BANK OF ISRAEL
Office of the Spokesperson and Economic Information

7 September 2009

Report to the public of the Bank of Israel's discussions prior to setting the interest rate for September 2009

The discussions took place on 23 and 24 August 2009

General

Before the Governor makes the monthly interest rate decision, 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 real, monetary and financial 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 Research and Market Operations Departments of the Bank and economists from various departments who prepare and present the material for discussion. The data, estimates and assessments in these minutes are those that were available at the time of the discussions.

In the narrow forum, the directors of the Research and Market Operations Departments and two other participating members of management 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 assessment

Most of the indices published in the month since the previous interest rate discussions on 27 July 2009 showed that the moderation of the decline in economic activity, which had not been expected to take place before the second half of 2009, was already largely evident in the second quarter of the year. The economy may actually have switched to an upward, though slow, trend in activity. Nonetheless there is uncertainty regarding the strength of the recovery.

The National Accounts

The initial National Accounts figures for the second quarter of 2009 indicate a halt in the decline of GDP, and even a switch to positive growth. According to the estimates, GDP increased, quarter on quarter, at an annual rate of 1 percent in the second quarter, compared with a fall of 3.2 percent in the first quarter. The turnaround in

GDP was the result of a surge of 20.2 percent in public consumption, an increase of 4.4 percent in private consumption, and of 5.8 percent in exports. Fixed investment continued to contract, however, and declined by 10.3 percent in the second quarter. Imports also fell, by 6.3 percent, a relatively moderate decline compared with the drop of 41.6 percent in the first quarter.

The composite state-of-the-economy index

The Bank of Israel's composite state-of-the-economy index for July increased by 1.2 percent from its June level, its third consecutive increase since it started a downward trend in June 2008. The rise in the index reflects increases in all its components, and in particular a 2.1 percent increase in the index of manufacturing production (compared with the previous month, seasonally adjusted), and a 3.4 percent increase in the index of trade and services revenue. Furthermore, the indices for the previous three months, April to June, were all revised upwards.

The labor market

The Ministry of Industry, Trade and Labor employers survey shows that the decline in the demand for workers continued in the second quarter, but at more moderate rate than in the previous quarters.

The number of employee posts (seasonally adjusted) in May was similar to the number of April. That said, in the three months March to May the number of employee posts in the business sector declined by 2.1 percent compared with the equivalent period in 2008, with all industries apart from banking and finance showing a fall. The nominal wage per employee post in the last three months was the same as in the equivalent period in 2008, but due to inflation this year, the real wage dropped.

Based on employers survey data on the number of vacant posts in the second quarter, the unemployment rate of 8.4 percent in May, and Google human resources (recruitment and staffing) query indices, it seems that the unemployment rate increased again in July.

Foreign trade

Goods exports increased by 1.1 percent in July from their June level. Exports of the high- and medium-high-tech industries, however, dropped considerably, by 8 percent, after increasing abnormally steeply in the previous months. Goods imports increased at the fast rate of 7.3 percent in July; this increase was mainly due to vehicle imports being brought forward in light of the impending imposition of the "green" anti-pollution tax on vehicles.

2. Budget data

The overall budget deficit in January–July 2009, excluding credit, totaled NIS 17.3 billion, compared with large surpluses in those months in previous years. The large deficit reflects the steep drop in tax revenues that started in mid-2008, moderated slightly by underspending in the first quarter of 2009. In July, however, for the first time this year, the government had an overall budget surplus (excluding credit) of NIS 0.4 billion. The surplus was partly due to the increase in indirect tax revenues, most of which resulted from purchases of vehicles and other durables being brought forward and from one-off receipts. Hence, these items are expected to decline in the next few months. Direct tax revenues have increased since April because of receipts of corporation tax, which may indicate a return to profitability.

3. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) rose by 1.1 percent in June, exceeding forecasters' expectations of an increase of between 0.6 percent and 1 percent. The increase in the index was in large part due to government decisions (the increased VAT rate and the water surcharge), the effect of which is nonrecurring, and which contributed 0.6 percentage points to the increase in the index (excluding those elements, the index rose by 0.5 percent). In the last twelve months the CPI increased by 3.5 percent, above the upper limit of the inflation target range. Since April, inflation—even excluding the one-off effects resulting from government decisions—has accelerated.

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

One-year-forward inflation expectations derived from the capital market ("break-even inflation") on 20 August reached about 2 percent, the midpoint of the inflation target range. This occurred after they had risen to 2.9 percent on 13 August, and then started declining after the announcement of the July CPI. The average level of inflation expectations from 1–20 August was 2.6 percent, slightly higher than the July level of expectations, 2.4 percent.

The Israeli forecasters predict, on average, that inflation one year ahead will be 2.3 percent, compared with expectations of 2.8 percent at the time of the previous month's discussions on the interest rate. On average they expect that the August index will increase by 0.6 percent and the September index will decline by 0.2 percent.

With regard to the interest rate, some Israeli forecasters expect that the Bank of Israel rate will remain unchanged for the next few months, and some predict that it will increase gradually (on average the forecasters expect that the interest rate will increase by 0.1 percentage points in each of the next two month). They forecast that twelve months hence the interest rate will be 2.1 percent. An analysis of the slope of the *makam* yield curve shows that capital market traders expect the interest rate for September to remain unchanged, and expect it to be about 2.5 percent in twelve month's time.

The makam and bond markets

The yields to maturity on short-term unindexed bonds increased in August (up to 20 August) from their levels in July, in light of expectations of an increase in the Bank of Israel interest rate. The yield on 5-year unindexed government bonds increased by 0.3 percentage points to an average of 4.1 percent. Real yields to maturity on CPI-indexed five-year government bonds remained unchanged this month at 1.5 percent.

The slope of the *makam* yield curve became steeper in August (up to 20 August), because of expectations of an increase in the Bank of Israel interest rate. The yield to maturity on three-month *makam* averaged 0.5 percent in August, compared with 0.4 percent in July; the yield on twelve-month *makam* averaged 1.6 percent in August, compared with 1.3 percent in July.

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

Prior to the current interest rate decision, the Bank of Israel interest rate was 0.25 to 0.5 percentage points higher than the US federal funds rate, and 0.5 percentage points lower than the ECB rate.

The gap between the unindexed ten-year shekel government bond yield and the ten-year US government bond yield widened a little, and on 20 August was 185 basis points.

The expected real interest rate

The Bank of Israel interest rate *minus* twelve-months-forward inflation expectations derived from the capital markets declined in August from its July level as a result of the increase in inflation expectations, and in August (until the 20th of the month) averaged a negative 2 percent. A comparison with expected real interest in other advanced economies (Australia, Canada, the EU, Japan, Sweden, Switzerland, the UK and the US) showed that the level in Israel was the lowest of all.

The monetary aggregates

In the twelve months to July 2009 the M1 monetary aggregate (cash held by the public and demand deposits) grew by 56 percent, similar to its twelve-month rate of increase to June, and the M2 aggregate (M1 plus unindexed term deposits of up to one year) by 18.4 percent. The rapid increase in M1 was partly due to the public's switching from term deposits to current accounts in light of the low level of interest on the term deposits.

The econometric models[1]

Various scenarios of the development of inflation and other variables in the next year were examined using the Bank of Israel’s econometric models. As in the previous month, the underlying assumptions were that real economic activity would decline in 2009 and that there would be a moderate increase in 2010 in line with the Bank of Israel macroeconomic forecast, that interest rates around the world would rise gradually, starting in 2010, that world trade would slump in 2009 and increase slowly in 2010, and that prices of imported inputs, which started increasing in the second quarter of 2009, would continue to increase.

