in wages was a more moderate 3.2 percent.

2. Budget data

In the first half of 2006 there was a cumulative surplus of NIS 4.7 billion in the general government budget (excluding the provision of credit), reflecting a higher level of tax revenues than that forecast in the budget and a lower level of spending, seasonally adjusted. As a result, the budget deficit is expected to total between 0.5 and 1 percent of GDP (an estimate made prior to the outbreak of hostilities in the north). The fighting in the north is expected to lead to a rise in expenditure on current defense spending and a fall in tax income following the impact on activity, though it is still too early to gauge the effect.

The government has expressed its intention of maintaining its budget targets for 2007. Accordingly increases in expenditure as a result of the fighting will need to lead to a change in spending priorities but no change in total government spending.

Total income from taxes (discounting for legislative changes and one-time revenues) grew in real terms in the second quarter by almost 8 percent (compared to the parallel quarter of last year). This follows a 10 percent rise in the first quarter. The increase in income from taxes was led by the increase in income from direct taxes, against the background of a rise in wages and in profits for companies and the self-employed. The rise in income from indirect taxes was more moderate.

3. Economic developments, nominal

Inflation

The Consumer Price Index rose by 0.1 percent in June, and by 3.5 percent in the past 12 months. The increase in energy prices in the past 12 months contributed 1 percent to the increase in the index. The CPI for June was higher than forecast by the Bank of Israel and the average expectations of private forecasters. Components of the index that rose by more than forecast were housing, clothing and footwear, and food.

In the first half of 2006 the CPI increased at an annual rate of 2.7 percent (seasonally adjusted), which is near the upper limit of the inflation target range (1-3 percent). During the first half, energy prices contributed about 0.7 percent of the rise in CPI (or 1.4 percent in annual terms), while the appreciation of the NIS in the same period contributed to a moderation of the rise in the CPI. The fall in demand likely to result from the fighting in the north—principally through a decline in private consumption and investment—will moderate the rise in prices. In the short term, the reduction in activity will also reduce supply, and is expected to lead to a rise in selected prices (for example, fruit). The rise in the economy's risk premium tends to reduce the pressures for the appreciation of the NIS, thereby putting pressure on prices.

Expectations and forecasts of inflation

Inflation expectations for the next 12 months derived from the capital market in July (up to July 11, before the outbreak of hostilities in the north) stood at 1.7 percent. The average inflation expectations derived from the capital market after the outbreak of fighting rose slightly, apparently expressing a modest rise in the risk premium concerning possible developments of prices in the economy. Breakeven inflation rates for the medium and long terms (up to 10 years) are near the upper limit of the inflation target range, at 2.7 percent on average; taking into account estimates of the risk premium, expected inflation is probably around 2.2 percent.

Forecasters' expectations of inflation in the next 12 months increased following the outbreak of hostilities in the north by about 0.6 percentage points to an average of 2.3 percent. The range of forecasts is wide, stretching from 1.8 to 3.0 percent. Their forecast for inflation in the coming months were also adjusted upward by an average of 0.3 percentage points. Average forecasts for July expect a fall of 0.1 percentage points in the CPI and for August an average increase of 0.4 percentage points.

Expectations and forecasts of the Bank of Israel interest rate

As derived from the average *makam* curve for July, the interest rate is expected to rise by about 0.4 percentage points over the next 12 months.

Forecasters raised their assessments of raises in the interest rate following the outbreak of fighting in the north, and these now (as of July 23) stand at an expected rise of 25 basis points in August and a further 25 basis point-raise in interest in September. The forecasters also predict that the Bank of Israel will raise rates by a further 25-50 basis points by the end of the year. In 12-months hence, they expect, on average, that the interest rate will reach 6.25 percent compared to their previous forecast of 5.75 percent.

