Bank of Israel

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

The discussions took place on March 25 and 26, 2007

April 2007

General

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

In the narrow forum, the directors of the economic departments present their recommendations regarding the interest rate, and following a discussion, the Governor makes his decision.

A. THE BROAD-FORUM DISCUSSION—THE STATE OF THE ECONOMY

1. Developments on the real side

General and Bank of Israel forecast for 2007

Data on economic activity indicate continued rapid growth. In March, the Central Bureau of Statistics revised the National Accounts data for 2006. According to the revised data, GDP grew in 2006 by 5.1 percent, private consumption by 4.8 percent, fixed asset investment by 6.4 percent and exports (excluding diamonds) by 9.3 percent. Due to the rapid growth, the unemployment rate fell during 2006 from 8.8 percent in the first quarter of the year to 7.7 percent in the fourth quarter.

The Bank of Israel's latest forecast for 2007 shows expected GDP growth of 5.1 percent and business sector growth of 6.2 percent. In comparison to the previous forecast of last December, the Bank of Israel has raised its forecast for growth by half a percentage point. In 2007, unemployment is expected to reach on average 7.5 percent, compared to an average of 8.4 percent in 2006.

In the Bank of Israel's revised forecast for 2007, private consumption is expected to grow by 4.4 percent, compared to 4 percent in the previous forecast in December 2006.

Indices of real activity

In February, the combined state-of-the-economy index rose slightly less than expected, by 0.3 percent. Furthermore, the combined index for recent months was revised downward from 0.9 percent to 0.5 percent for January and from 0.7 percent to 0.5 percent for last December.

The latest data point to an expansion in the general productivity index as a factor in the rise in the state-of-the-economy index, while the decline in the manufacturing production index moderated the rate of expansion.

The seasonally-adjusted monthly foreign trade figures show that in February high-tech exports declined by about 17 percent and manufacturing exports fell by about 14 percent. Total imports of goods (seasonally adjusted) were 2.2 percent higher in February than in January.

The labor market

The rate of unemployment fell to 7.7 percent of the civilian labor force in the last quarter of 2006, compared to 8.3 percent in the preceding quarter. The rate of employment rose by 0.3 percentage points, reaching 51.3 percent of the population of working age. The rate of participation in the labor force was stable relative to its level in the third quarter.

The nominal wage per employee post in the business sector rose in the last quarter of 2006 by about 3.8 percent compared to the same quarter of 2005.

2. Budget data

The domestic government budget surplus in the first months of the year totaled about NIS 6.5 billion (about 1 percent of annual GDP), which was NIS 5 billion higher than the seasonal path consistent with meeting the budget target. The source of the surplus is mainly the additional collection of income taxes. Total tax revenues (adjusted for legislative changes) in January-February were some 10 percent higher than in the same period of last year. Expenditure in January-February was about NIS 0.5 billion lower than the budgeted levels.

3. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) declined by 0.3 percent in February, in line with forecasters’ predictions. Adjusting for seasonal factors, the index fell by 0.4 percent. With the decline in the CPI in February, the seasonal path of inflation is below that consistent with the inflation target.

Over the past twelve months the CPI has fallen by 0.8 percent, significantly below the target. Excluding housing, the CPI has fallen by 0.4 percent over the past twelve months.

If the components of the CPI are divided into those directly affected by the exchange rate and the price-of-energy component ("imported" items) on the one hand, and "domestic" components not affected by them on the other, a marked difference between the paths followed by the two groups is evident in the past year. The prices of the domestic components of the index continued to rise in the first quarter of 2007. In contrast, the prices of the imported components of the index continued to fall in the first quarter of 2007 further to the decline over the past year.

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

Inflation expectations for one year ahead derived from the capital market—break-even inflation—remained unchanged in March at about 1.4 percent, below the midpoint of the target range. Since October 2006, these expectations have been below the midpoint.

Israeli forecasters' assessments of one-year inflation are close to the midpoint of the target range, and this month the average of their forecasts is 2.3 percent, an increase of 0.4 percentage points relative to the previous month. On average they forecast that the March index will rise by 0.2 percent, and that the April index will rise by 0.7 percent. Over the next three months—March to May—the forecasters expect the CPI to rise in total by between 1 and 1.5 percent. However, inflation measured over the previous twelve months is expected to remain negative until the last quarter of 2007.