In the baseline scenario of the quarterly DSGE (dynamic stochastic general equilibrium) model, inflation measured over the previous twelve months is expected to remain above the upper limit of the inflation target range until the middle of 2010, due to the transitory effect of the increases in taxes and water prices by the government. In the second half of 2010, when the effect of these factors will have run

[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. In the abnormal conditions prevailing in the global financial markets since the outbreak of the worldwide financial crisis, and bearing in mind that the models do not directly reflect such events, the weight that can be attached to the forecasts derived from the models is reduced.

its course, inflation is expected to decline to 1.3 percent, partly due to the output gap that has developed. According to this model, the increase in the interest rate during the year will be a modest one. An alternative scenario was examined, in which world trade recovers more rapidly, and thus interest rates increase faster and inflation around the world is higher. Under those assumptions inflation in the next four quarters would be 2.1 percent (compared with 1.3 percent in the first scenario above). An alternative model that gives greater weight to the inertia in the inflation process yields a higher rate of inflation in the next four quarters, 2.3 percent, even without an accelerated recovery in world trade; the reason is the higher initial (i.e., current) rate of inflation. According to this model, inflation will moderate only from 2011.

All the models yielded an increase in the Bank of Israel interest rate. The basic DSGE model, however, gave only a moderate increase in the interest rate in the next year, while the DSGE model with the assumption of a rapid global recovery and the alternative model gave a rising interest rate path similar to that derived from the slope of the *makam* yield curve.

4. The foreign currency market and the share market

The foreign-currency market

During the month between the previous and the current interest rate discussions (i.e., from 27 July to 21 August), the shekel strengthened by about 1.3 percent against the dollar, and on 21 August the exchange rate was NIS 3.82 to the dollar. In the same period the shekel strengthened by about 0.7 percent against the euro, to NIS 5.46 to the euro.

The nominal effective exchange rate of the shekel, calculated as the average shekel exchange rate against 24 currencies (representing 33 countries) weighted according to the volume of Israel's trade with those countries, showed a shekel appreciation of 1 percent in the period from 27 July to 21 August.[2] The strengthening of the shekel was supported by the positive indicators relating to Israel's economy published during the month, and by the July CPI, which exceeded expectations. The Bank of Israel's announcement about the change in its intervention policy in the foreign exchange market and the ending of its regular daily purchases of foreign currency also contributed to the strengthening of the shekel.

The share market

Between 26 July and 20 August the Tel Aviv 25 share price index edged up by 0.3 percent. At the beginning of the period, till 7 August, it increased sharply, by 4.3 percent, an increase that was subsequently wiped out. In the same period, 26 July to 20, the Dow Jones index rose by 2.8 percent.

5. Israel’s financial risk, the sovereign risk premium

[2] The weight of the dollar in the effective exchange rate is about 24 percent, and that of the euro, about 35 percent.

Israel’s risk premium, as measured by the five-year CDS spread, declined by 0.16 percentage points in the period between the previous and the current discussions on the interest rate, and reached 1.15 percent. The risk premium of other countries declined too in this period, including those of emerging market countries.

6. Global economic developments (see Appendix for further details)

Recent indicators of economic activity in economies around the world show that the worst of the crisis has passed, and a modest recovery is expected to start. Leading indicators of manufacturing activity, and in particular purchasing managers indices, continue to point to an improved situation in many countries, and world trade is also continuing to recover. Nevertheless, the withdrawal of fiscal support and the continuing process of reducing leverage by banks are likely to hold demand down and thus represent a downside risk to the forecast recovery.