The makam market and the bond market

Developments of nominal and real yields in the government bond market were relatively stable in July, after a trend of rising yields in the first four months of the year. Nominal and real long-term yields reached 6.5 and 4 percent, respectively. The relative stability of yields continued after the outbreak of fighting in the north and was influenced by the government budget surplus in the first half of the year.

Interest-rate differential and yield gap between Israel and abroad

The interest rate differential between the Bank of Israel rate and the US Federal Reserve rate contracted to zero after the Fed raised its rate by 25 basis points at the end of June, in line with expectations. Market expectations (as of July 23) are that the Fed will raise its rate a further 25 basis points in August though the probability that the markets ascribe to this raise has fallen. In addition, the expectations are that if the rate is raised, this will be the last in a session of interest rate rises that began two years ago.

Nominal yield gaps between Israel and the US for five- and 10-year terms continued to contract in July, reaching 1 and 1.2 percent respectively. Real yield gaps for these terms also contracted in July both reaching 1.3 percent. However there was some rise in these gaps after July 15.

Expected real interest rate
The expected short-term real interest rate on Bank of Israel sources, which has been on a rising trend since the last quarter of 2005, stood at 3.5 percent in July, compared to an average 2.7 percent at the start of the year.

The money supply
The annual rate of increase of the money supply (M1) has been on a downward trend since the beginning of the year, and stood at 15.5 percent in June. This is still though a higher rate than the forecast GDP growth rate with the expected rise in prices. Since the beginning of the year, the cash component of the money supply increased by 5 percent, while the checking account component increased more moderately by 1.6 percent.

The annual rate of increase of broad money (M2) continued to fall in June and was slightly below 3 percent.

The annual rate of growth of total banking credit (C3) in the first half of the year reached about 7 percent on average, against the background, *inter alia*, of a continued rapid growth in the economy and a fall in the rate of increase of nonbanking credit sources.

The econometric models[2]
Various scenarios that were examined using econometric models developed by the Bank of Israel show that the rise in the prices of imported goods, particularly energy prices, constitutes a factor for continuing price increases. The main channel by which the fighting affects inflation is through its effect on the exchange rate. In various scenarios some increase in the interest rate is required during the year in order to keep inflation within the target range.

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

Capital flows
In the past month nonresidents were net sellers of bonds and shares on the Tel Aviv Stock Exchange. In contrast, falling prices in the emerging markets led Israeli households to sell investments in mutual funds specializing in foreign investments, leading to a net inflow of capital to the economy. In addition, institutional investors reduced their investments overseas compared to previous months.

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[2] The Bank of Israel uses results of various scenarios derived from econometric models. Due to the nature of the models, including the fact that their results naturally depend on certain assumptions about relevant variables, these scenarios are taken as just one among several inputs in the discussions on the interest rate.

The foreign currency market

From the discussion on the policy rate for July (on June 26) until the outbreak of fighting in the north, the NIS strengthened against the dollar by 1.8 percent against a background of a weakening dollar globally and a continued inflow of capital into the economy. In the first three days of fighting the NIS weakened by 3 percent with daily volatility increasing sharply from 6 percent to about 12 percent. With the outbreak of hostilities daily trading volumes soared, reaching a new record of $ 3.4 billion (compared to an average daily trading volume of $ 1 billion in 2005), and daily spreads reached a high level of 10 agorot. Despite this, there was no halt in normal trading and there were no signs of market failures. After a number of days the trends moderated and the exchange rate stabilized around NIS 4.46 to the dollar, showing a depreciation of around 2 percent since the outbreak of the fighting.

High levels of activity were also recorded on the side of foreign investors during the period of fighting in the north, with their buying more than $ 1 billion net. The share of nonresident activity in market activity increased since the outbreak of fighting and reached an average of 33 percent, compared to an average of 28 percent in the second quarter of 2006 and 21 percent in 2005.

The share market

After the outbreak of fighting in the north, the stock market saw increased volatility and the leading indices, which fell initially by around 12 percent, later made some recovery, such that the overall fall in indices from July 12 to July 20 was 6 percent.

