BANK OF ISRAEL
Office of the Spokesperson and Economic Information

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Press Release

Report to the public on the Bank of Israel's discussions prior to deciding on the <u>interest rate for November 2014</u>

The discussions took place on October 26 and 27, 2014.

General

In the process of making the monthly interest rate decision by the Monetary Committee, discussions are held at two levels—the first in a broad forum, and the second in a narrower one.

In the broad-forum discussion, the relevant background economic conditions are presented, including the real and financial-monetary developments in Israel's economy, and developments in the global economy. Participants in this discussion include the members of the Monetary Committee, senior representatives from the various departments of the Bank, and economists from the economic departments (Research and Market Operations), who prepare and present the material for discussion. The data, estimates and assessments in this document are those that were available at the time of the interest rate decision.

In the narrow forum, which consists of the Monetary Committee and the Director of the Market Operations Department, the Directors of the Research Department and of the Market Operations Department present their recommendations regarding the interest rate. An open discussion follows, which ends with a vote on the level of the interest rate. According to Section 18(c) of the Bank of Israel Law, 5770-2010, the decision on the interest rate is reached by majority vote of the members of the Monetary Committee who participate in the voting. If the vote is tied, the Chairperson (the Governor) has an additional vote.

A. THE STATE OF THE ECONOMY

1. Developments on the real side

Indicators of the state of the economy

Some monthly indicators of real economic activity have not been updated since the previous Monetary Committee discussion, due to the holidays. Most data which became available this month indicate that due to Operation Protective Edge, activity in the third quarter slowed, and perhaps even declined, although there are signs of recovery in September. Goods exports (excluding ships, aircraft and diamonds) increased moderately, by 1.3 percent, in September, after declining by 6 percent in August, and imports (excluding ships, aircraft, diamonds and fuels) declined by 3.9 percent. The export of other business services (excluding startups) declined by 0.9 percent in July, compared with the peak levels of the second quarter. There was a very slight recovery in the number of tourist entries in September, following the low reached in July–August. The Bank of Israel's Companies Survey for the third quarter showed a decline in business sector activity, reflected in the fact that the weighted net balance is significantly negative. All industries reviewed in the Companies Survey show negative net balances, with the sharpest decline in hotels' activity. The business sector Climate Index, based on the Business Tendency Survey conducted by the Central Bureau of Statistics for September, reflects a monthly growth rate of 0.16 percent. This is an improvement compared with the rate of 0.13 percent in August, but is still significantly lower than the rate in the months prior to Operation Protective Edge—0.22 percent to 0.27 percent. The Purchasing Managers Index increased by 7.3 points to 49.9 points in September, the level that distinguishes between contraction and expansion, following a marked decline in July and August. Consumer confidence indices show a mixed picture: The Central Bureau of Statistics index improved in September compared to August, the Bank Hapoalim index declined, and the Globes Index remained virtually unchanged.

The labor market

The number of employee posts declined by 0.3 percent in July compared with the second quarter, with a decline of 1.1 percent in the business sector offset by an increase of 0.7 percent in public services. The number of full time positions declined by about 0.8 percent in July–August compared with the second quarter. Health tax receipts are increasing at a stable rate: receipts in August–September were 5.5 percent higher (in nominal terms) than the same period last year, compared to a year over year increase of 4.8 percent in July-August. Nominal wages increased in May–July by 0.9 percent, and real wages increased by 0.7 percent, compared to February–April (seasonally adjusted data).

Budget data

In January–September, the deficit in the government's domestic activity (excluding net credit) totaled about NIS 7.2 billion. This is about NIS 3.6 billion smaller than the deficit in the seasonal path consistent with meeting the 2014 deficit target, as expenditure has been lower than the seasonal path consistent with full budget performance. Ministry expenditures are only 3.4 percent greater in nominal terms than the same period last year. With that, an acceleration in expenditure is expected over the remainder of the year. Domestic revenues from the beginning of the year are about

NIS 1.5 billion lower than the seasonal path consistent with the budget forecast. Based on trend data, VAT on gross domestic activity—an indicator of private consumption—increased by about 0.6 percent in the third quarter, compared with the previous quarter.

2. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) for September declined by 0.3 percent, below forecasters' projections for a decline of 0.1 percent, on average. There were marked declines in the food and in the fruit and vegetables components, and no component increased this month. In five of the past six months, the actual CPI reading was lower than the average of the forecasters' projections. The inflation rate over the preceding 12 months was -0.3 percent, compared with 0 percent over the 12 months ended in August. The tradable goods components of the CPI declined by 2.5 percent over the past 12 months. The rate of increase in components consisting of nontradable products also declined to below the inflation target range, to 0.8 percent.

Expectations and forecasts of inflation and the interest rate

This month, 1-year inflation expectations (seasonally adjusted) derived from the capital market declined sharply to 0.6 percent, and expectations for two years also declined, to 1.0 percent. Private forecasters' projections for the next 12 CPI readings declined to 0.9 percent, on average. Expectations for the coming 12 CPI readings derived from banks' internal interest rates declined to 0.5 percent. Expectations for medium and long terms continued to decline this month, by about 15 basis points for long terms and by about 10 basis points for medium terms, compared to last month. Some private forecasters expect some reduction in the Bank of Israel interest rate during the next three months, and this expectation is also indicated in data from the *makam* and Telbor curves.

Monetary aggregates

In the twelve months ending in September, the M1 monetary aggregate (cash held by the public and demand deposits) increased by 24.6 percent, and the M2 aggregate (M1 plus unindexed deposits of up to one year) increased by 7.9 percent.

The credit market

Total outstanding debt of the business sector increased by about NIS 10.6 billion (1.4 percent) in August, to NIS 781 billion, mostly a result of the depreciation of the shekel against the dollar, which increased the shekel value of debt indexed to and denominated in foreign currency. However, the figure also reflects net debt raised of about NIS 2 billion, mainly in the nonbank market. In September, the nonfinancial business sector issued about NIS 4.1 billion in bonds, compared with a monthly average of NIS 3.6 billion since the beginning of the year. Net new investment in corporate bond mutual funds continued, though at a lower volume than during the first months of the year. Corporate bond market spreads remained low, at a level that may indicate the underpricing of risk in this market. Outstanding household debt increased by about NIS 1.9 billion (0.5 percent) in August, to about NIS 425 billion. The increase derived mostly from continued growth in housing debt, which increased by NIS 1.5 billion. In September, new mortgages taken out totaled NIS 3.9 billion, compared with a monthly average of about NIS 4.3 billion since the beginning of the year. The interest rate on new variable-rate, unindexed mortgages taken out declined in September by 0.17 percentage points, against the background of the decline in the Bank of Israel interest rate. The average interest rate increased by about 0.04 percentage points on new CPI-indexed, fixed rate mortgages, and by 0.14 percentage points on new CPI-indexed, variable rate mortgages.

The housing market

The housing component of the CPI (based on residential rents) remained unchanged in September, after increasing for 7 consecutive months at an average monthly rate of 0.5 percent. In the 12 months ending in September, this component increased by 2.1 percent, and over the course of the year a trend of decline is apparent in its rate of increase. Home prices, which are measured in the Central Bureau of Statistics survey of home prices but are not included in the CPI, declined by 1 percent in July–August. The annual rate of growth in prices moderated, such that over the 12 months ending in August, home prices increased by 5 percent, compared with an increase of 6.5 percent in the 12 months ended in July. The number of transactions in the housing market continues to decline sharply. The volume of such transactions in the second quarter was about 20 percent lower than in the first quarter, and partial data show that there was a similar decline in the third quarter. The decline encompassed all types of transactions, but it appears that it was especially sharp for homes priced at up to NIS 1.6 million. In the 12 months ended in July, there were about 45,000 building starts.