Most share indices recorded marked increases. The global MSCI (Morgan Stanley Capital Index) equity index reached its highest level since October 2008. That said, in the last two weeks the situation changed somewhat, following the publication of weak data that increased concern that the economic recovery would be slower than expected previously. The money markets continued their rapid process of stabilization. The Libor–OIS (Overnight Index Swap) spread continued to contract in the US, the eurozone and the UK. The corporate credit spreads also contracted in most rating categories. In addition, at the beginning of 2009 new issues in the US were 36 percent higher than in 2008. Inflation is low, with even some increased concern over possible deflation, against the background of the slack labor market, despite the increase in commodity prices. Investment houses' predict global inflation of 2.6 percent in 2010. Their forecasts and information derived from the capital markets are still for stable interest in the US, the eurozone and Japan until the end of the year and even beyond

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR SEPTEMBER 2009

In the narrow-forum discussion, four members of management make recommendations to the Governor regarding the appropriate rate of interest for the economy and regarding the operation of additional instruments to implement the Bank's monetary policy. In the discussion of the interest rate for September, all four recommended that the Governor increase the interest rate. Three of them recommended an increase of a quarter of a percentage point, and the fourth recommended an increase of half a percentage point.

The participants in the discussion spoke of the latest indications that Israel's economy had switched from rapid contraction to moderate growth in a wide range of industries. Nevertheless, they noted that activity was still at a low level, that the output gap was expected to continue widening, and that unemployment was expected to increase in the next few months. In addition, there is great uncertainty with regard to the extent to which the recovery would endure. Specifically, the participants voiced concern that the US economy, which greatly influences Israel's exports, would recover more slowly than the currently prevailing market assessments.

The participants noted that inflation in the previous twelve months was above the upper limit of the target range despite the low level of real activity. They added, however, that a significant part of the deviation from the target was the result of non-recurring factors (the increase in the VAT rate, the tax on cigarettes, and the water surcharge), but even excluding those factors, the rate of inflation in the last few months was close to the upper limit of the range. In that context there was discussion of the degree of persistence of the rise in the inflation rate. The participants argued that as some of the increased rate of inflation was due to one-off factors, its degree of persistence is expected to be low. In addition, the existence of the output gap and the relatively high rate of unemployment will act to moderate inflationary pressures. They also noted that since the middle of August, twelve-month-forward inflation expectations derived from the capital market have fallen considerably, to the midpoint of the inflation target range, but this was based on the assumption that the Bank of Israel interest rate will be increased in the next few months.

The participants pointed out that short-term real interest in Israel was one of the lowest in advanced economies, and in most of those countries inflation next year was expected to be low.

The member of management who recommended a half-percentage-point increase in the interest rate stressed its low level relative to interest in economies similar to Israel—and the turnaround in the growth rate. He emphasized that this was not necessarily the start of an upward trend in the interest rate, but was a necessary adjustment to its level. The three members who recommended the smaller increase, of a quarter of a percentage point, emphasized the uncertainty surrounding the transition to positive growth, and the fact that in any case the growth rate was modest and the level of activity low. Moreover, an interest rate of 0.75 percent still expressed an expansionary monetary policy, which is still needed at this time.

At the end of the discussion, the Governor decided to increase the interest rate by a quarter of a percentage point to 0.75 percent. The decision strikes a balance between the need to return inflation to within the target range and the need to continue to support the recovery of economic activity.

In its announcement of its decision the Bank of Israel related to the factors supporting the decision to increase the interest rate by a quarter of a percentage point.

- In the last few months, inflation measured over the previous twelve months was above the target range of price stability. A considerable part of the deviation was the result of non-recurring factors (increased tax rates, including VAT, and water prices), but even excluding these elements, inflation was close to the upper limit of the target range. Twelve-months-forward inflation expectations, both those of forecasters and those derived from the capital market, have fallen to around the midpoint of the target range. Nevertheless, it is thought that the reduction in twelve-month inflation expectations is due not only to the continued widening of the output gap, but also to expectations that the Bank of Israel will increase the interest rate in the next few months.

- The most recent data on real activity in Israel strengthen the assessment that there has been a turnaround, although there is great uncertainty regarding the expected rate of growth.
- Interest rates of the leading central banks around the world are expected to remain unchanged till the end of the year, and possibly even to the middle of 2010. However, unlike in Israel, inflation in those countries is expected to remain low both this year and next.