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

Israel's risk premium, as measured by the 5-year CDS spread, increased in the week following the outbreak of fighting in the north by 7 basis points to 37 bp. Ten-year CDS spread increased by the same amount. Trends were mixed in other emerging markets.

Credit rating agencies Fitch and Standard & Poor's published updates on the latest developments in Israel in which they kept Israel's credit ratings unchanged and the economic outlook at "Stable". In their announcements, the agencies noted the Israeli economy's strong starting point which, together with a responsible fiscal policy, is expected to limit the negative economic implications of the hostilities.

The reviews of foreign investment houses published after the outbreak of fighting expressed confidence in the Israeli economy and noted that for as long as the fighting did not escalate and that the government maintained its budget framework, the negative economic implications of the fighting were limited. Furthermore they stressed that despite the slight impact on the economy, the NIS was not expected to continue weakening.

6. Developments in the global economy[3]

Global growth remained strong, though the rate of growth is expected to slow down, particularly in light of the expected fall in US domestic demand. Nevertheless, most forecasts point to a "soft landing" of the US economy. The expected slowdown in the US will be moderated by faster growth in the euro zone, Japan and the emerging markets. Global inflation has increased modestly and is expected to be 3.3 percent in 2006 and to fall slightly during 2007. However rising prices of energy and goods raise the risk of global inflation.

B. NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR AUGUST 2006

The discussions this month took place against the background of the fighting in the north and the possible implications for the Israeli economy, both on real activity and on inflation and the financial markets Basic economic data are strong, and, according to the indicators in general prior to the fighting, point to rapid growth in the economy. Rapid growth leading to a narrowing output gap, and higher import prices, particularly energy prices created inflationary pressures. The impact of these factors on prices was partly tempered by the continued appreciation of the exchange rate, particularly as a result of the current account surplus and long-term capital inflow to the economy by nonresidents. At the time of the meeting the 12-month inflation rate stood at 3.5 percent, above the upper limit of the target inflation range of 1-3 percent a year. Prior to the outbreak of fighting, the assessment was that the 12-month inflation rate would return to within the target range in the coming month, despite the inflationary effects of growth and higher import prices. This was based mainly on the assumption that the factors behind the NIS' appreciation would continue.

The discussion concentrated on the possible effects of the fighting on the economy's real activity, on inflation, on the foreign currency market and on the financial system, and covered also the factors that could determine the strength of these effects. The aim was to obtain the clearest macroeconomic picture possible given the uncertainty surrounding the fighting and its outcome.

With the economy on a path of continued rapid growth and a narrowing output gap, the fighting has added uncertainty over this growth and its strength. The effects of the fighting depend in large part on its military and geopolitical outcome. Even assuming a rapid and successful end to the hostilities, the fighting will likely affect both the supply side of the economy—that is the economy's production capacity—and the demand side, in light of the effects of greater uncertainty and fall in income on private demand. According to Bank of Israel calculations the damage to real activity is expected to total up to 1 percent of GDP. The major harm on real activity will be felt through tourism. Even after the security situation improves, recovery of incoming

[3] Further details on the major developments in the US, Europe, Japan and the emerging markets are presented in the appendix.

tourism is slow. A further component is the shutdown of economic activity in the north.

Until the outbreak of fighting in the north, the economy enjoyed an inflow of long-term capital through the surplus in the current account of the balance of payments, which reached around an annual rate of $ 3 billion in the first half, and from an inflow of foreign investment. All of this encouraged an appreciation of the NIS. The fighting in the north is expected to affect this trend, given the possible reduction in foreign investment and current account surplus, particularly through the possible drop in tourism. The measure of the damage is also dependent on the developments of the fighting and its outcome, though assuming a quick and successful end to hostilities, the damage will be relatively moderate.