3. The foreign exchange and capital markets

The foreign exchange market

From the monetary policy discussion on September 21, 2014, through October 24, 2014, the shekel weakened by 4.1 percent against the dollar, and by 2 percent against the euro. In terms of the nominal effective exchange rate, the shekel weakened by 2.8 percent. For the year to date, the shekel has weakened by about 4.1 percent in terms of the effective exchange rate.

The capital market

From the monetary policy discussion on September 21, 2014, through October 24, 2014, the Tel Aviv 25 Index declined by 0.9 percent, a smaller decline than the worldwide trend. Yields in the government bond market declined sharply, mainly against the background of a decline in yields abroad. Yields on the unindexed bond yield curve declined by up to 35 basis points, with a decline in the steepness of the curve. The yield on the 10-year unindexed bond declined by about 35 basis points, to 2.1 percent. The decline in yields on the CPI-indexed curve was more moderate, and reflected a decline in the inflation expectation implied in the medium and long portions of the curve. The yield differential between 10-year Israeli government bonds and corresponding 10-year US Treasury securities remained virtually unchanged, at a negative level of about 15 basis points. *Makam* yields declined by about 5–8 basis points along the entire curve, and the 1-year yield is 0.17 percent. Israel's sovereign risk premium as measured by the five-year CDS spread remained virtually unchanged at 89 basis points.

4. Global economic developments

Concern about further moderation in the global economy increased this month, against the background of an increase in uncertainty and in volatility on various markets. The IMF reduced its global growth forecast for 2015 by 0.2 percentage points, to 3.8 percent. The forecast for world trade growth was reduced by 0.3 percentage points, to 5 percent, concurrent with a decline in world trade in August. In the US, the recovery in growth continued, but in the background are a significant number of downside risks to the forecast. Despite the improvement in the labor market, most of those joining the labor force are earning low salaries, so that salaries increased at a moderate pace and continue to weigh on a recovery in personal consumption. The dollar continues to strengthen vis-à-vis the basket of major currencies (DXY), which may also weigh on the recovery of the US economy. The global economic environment and comments by leading Fed officials led to a change in market estimates of the timing of the start of interest rate increases in the US, which is now expected to be delayed by a few months to around October 2015. In the eurozone, the flow of disappointing data continues. Germany’s economy has weakened, and the French and Italian economies are having difficulty recovering. The IMF reduced its forecast for eurozone growth in 2015 by 0.2 percentage points, to 1.3 percent. Companies surveys and expectations indices continue to weaken and to indicate negative sentiment. The unemployment rate remains high, at 11.5 percent. The annual inflation rate declined to a new low of 0.3 percent, and concerns of deflation are increasing. The ECB published the details of an asset purchasing program, which were received with some disappointment in the markets since it did not include quantitative targets. In Japan as well, most of the data published this month were disappointing, and indicated the lack of recovery since the VAT increase in April. The Bank of Japan repeated its commitment to adopt accommodative policy as long as necessary. The growth rate in the Chinese economy is stabilizing, and the composition of growth improved recently, while in the background, the decline in real estate prices continued. In Brazil there is continued instability, while data for India indicate a mixed trend. Concerns over the weakening global economy led to sharp fluctuations in stock markets, and the MSCI World index declined by about 3.5 percent at the end of the period. Due to the concern over weakness in global activity, and despite the geopolitical instability in Ukraine and the Middle East, energy prices continue to decline sharply. The price of a barrel of Brent Sea crude oil declined by 15 percent to $86. In contrast, agricultural commodity prices increased by 5 percent this month.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR NOVEMBER 2014

Main points of discussion

The members of the Monetary Committee participating in the discussion decide on the appropriate rate of interest for the economy. After the discussion on the interest rate for November 2014, it was decided to keep the interest rate unchanged at 0.25 percent. The decision was unanimous.

The discussion focused on several main issues: (1) inflation; (2) economic activity; (3) the global economy; (4) the exchange rate; (5) the housing market; (6) the corporate bond market, and (7) the fiscal situation.