The Bank of Israel announced that it will continue to monitor Israeli and worldwide economic developments, and will use the instruments available to it to achieve its objectives—price stability, the encouragement of employment and growth, and support for the stability of the financial system.

The decision was made and published on 24 August 2009.

Those participating in the narrow-forum 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, Member of Management and Head of the Monetary and Finance Division, Research Department
Mr. Barry Topf, Director of the Market Operations Department
Ms. Irit Mendelson, Head of the Markets Division, Market Operations Department
Mr. Eddy Azoulay, Chief of Staff to the Governor
Dr. Yossi Saadon, Bank of Israel Spokesperson
Mr. Eyal Argov, Economist, Monetary/Financial Division, Research Department

Appendix: Major Global Economic Developments

US

The economic data are starting to indicate stability. The first indication of GDP in the second quarter of the year shows that the US economy contracted by only 1 percent (annual rate) in that quarter, compared with a decline of 6.4 percent in the first quarter. On average the investment houses expect a return to positive growth (at a rate of 2.6 percent) as early as in the third quarter of 2009. Nevertheless, signs of weakness are still evident, particularly in private consumption: consumer expenditure declined by 1.2 percent in the second quarter, retail sales dropped in July, and the Michigan University consumer confidence index went down in August. Although the unemployment rate declined marginally in July (by 0.1 percentage points), at 9.4 percent it is still high. Manufacturing production increased in July for the first time in nine months, the outcome of a government program ("Cash for Clunkers") that boosted the demand for cars.

Inflation over the previous twelve months continued to decline in July, and reached a negative 2.1 percent. Excluding the energy and food components ("core inflation"), inflation in the last twelve months was 1.5 percent. On average the investment houses expect positive but low inflation not before the fourth quarter of 2009.

At its meeting on 12 August, the Fed left its interest rate unchanged at zero to 0.25 percent, and referred to the stabilization of economic activity. It stated that it expects to keep interest low in the near future. The investment houses and the capital market now expect no change in the interest rate before the end of the year.

Europe

The eurozone economy contracted by 0.1 percent (annual rate) in the second quarter of 2009, following a 2.5 percent decline in the first quarter. Germany and France actually recorded positive growth of 0.3 percent. The nascent global recovery supported exports, and fiscal acceleration programs together with low interest rates supported domestic demand. On average, the investment houses expect positive growth of 1 percent (annual rate) in the next two quarters.

Inflation over the previous twelve months in July was a negative 0.7 percent. On average the investment houses expect a return to positive but low inflation not before the fourth quarter of 2009.

Against this background, the ECB left the interest rate unchanged at one percent. The investment houses expect the ECB to continue to follow this policy at least till the end of the year.

Japan

Japan's economy grew at an annual rate of 3.7 percent in the second quarter, after four quarters of contraction. This occurred against the background of a recovery in exports, which increased by 6.3 percent, and a 0.8 percent increase in consumer expenditure. Concern that the recovery may not be sustainable remains, as the recovery derived from government support packages around the world. The investment houses expect that growth in the third quarter will be at a similar rate, about 4 percent, and that thereafter there will be a significant slowdown. Inflation in Japan fell to a negative 1.7 percent in June in light of the drop in oil prices. The investment houses expect that deflation will continue into next year. The Bank of Japan therefore left the interest rate at 0.1 percent, and it is expected to do so for the next year

The emerging markets

In the emerging market countries recovery is evident, and growth is expected to become stronger, with China and India leading the way with impressive growth figures. In China growth increased to 7.9 percent as a result of the implementation of the government's program that led to a marked acceleration in the increase in credit to companies and households, and to a considerable rise in domestic demand. In Asia, the recovery in world trade and manufacturing production from very low levels is expected to continue to support the economic recovery. At the same time, the position of Europe's emerging market countries still gives rise to concern, as they must make difficult adjustments to excess leverage. As a result, some countries like Latvia are still stuck in deep recessions, with persistently high downside risks.