The financial markets reacted with stability to the events in the north. Though share prices fell and the NIS depreciated, these changes occurred within the first few days of fighting. Afterward, the cumulative drop in share prices contracted and the exchange rate strengthened somewhat. During the whole period of the fighting the markets functioned well, with particularly high volumes of trade, especially in the foreign exchange market. This picture is based probably on the firm economic foundations of the Israeli economy, investors' confidence—both nonresident and local—in macroeconomic policies and the assessment of a quick and successful end to the fighting. In this context, it was very important that the government declare its commitment to the budget framework for 2006 and 2007, despite the expected increase in certain expenditure items connected with the fighting and its economic implications, and a decline in tax income given the possible affect on activity.

Against the background of fighting in the north Israel's risk premium increased, albeit at a relatively modest rate. Since the outbreak of hostilities, the CDS index increased only moderately, and the credit rating agencies and investment houses which reexamined the Israeli economy did not change their assessments. It is important to note that according to them, the economy's commitment to pursue its macroeconomic policies was the most important factor affecting their decision. The 10-year interest rate gap with the US also rose by 15 basis points.

As for inflation, apparently the factors that up to now have created pressure on inflation—these being the effects of continued fast growth and the increase in import prices, particularly energy prices—are continuing to operate. If the inflow of capital into the economy—which led to an appreciation of the NIS and hence a moderating force on prices—does contract, then the factors pushing prices up will be stronger than before. The long-term possible damage of the fighting on private sector demand will create a moderating force on price rises. However in the short term, the effect will be to raise prices given the more immediate impact on supply.

Some of the participants in the discussion recommended that the Governor raise the interest rate for August by 25 basis points. They were of the opinion that the factors creating inflationary pressures were expected to continue, while the factors moderating the rise in prices would subside, and that while the possible slowdown in activity would be a moderating force on prices, this effect would not be present in the immediate term. Furthermore, and more importantly, they believed that it was important to take the increase in Israel's risk premium into consideration. It is important to note that the extent of the increase in the risk premium depends on policy responses, both fiscal and monetary. Therefore, they argued, current circumstances dictate a raise in the interest rate as part of this policy in order to maintain price stability, according to the inflation target, and to support the financial stability of the economy. By so doing, these participants argued, the Bank would contribute to strengthening the future growth of the economy.

Some of the participants in the discussion recommended that the Governor leave the interest rate for August unchanged. They were of the opinion that greater weight should be given to those factors acting to moderate the rise in prices relative to others, and to the stability demonstrated by the financial markets even at a time of hostilities. The probability that stability would continue was high, and the expected reduction in capital inflows and the rise in the economy's risk premium in the eyes of investors, would be moderate. Furthermore, the impact of capital movements on the exchange rate, and through that on prices, would continue to be moderate. The possible damage of the fighting on real activity, principally through a fall in demand, will also act to moderate the rise in prices and therefore these participants believed that the interest rate at the time of discussion could maintain price stability.

The Governor decided to raise the interest rate by 25 basis points to 5.5 percent for August. In reaching this decision, the Governor ascribed a decisive weight to the rise in the economy's risk premium, in light of the fighting, and also to the continuation of inflationary factors that had operated in the first half of 2006. The Governor was of the opinion that this decision would increase the chances of a rapid recovery from the estimated damage to economic activity as a result of the fighting and after it is over. This was an important step in an overall macroeconomic policy that contributes to strengthening the infrastructure for sustainable growth in the economy while maintaining price and financial stability.

The decision was made and published on July 24, 2006.