During the course of the discussion on inflation, Committee members referred to inflation, as measured over the preceding 12 months, reaching negative levels, currently -0.3 percent. Among the contributing factors to the decline in consumer prices were the continued decline in the food and fruit and vegetables components, and the moderation in the increase in the housing component, with the latter remaining unchanged this month. Committee members assessed that the decline in prices, mainly in food prices, derives partially from the structural adjustment that has developed due to public pressure surrounding the cost of living. The committee members discussed the decline in prices of tradable goods, and expressed the opinion that it has been affected by the decline in energy and commodity prices around the world, and by the continued appreciation of the shekel during the first half of the year. These forces are being countered by the trend of depreciation in the shekel which began to develop about three months ago, but which, in the opinion of the Committee members, has not yet been fully reflected in prices. Committee members also discussed the moderation that has taken place in recent months in the increase of prices of nontradable goods—a reflection of the moderation in domestic demand. The Committee members related to the decline in inflation expectations for one year forward, which are below the lower bound of the price stability target range (1–3 percent), but emphasized that inflation expectations for longer terms remained anchored within the target range. The Committee members expressed their commitment to meeting the price stability target defined by the Bank of Israel Law.

In their discussion on economic activity, Committee members noted that indicators point to a slowdown in the growth rate of the economy in the third quarter, further to its moderation in the second quarter, but agreed that the slowdown is derived to a large extent from the moderating effects of Operation Protective Edge. In addition to these effects, the continued contraction in exports and the continued virtual standstill in investments contributed to the slowdown in growth. In contrast, private consumption contributed to growth during the recent period.

In terms of the global economy, Committee members mentioned the uncertainty surrounding the global economy and the concern of a deepening recession—factors that were reflected in strong volatility in the markets, among other things. While the US continues to show signs of recovery, there is an apparent assessment in the markets that the timing of an increase in the interest rates in the US will be delayed.

Data from the European market showed that the weakness there is continuing, and mainly raised the concern of signs of weakening in the German economy. The Committee members noted that the Israeli economy is influenced to a large extent by the moderating growth rate of world trade. In this context, the Committee members noted that the International Monetary Fund revised its growth forecast for world trade downward. They discussed the possible ramifications of this scenario on exports and domestic growth, and assessed the implications of the possibility that world trade volumes will increase even less than the increase projected in the IMF's revised forecast.

In the discussion on the exchange rate, Committee members referred to the shekel's depreciation in the past three months, and noted that it is partially derived from the interest rate reductions carried out by the Bank of Israel during that period, and by the strengthening of the dollar globally. The Committee members assessed that the effects of the depreciation have not been fully expressed, and that it is expected to continue to support exports and growth, and will continue to contribute to returning inflation to the price stability target range. Committee members noted that despite the depreciation, the prices of tradable goods continue to decline, and that this is partially explained by the decline in energy and commodities prices around the world. Continued depreciation can be expected to assist in offsetting the effects of these global factors on prices.

With regard to the housing market, Committee members noted that the trend of decline in the volume of transactions continues, and is accompanied by moderation of the pace of taking out new mortgages. In parallel, there has been a slowdown in the rate of home price increases, and the latest data even indicated a decline in prices. Committee members attribute these developments to the uncertainty surrounding the plan to reduce the VAT on new homes for eligible buyers to zero. Committee members noted that it is difficult to assess how clarifications of the picture in this area will affect the housing market.

Committee members noted that corporate bond spreads remained low, which may point to the underpricing of risks in this market. In addition, net new investment in corporate bond funds continues, though at low volumes.

With regard to the fiscal situation, Committee members related to the fiscal expansion discussed as part of the debates on the 2015 budget. They assessed that a moderate fiscal expansion could strengthen economic activity, to the extent that it focuses on encouraging growth and domestic demand, but noted their concern of a prolonged increase in the deficit.

