Bank of Israel

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

The broad-forum discussion took place at the Bank of Israel on October 22, 2006, and the narrow-forum discussion on October 22 and 23, 2006.

General

Before the Governor makes the monthly interest rate decision, discussions are held at two levels. The first 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 (Research Department, Monetary Department, Foreign Currency Department, Foreign Exchange Activity Department) and economists from different 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

The data presented on real activity indicated that the economy was recovering rapidly from the impact of the fighting in the north. In October the Central Bureau of Statistics published its forecast of growth in 2006—4.5 percent. Companies' responses to the Bank of Israel's Companies Survey for the third quarter of 2006 also support the assessment that the economy is making a swift recovery following the shock occasioned by the war.

Data from the Bank of Israel Companies Survey

The survey shows that the impact of the war on economic activity was short-lived and moderate, and that it affected different industries to different degrees. Tourism and the business services sector in the north suffered most severely. In the third quarter of 2006 the output of manufacturing companies continued rising. Construction companies reported a steady level of activity in the third quarter, following increases in the previous two months. Analysis of the responses of all the participating companies shows that in most industries, the increase in activity is expected to continue in the fourth quarter, the exceptions being in the hotel and commerce sectors.

The labor market

According to data from the Manpower employment agency, demand for employees in September was 10.3 percent higher than in August, and 3.3 percent higher than in September 2005. The increased demand for labor included most industries.

2. Budget data

Tax revenues in 2006 are expected to exceed the budget forecast by some NIS 9.5 billion. The budget deficit is expected to be 1.5 percent of GDP. The budget for 2007, approved by the government and still to be passed by the Knesset, includes an increase in the deficit to 2.9 percent of GDP and a rise in the expenditure ceiling to 3.3 percent, due to the cost of the war in the north.

3. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) posted a large drop of 0.9 percent in September, more than that expected by private economic forecasters, whose estimates were of a drop of between 0.3 percent and 0.6 percent. The decline in the index was due mainly to the appreciation of the shekel, the fall in fuel prices, and seasonal price reductions. Dollar prices of owner-occupied apartments stabilized in September, in contrast to the increases in the previous three months.

The CPI rose by 1.3 percent in the last twelve months, and by 0.8 percent since the beginning of 2006, close to the lower limit of the seasonal path consistent with the target range of inflation.

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

Inflation expectations to one year ahead derived from the capital market have declined from their level in the last ten days of September, and in October they averaged about 1.5 percent, down from an average of 1.9 percent in August−September.

Forecasters' lowered their assessment of one-year inflation to 1.3 percent, from 1.9 percent in September. They cut their assessments of inflation for 2006 to a mere 0.3 percent, from 1.8 percent in September.

The break-even inflation rate for ten years, calculated from the returns on nominal and real bonds, fell by about 0.2 of a percentage point to about 2.3 percent. This exceeds the expectation of the ten-year inflation rate by a risk premium that is about 0.3-0.5 percent.

Following the publication of the most recent CPI, there was a consensus among all forecasters that the Bank of Israel would lower the interest rate for November by a quarter of a percentage point. Most of them expect a further similar reduction in December.

The *makam* curve (see below) reflects expectations of a cut in the interest rate over the next year.

The makam and bond markets

In the month prior to the interest rate decision, short-term real interest rates rose by about 0.2 of a percentage point to a level of 4 percent (up to 4 years) while long-term real interest rates reached a level of 3.8 percent (10 years). The nominal yield curve dropped in the month prior to the interest rate decision by 0.4 of a percentage point for the short run and by 0.2 of a percentage point for 10 years. The *makam* curve dropped along its entire length by 0.3 of a percentage point, and is flat at 5.6 percent.

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

Before this interest rate decision, the Bank of Israel interest rate exceeded that of the Fed by 25 basis points. US capital market data indicate a strong probability of no change in the US federal funds rate in the coming months and a cut in the first half of 2007.

The gap between the unindexed shekel yield curve and the US 10-year bond curve contracted during October to 127 basis points (from about 173 basis points in the middle of September). The narrowing of the gap reflects the fall of the *Shahar* unindexed bond yield curve.

The expected real interest rate

The expected real interest rate for one year forward rose in October by 0.4 of a percentage point to 4.1 percent because of the decline in inflation expectations. Since the beginning of the year the expected real interest rate has risen by 1.4 percentage points.

The money supply

The growth rate of the money supply (M1) over the past twelve months has been slowing since the beginning of the year and in September it stood at 11.6 percent. The growth was led by the demand deposit component, which grew in September at an annual rate of 14.7 percent, down from 16 percent in August. The cash element, which has been contracting since April, expanded by 7.6 percent over the past year.