Most of the private forecasters predict that the Bank of Israel interest rate will remain unchanged in April and May, but on average they forecast that the rate in a year's time will be 4.2 percent.

Prior to the interest rate decision for April, the *makam* curve reflected expectations in the financial markets that the Bank of Israel interest rate a year hence will be at about the same level as at present.

The makam and bond markets

In the month prior to the interest rate decision, the five-year CPI-indexed interest rate rose by 0.1 of a percentage point to 3.2 percent, and the 10-year indexed rate rose by 0.1 of a percentage point from 3.2 percent to 3.3 percent. The nominal yield on unindexed 5-year *Shahar* bonds remained stable at 5.1 percent, and on 10-year bonds it declined by 0.1 of a percentage point, to 5.3 percent. The *makam* yield for one year declined last month from 4.5 percent to 4.4 percent.

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

Before the current interest rate decision, the Bank of Israel interest rate was 1.25 percentage points lower than the Federal Reserve rate. US capital market data indicate a strong probability of no change in the US federal funds rate in the coming months.

The gap between the yields on 10-year unindexed shekel bonds and US bonds of the same term increased during the last month from about 66 basis points to 72 basis points.

The expected real interest rate
The expected real interest rate for one year forward fell in March from a level of 2.9 percent to 2.7 percent—its lowest level in the past year—following the sharp decline in February from 3.6 percent to about 2.9 percent.

The money supply
The (M1) money supply has increased by 8.9 percent since the beginning of 2007, after expanding by 8.2 percent in the whole of 2006.

The econometric models[1]
Various scenarios were examined using the Bank of Israel’s econometric models. According to the Research Department's model, in the scenario with the interest rate remaining fixed and assuming relative stability in the exchange rate, inflation would return to within the target range in the last quarter of 2007, following the drop in the unemployment rate and the decline in the short-term real interest rates that have already occurred. According to the Monetary Department's model, some depreciation of the shekel would return inflation to within the range. The results of the models are sensitive to changes in the exchange rate.

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

Capital flows
In the month since the last interest rate decision, the shekel traded at about the same level against the dollar, and weakened by about 1 percent against the euro.

The negative interest rate gap between the shekel and the dollar was a factor in the last month contributing to the export of short-term capital by the business sector and nonresidents. In contrast, an inflow of capital was registered in the past month as a result of nonresidents' investments in Israel, Israelis' redemptions of mutual funds in foreign currency, and the sale of investments abroad by institutional investors.

The foreign-currency market and the share market
As mentioned above, in the month since the last interest rate decision, until a few days before the current discussion, the shekel remained stable against the dollar, at around NIS 4.20 to the dollar, while during the past month the dollar weakened against other currencies. The shekel weakened against the euro in the last month by about 1 percent, from NIS 5.53 to the euro at the time of the previous interest rate decision, to NIS 5.58 in the days before the current decision.

In the first week of March, the leading share indices on the Tel Aviv Stock Exchange fell by about 5 percent. At the same time, the leading share indices fell sharply in many developed and developing markets. During the past month, the volatility of the Tel Aviv stock exchange rose, similarly to developments in the main stock markets around the world.

[1] The Bank of Israel uses econometric models to test various scenarios. Due to their nature, including the fact that their results naturally depend on certain assumptions about relevant variables, the scenarios should be viewed as one input among several in the discussions on the interest rate.

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

Israel’s risk premium as measured by the five-year CDS spread remained stable in March at around 18 basis points. The yield gap between 10-year *Shahar* bonds and US government bonds of the same term increased from the time of the previous interest rate decision to date by about 6 basis points.

The foreign investment houses continue to describe Israel’s economy in a positive light, and commend its strong macroeconomic performance.

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

Most investment houses expect global growth of more than 5 percent in 2007. Growth in the US is expected to slow from a pace of 3.4 percent in 2006 to around 2.6 percent in 2007, while growth in Europe is expected to slow from 2.8 percent in 2006 to 2.3 percent in the current year. China's economy is expected to grow by about 10 percent, and India's by 8.3 percent.

The Fed is not expected to change the interest rate before the middle of the year. The ECB raised its interest rate in the past month to 3.75 percent, and is expected to raise its interest rates by a further 0.25 percentage points before the end of the year.

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

The inflation rate in the last twelve months, minus 0.8 percent, was significantly below the target range. Inflation expectations for one year forward derived from the capital market stand at 1.4 percent, and the average of the forecasts of Israeli economic forecasters is about 2.3 percent.