In conclusion, Committee members were of the opinion that the effects of the interest rate reductions made in recent months have not yet been fully realized, and that the low interest rate supports real economic activity and prices. Moreover, the Committee members were of the opinion that the current level of the interest rate is in line with a flexible inflation target regime, which makes it possible—by law—to temporarily deviate from the price stability range. Since the interest rate tool is close to full use, the Committee decided to assess the use of additional tools as necessary.

Following the discussion, the five members of the Monetary Committee voted on the Bank of Israel interest rate for November 2014. All five members supported keeping the interest rate at 0.25 percent.

The decision to keep the interest rate for November 2014 unchanged at 0.25 percent is consistent with the Bank of Israel's monetary policy, which is intended to return the inflation rate to within the price stability target of 1–3 percent a year over the next twelve months, and to support growth while maintaining financial stability. The path of the interest rate in the future depends on developments in the inflation environment, growth in Israel and in the global economy, the monetary policies of major central banks, and developments in the exchange rate of the shekel.

The main considerations behind the decision

- The inflation environment continued to decline this month. The inflation rate measured over the preceding 12 months was negative 0.3 percent. Inflation expectations for the coming year, from various sources, declined to below the lower bound of the inflation target range, and two-year expectations are at the lower bound. Expectations for longer terms declined as well, though they are near to the midpoint of the target range.
- Most indicators that became available this month signal that activity in the third quarter slowed, and perhaps even declined. Most of the slowdown in activity derives from Operation Protective Edge. The Companies Survey points to a decline in activity in the third quarter in all industries, primarily in tourism. There was no substantial decline in confidence indices despite Operation Protective Edge, and there was improvement in the Purchasing Managers Index.
- In view of the reductions in the Bank of Israel interest rate, and the strengthening of the dollar worldwide, the shekel weakened by 2.8 percent this month in terms of the nominal effective exchange rate, and it has weakened by about 4.1 percent since the beginning of the year. Continued depreciation will support a recovery in exports and in the tradable sector as a whole, and is expected to contribute to returning the inflation rate to within the target range.
- Concern increased this month of a further moderation in the global economy, against the background of the increased uncertainty and volatility in various markets. Disappointing data were received this month in the eurozone, with an emphasis on its larger economies. In the US, the recovery in growth continues, though there are downside risks to the forecast. Based on market assessments, the timing of when the Fed will begin to raise the federal funds rate has been deferred to around October 2015.
- The sharp decline in the number of transactions in the housing market continues, and there is a moderation in the rate of mortgages being taken out. Home prices declined by 1 percent in July-August, and their rate of increase over the 12 months ending in August slowed to 5 percent. It is difficult to assess the response that will occur when the uncertainty regarding the zero-VAT law is removed.
- Net new investment in corporate bond funds continues, though at relatively low volumes. Spreads in this market continue to indicate an apparent underpricing of risks.

The Monetary Committee is of the opinion that the effects of the recent interest rate reductions, which brought the interest rate to a level of 0.25 percent, have not yet been fully reflected in activity and in inflation, and in view of that decided to keep the interest rate unchanged this month.

The Bank of Israel will continue to monitor developments in the Israeli and global economies and in financial markets. The Bank will use the tools available to it and will examine the need to use various tools to achieve its objectives of price stability, the encouragement of employment and growth, and support for the stability of the financial system, and in this regard will continue to keep a close watch on developments in the asset markets, including the housing market.

The decision was reached and published on October 27, 2014.

Participants in the narrow-forum discussion:

Members of the Monetary Committee
Dr. Karnit Flug, Governor of the Bank and Chairperson
Dr. Nadine Baudot-Trajtenberg, Deputy Governor
Prof. Alex Cukierman
Prof. Reuben Gronau
Prof. Nathan Sussman, Director of the Research Department

Other participants in the narrow-forum discussion:
Mr. Andrew Abir, Director of the Market Operations Department
Mr. Daniel Hahiashvili, Chief of Staff to the Governor
Ms. Esti Schwartz, Secretary of the Monetary Committee
Mr. Yoav Soffer, Spokesperson of the Bank of Israel
Ms. Osnat Zohar, Economist in the Research Department