The econometric models[1]

The various scenarios that were examined using the Bank of Israel's econometric models showed that achievement of the inflation target over the next twelve months would require a cut in the interest rate, as a result of the appreciation of the shekel and the fall in energy prices.

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[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.

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

Capital flows

The shekel appreciated against the background of a surplus in the balance-of-payments current account that is expected to exceed $ 6 billion in 2006, and foreign investment in Israel. The strengthening of the shekel was also partly due to the activity of nonresidents, who bought shekels in forward transactions, where most of the contracts were short term (up to three months).

The foreign-currency market and the share market

In October the shekel continued to appreciate: in the days immediately preceding the interest rate decision the exchange rate was around NIS 4.28 to the dollar. The shekel appreciated at a similar rate also against the currency basket.

Israel's share indices have been rising since the first third of September.

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 edged down in October to 29 basis points. Other emerging-market economies showed no change in their CDS levels.

Investment houses' surveys showed that the strength of the shekel and of the capital market during and after the war in the north reinforced nonresidents' confidence in Israel's economy, and as soon as it became clear that the hostilities had had only a limited effect on the economy and that the government coalition was more stable, investors returned to Israel. The strength of the shekel led many nonresidents to the conclusion that a reduction in the interest rate was imminent, and they therefore bought *Shahar* bonds and boosted their activity in the interest rate derivatives market. Apparently many of them considered Israel a safe haven among the emerging markets, partly due to its strong economic fundamentals.

6. Global economic developments (Full details in appendix)

Global growth is holding firm and, against the slowdown registered recently in the pace of growth in the US, the economies of Europe, Japan, and the developing countries—particularly China and India—are expanding and increasing their share. Expectations are that the Fed will keep its interest rate unchanged in the coming months, but will cut the rate in the first half of 2007. The European Central Bank is expected to raise its interest rate to 3.5 percent by the end of the year.

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

The inflation rate in the last twelve months, 1.3 percent, was below the mid-point of the target range. The inflation estimates and expectations to twelve months ahead are also lower than the mid-point. The major factors behind the reduction in the inflation environment are the strengthening of the shekel and the drop in global energy prices. As a result of the drop in the inflation rate, private forecasters and the players in the capital market expect a cut in the Bank of Israel interest rate for November and a further reduction for December, which would take the rate at the end of the year to 5.0 percent.

The data on real activity continue to indicate that the economy is recovering rapidly from the shock caused by the war, that led to reduced activity, mostly in the third quarter. The CBS revised its forecast of growth in 2006 to about 4.5 percent, and the Bank of Israel's forecast of growth in 2007 is about 4 percent. At the same time no inflationary pressures from the labor market are evident, as unit labor cost is showing a gentle downward trend due to the rapid rise in labor productivity.

As in last month's discussions on the interest rate, assessments of the fiscal cost of the hostilities and the implications for budget policy were discussed this time too. As a result of the cost of the war and the economic damage suffered, the government decided to increase its expenditure and to spread the increase over three years. This is expected to bring the government deficit to about 1.5 percent of GDP in 2006 and to 2.8–2.9 percent of GDP in 2007. Pressures for additional budget expenditures to improve Israel's defenses and to tackle welfare-related issues created uncertainty about the final shape of the budget. This uncertainty may persist for the next few months, until the Knesset approves the budget.

Israel's financial indicators strengthened further in the past month. Israel's risk premium, as measured by the five-year CDS spread, contracted slightly. The yield gap between 10-year *Shahar* bonds and US government bonds of the same term declined to 127 basis points from 173 basis points in mid-September. The shekel continued to appreciate, against the background of the surplus in the balance-of-payments current account, which is expected to exceed $ 6 billion in 2006, and substantial foreign investment in Israel. The strengthening of the shekel in the last few months follows a period since 2002 when a trend of real depreciation of the shekel against the currency basket—depreciation adjusted for differences in inflation rates in Israel and abroad—was evident; that depreciation totaled more than 25 percent. Prior to the Bank of Israel decision for November, the Bank of Israel interest rate exceeded that of the Fed by 0.25 of a percentage point.

The Bank of Israel's assessments and models indicate a high probability that the rate of inflation in the next few months will drop below the lower limit of the target range. Participants in the discussion related to scenarios tested by the various econometric models according to which it was reasonable to assume that, even after a cut in the interest rate for November of 25 basis points, the inflation environment would enable a further reduction in the interest rate.