Prior to this current interest rate decision, most of the private forecasters expected that the Bank of Israel would not change the interest rate for April, but the average of the assessments of the Israeli forecasters is that in a year’s time the Bank’s interest rate will be higher than the current level, at 4.2 percent. The expectation derived from the capital market via the *makam* yield curve is that the interest rate a year hence will be at about its current level.

On average, the Israeli forecasters assess that the March CPI will rise by 0.2 percent, and that the April index will rise by 0.7 percent. Given the cumulative negative indices from September to November 2006, inflation viewed retrospectively over twelve months is expected to be below the target range for most of 2007. The CPI over the next three months, i.e., from March to May, is expected to rise by a total of between 1 percent and 1.5 percent.

The scenarios examined using the econometric models show that in addition to the reduction in the short-term real interest rate, the decline in unemployment would act to return inflation to within the target range. The interest rate required to attain the inflation target depends to a considerable degree on future exchange rate developments.

In the month preceding the current interest rate decision the international financial markets became more volatile. Nonetheless, Israel's sovereign risk premium, as measured in the 5-year CDS market, remained steady. The yield gap between 10-year *Shahar* bonds and US government bonds of the same term widened by less than 10 basis points in the last month.

Israel's economy is enjoying the benefits of several positive developments, the most notable of which is the current account surplus, which in 2006 reached about 5 percent of GDP. Fiscal discipline too was notable. In January and February 2007 tax revenues exceeded and expenditure fell short of their expected seasonal paths. These developments help bolster foreign investors' faith in Israel's economy, which is reflected by the extent of foreign investments in Israel. In the discussion the point was made that the expected surplus in the current account tends to strengthen the shekel.

The data on real activity continue to indicate a high rate of growth. No inflationary pressures from the labor market are evident as yet, due to the rapid rise in productivity that caused a reduction in unit labor costs. However, the rate at which unit labor costs are falling has slowed.

Changes in the exchange rate affect inflation in Israel relatively strongly and quickly. In the last month the shekel weakened by about 1 percent against the euro, while it remained steady against the dollar. In the discussion it was noted that hitherto, over the last year, the strengthening of the shekel—including its effect on housing prices—has been a key cause of negative inflation.

All the departmental directors participating in the discussion recommended leaving the interest rate unchanged for April. They expressed the view that rapid economic growth in the year ahead together with the narrowing of the output gap would create inflationary pressures that would help to return inflation to within the target range. They noted that the fall in the rate of unemployment to 7.7 percent in the last quarter of 2006 strengthens the assessment that the process of closing the output gap is proceeding faster than could have been assumed previously, and increases the probability that inflationary pressures will develop in the course of the year ahead.

It was also noted in the discussion that the five consecutive monthly cuts in the interest rate since November 2006 totaled 1.5 percentage points. These cuts, against the background of the relatively stable inflation expectations for one year forward, had reduced the short term real interest rate to a low level, thus encouraging economic activity. With regard to developments abroad, the international financial markets had become more volatile in the last month, and this had been reflected to only a small degree in Israel's domestic markets. Currently, following the cuts in the interest rate by the Bank of Israel, the Bank's interest rate was 1.25 percentage points lower than the Fed rate.

In the light of the above considerations, the participants in the discussion recommended that more time be allowed to assess the effects of the previous interest rate reductions on inflation, and that the interest rate be left unchanged for April.

Following the discussion, the Governor decided to leave the interest rate for April unchanged, at 4 percent.

The decision was made and published on March 26, 2007.

Those present at the discussion:

Prof. Stanley Fischer, Governor of the Bank of Israel
Prof. Zvi Eckstein, Deputy Governor of the Bank of Israel
Dr. Karnit Flug, Director of the Research Department
Dr. Edward Offenbacher, Director of the Monetary Department
Mr. Barry Topf, Director of the Foreign Currency Department
Mr. Balfour Ozer, Director of the Foreign Exchange Activity Department
Dr. Ohad Bar-Efrat, Advisor to the Governor and Head of International Affairs
Mr. Gaby Fiszman, Chief of Staff to the Governor

Appendix: Major Global Economic Developments

U.S.

The rate of growth in 2007 was expected to be about 2.6 percent. The investment houses expect that in the first quarter of 2007 growth will be 2.1 percent. The investment houses and the Fed predict that the rate of growth will rise in the second half of the year.