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. Edward Offenbacher, Director of the Monetary Department
Barry Topf, Director of the Foreign Currency Department
Balfour Ozer, Director of the Foreign Exchange Activity Department
Dr. Karnit Flug, Director of the Research Department
Ohad Bar-Efrat, Head of International Affairs and Advisor to the Governor
Gaby Fiszman, Chief of Staff to the Governor
Amnon Jacoby, Advisor to the Governor

Appendix: Major developments in the World Economy

US

Recently published macroeconomic data point to a slowdown in the rate of growth in the second quarter of 2006 after the rapid 5.6 percent growth in the first quarter. However according to most assessments the slowdown in the rate of growth for the rest of the year will represent a "soft landing" for the economy, which is expected to continue growing at a rate of about 3 percent, a level assessed as the economy's potential. Private consumption continues to fall against the background of high fuel prices, the lagged effect of higher interest rates and developments in the housing market. Despite the signs of a deceleration, this month saw a sharp rise in manufacturing output and a continued growth in the export sector which is expected to strengthen in light of the strong global economy and to provide support for continued growth during the year. In addition, companies are in a fairly strong situation given the high rates of profitability and manufacturing capacity which are expected to continue and to support investment in the business sector. Tax revenues also saw a surprising increase. Inflation is rising and inflationary pressures are getting stronger; the CPI and the core inflation rate reached annual levels of 4.3 and 2.6 percent respectively, against a narrowing output gap. Average forecasts from investment houses on the CPI rate for the second quarter of 2006 stand at 4 percent, though the inflation rate is expected to fall gradually during the remainder of the year. The US Federal Reserve decided at its last meeting to raise its interest rate by 25 basis points to 5.25 percent. Fed-rate futures contracts factor in a further increase of 25 basis points at the next meeting, similar to the expectations of the investment houses.

Europe

The improvement in economic activity continued in the euro zone and apparently growth is picking up pace and becoming more established and broader, and is expected to remain close to its potential growth rate. The growth in investment is expected to continue, benefiting from the favorable terms of financing, the structural changes in company balance sheets, and the rise in profits and corporate efficiency. Domestic demand on the side of companies shows signs of acceleration. Private consumption is on the recovery path and is expected to continue strengthening in light of the recent fall in unemployment in the euro zone, particularly in Germany, France and Italy. The investment houses expect, on average, growth of 2.7 percent in the second quarter and growth of 2.3 percent for the year 2006. Inflation in June showed no change at 2.5 percent, in annual terms. The ECB expects inflation in the second half of 2006 and for 2007 to remain above the central bank's target of 2 percent. The investment houses, on average, expect inflation to be 2.4 percent in the second quarter and to fall gradually during the rest of the year. The ECB left its interest rate unchanged at 2.75 percent, and the market expects the ECB to raise its interest rate for August by 25 basis points. The markets and investment houses believe the interest rate will reach 3.5 percent at the end of the period of tightening monetary policy.

Japan

Japan's economy continues to recover, supported mainly by the growth of domestic demand. Business sector investment continues to grow against a background of high company profitability and private consumption is on a rising trend in light of the growth registered in household income. Manufacturing output is expected to continue growing in light of increased demand both domestically and abroad. Japan's central bank expects that the economy will continue to grow and the government expects growth of 2.1 percent in 2006. The investment houses expect, on average, growth of 2.5 percent in the second quarter and a faster rate of growth for the rest of the year. The change in the core inflation in May maintained the positive trend with a rise of 0.6 percent, and is expected to remain positive. In addition, the CPI also rose. The central bank raised its interest rate this month by 25 basis points to 0.25 percent, for the first time in about five years. The investment houses expect, on average, that the interest rate will continue to rise, to 0.5 percent by the end of the year.

Emerging markets

From mid-June there was a fall in the risk associated with the emerging markets, which was expressed in a rise in share prices and a strengthening of the exchange rates against the dollar. However against a background of a significant rise in the geopolitical risk as a result of the conflict in the Middle East, following the outbreak of hostilities the emerging markets saw sharp falls in shares prices particularly in the Middle East. Apart from the Israeli markets, the Turkish stock market stood out, losing more than 6.5 percent since the outbreak of fighting on the Israel-Lebanon border. However there has been no change in the major economic data of the emerging markets and they continue to present impressive rates of growth.