The participants considered the possibility of a larger reduction in the interest rate for November but decided that it was important to pursue a gradual approach, both to avoid shocks in the financial markets and given the possibility of rapid changes in the inflationary environment.

To summarize: the decline of inflation to the lower part of the target range, the high probability of a temporary drop in the inflation rate (over the past twelve months) to below the lower limit of the target range, the appreciation of the shekel in the foreign-currency market as a factor affecting inflation, and the decline in global energy prices continue to constitute important factors that support a lowering of the interest rate. On the other hand, economic activity is continuing to expand rapidly, and pressures are being exerted to increase budget expenditure, and these are reflected in fiscal uncertainty that will persist until the budget is passed by the Knesset. The objective of the Bank of Israel's monetary policy is to bring inflation gradually back to around the mid-point of the target range.

In view of these various considerations, all the department directors who took part in the discussion recommended that the interest rate for November be cut by 0.25 of a percentage point. The Governor decided to reduce the rate for November to 5.25 percent.

The decision was made and published on October 23, 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
Mr. Yosi Fisher, Assistant Director of the Foreign Exchange Activity Department
Dr. Ohad Bar-Efrat, Head of International Affairs and Advisor to the Governor

Appendix: Major Global Economic Developments

U.S.

The latest economic data were mixed: on the positive side, employment figures were stronger than expected. Unemployment fell to 4.6 percent. The annual update of employment data showed that the number of employed was some 800,000 higher than the previously known figure**.** Housing market data on the other hand cast a shadow, indicating that the slowdown was persisting. As yet there is no consensus on the effect the housing market is likely to have on the economy. The concern is that stability or even a possible future drop in housing prices is likely to result in a considerable cutback in consumer spending. The wealth effect, however, created by rising share prices, the rise in incomes and the fall in oil prices will offset, at least in part, the moderating effect of the housing market, and will boost consumer confidence and support the continued rise in consumer spending.

Investment houses differ widely in their assessments of the growth rate, and their forecasts vary from 2.5 percent to 1.5 percent annual rate for the second half of 2006.

The inflation indices are still at a high level, with the main risk deriving from the persistent rapid rise of unit labor cost. At its October meeting the Fed left the interest rate unchanged at 5.25 percent. In its accompanying statement it mentioned that some additional firming may be needed in the future.

The bond market still believes that the round of interest rate hikes has ended and that the next change will be a cut in the course of the first half of 2007. Nevertheless, the probability of a reduction in the interest rate, as derived from the financial markets, declined.

Europe

The European economy continues to grow at a buoyant pace; the growth is becoming more firmly based and is expanding in scope, and is supported mainly by domestic demand. Data on economic activity, and the results of various confidence surveys for the third quarter published so far came as a pleasant surprise and support the assessment that the rate of growth during 2006 will stay at 2 percent, which is taken to be the potential long-term growth rate. European exports remain strong, and the rise in investment is expected to continue and to benefit from favorable financing conditions and from the rise in business profits. The rise in domestic consumption is expected to continue, against the background of the continued gradual improvement in the labor market and the fall in oil and commodity prices.

That said, the rate of growth is expected to slow in 2007, mainly because of the increase in VAT in Germany planned for the beginning of the year, the slowdown in global growth, and the strengthening of the euro against the dollar. These considerations led the European Commission to revise downwards its 2007 growth forecast for the eurozone. The investment houses also share the view that European growth will weaken in the first half of 2007, and expect it to average an annual rate of 1.5 percent.

The rate of inflation fell in September to an annual rate of 1.7 percent, from 2.3 percent in August, apparently due to the recent drop in energy prices. The ECB expects inflation to rise again in the coming months to more than 2 percent, and assesses that the risks in this forecast are biased upwards.

As expected, the ECB raised the interest rate in October by 25 basis points to 3.25 percent. The markets and the investment houses expect a further increase to 3.5 percent by the end of the year with complete certainty, and another rise in the first half of 2007 with a 70 percent probability.

Japan

The investment houses expect that the growth rate in the last quarter of the year will reach about 3 percent, and that it will ease back to close to 2 percent in 2007.

The Consumer Price Index rose by 0.9 percent in August, and core inflation by 0.3 percent, and both these indices reached their highest level in eight years. Inflationary pressures are likely to ease in the short term, however, as a result of the fall in commodity prices in general and oil prices in particular. The renewed decline in unit labor cost is also expected to restrain inflation.

In its October meeting, the central bank left the interest rate unchanged. It is expected to start raising the rate in the first half of 2007. The investment houses expect on average a rise of 25 basis points to 0.5 percent as early as the last quarter of 2006, with a probability of 40 percent.