Data relating to the housing market were at the top of the list of figures published this month indicating the weak performance of the economy, showing relatively sharp reductions in building starts and sales of new houses. The investment houses consider that the marked weakness of the housing market may be affected by the recent cold weather, and that it does not necessarily reflect a further real deterioration in the activity of this sector.

Private consumption has so far remained fairly solid and appears to have barely been affected by the slowdown in the housing market. However, recently published indicators of consumer behavior such as the consumer confidence index and the retail sales index were relatively weak, and it is not clear if this can be attributed to the cold weather or if it indicates a trend change.

On the positive side, labor market data for February were notable, indicating that the positive trend of the last few months was persisting. Manufacturing production produced a positive surprise, with a greater than expected increase. The manufacturing sector was helped by the increase in exports this month that led to a further improvement in the trade balance, against the background of the strength of the global economy and the depreciation of the dollar over the last year.

Despite the easing of the inflation rate in the last few months, core inflation remains high, and the Fed still considers that there is an upside risk of inflation. The probability of continued inflationary pressure, particularly from the labor market, still exists, against the background of the continued rise in the average hourly wage and the low rate of unemployment that stands at 4.5 percent. The Fed anticipates, however, that inflationary pressures will ease, with the decline in energy prices and the slowing of growth to below its potential level. The investment houses also expect, on average, a fall in inflation to a level of 2 percent at the end of the first half of the year, but they expect a rise to above 2 percent in the last quarter of 2007.

The investment houses on average expect the Fed to lower the interest rate once during the second half of the year. On the other hand, futures contracts on the Fed interest rate reflect a 100 percent probability of a cut of 50 basis points in the rate by the end of the year.

Europe

The European economy is expected to grow by 2.3 percent in 2007. European consumer confidence surveys remain positive, and are expected to continue to support private consumption, which is on a path of recovery against the background of the further decline in unemployment and the ongoing improvement in the labor market. The strong global economy is expected to support the European export sector. The business sector is expected to continue benefiting from advantageous financing conditions, structural changes in companies' balance sheets, and from businesses' increased profits and efficiency.

Inflation remained unchanged in February at an annual rate of 1.8 percent. The decline in the inflation rate since last August was due mainly to the fall in oil prices. The ECB expects inflation to remain around its target level of 2 percent over the next two years. The risk of this forecast remains on the upside, due to concern over renewed rises in oil prices and the probability that strong growth could lead to pressure for wage hikes. At the same time, the continued rapid rise in the money supply and credit to the private sector also presents a threat to price stability in the medium and long term.

As expected, the ECB raised the interest rate in March by 25 basis points to 3.75 percent. The market factors in a rise of a further 25 basis points by the end of the year with a probability of 70 percent. The investment houses also expect the same development in the central bank's interest rate.

Japan

The growth rate in the last quarter of 2006 was revised upwards to an annual rate of 5.6 percent, compared to the original figure of 4.8 percent. This brings growth in Japan's economy in 2006 to 2.3 percent. The Bank of Japan and the investment houses expect that growth will be at a similar level in 2007.

Japan's growth is led mainly by the companies sector and the continued increase in exports. Business sector investment continues to rise, with high rates of company profits and business confidence. In addition, manufacturing production is expected to continue rising in the light of the rise in both domestic and foreign demand. Data on private consumption, however, indicate only a modest rise in the light of the slow rise in households' income. Public investment is expected to continue on its downward trend.

Prices of domestic goods rose more slowly as world oil and commodities prices fell.

The Bank of Japan kept its interest rate unchanged at 0.5 percent. The statement accompanying the announcement transmitted a calm message and it seems that any rise in the interest rate will be very small.

The emerging markets

At the end of February the Chinese stock exchange indices recorded sharp falls of 9 percent, against the background of rumors that the authorities were planning to act against speculative activity in that market. Furthermore, the publication of weak data on the US economy, the comments by the previous chairman of the Federal Reserve Board Alan Greenspan that the US economy could go into recession this year, and concern over instability in the US mortgage market, boosted the rise in global risk adversity among investors. This led to a process of closing positions in assets considered risky, with a relatively steep increase in volatility. As a result, share indices in the developed and emerging markets posted drops, with the steeper falls occurring in the emerging markets, such as Russia and Brazil, which posted declines of about 12 percent and 11 percent respectively. The yield gaps between US bonds and those of the emerging markets widened to more than 20 basis points, as measured by the EMBI+ index.