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 setting the interest rate for April–May 2013

The discussions took place on March 21 and 24, 2013

General

In the process of making the monthly interest rate decision (which in this case applies to the next two months) 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 real, monetary and financial developments in Israel's economy, and developments in the global economy. Participants in this discussion include the three members of the Monetary Committee from the Bank—the Governor, the Deputy Governor and the Senior Advisor to the Governor—and the three members of the Monetary Committee from the public. Other participants in the discussion are the Directors of the Research and Market Operations Departments, and economists from various departments who prepare and present the material for discussion. The data, estimates and assessments in this report are those that were available at the time of the discussions.

In the narrow forum, which consists of the Monetary Committee and the Directors of the Research and Market Operations Departments, the two Departmental Directors 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 the Bank of Israel Law, 5770-2010, (section 18(c)), 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 BROAD-FORUM DISCUSSION—THE STATE OF THE ECONOMY

1. Developments on the real side

General assessment

Indicators which became available in the past month point toward an entrenchment of the assessment that there was an improvement in the level of activity in the economy during the first quarter of 2013. With that, it is too early to tell if this was the beginning of a positive turning point, or if it was a correction to weak results in the previous quarter.

Monthly indices of the economic situation

Updated indicators of economic activity in February point toward continuation of the improvement which began to be seen in January. Most indicators which became available this month are positive—the Business Tendency Survey indicates that there was improvement in activity in February, continuing that of the previous month. Similarly, the Climate Index indicates a continuation of the positive trend in the business sector, and the Composite State of the Economy Index increased in February at a rate similar to that of the previous month, and its growth rate is relatively high compared with the final quarter of 2012. The industrial production index increased by 5.7 percent in January, and the Purchasing Managers Index increased and reached the level indicating expansion in manufacturing industry. Most consumer confidence indices increased. Tax revenues in January–February were in line with the seasonal path consistent with the growth estimate of 3.8 percent. With that, it is likely that the positive picture derives from a correction from the weakness in the final quarter of 2012, following, among other things, security issues, and it is too early to tell if this is a change in trend.

The labor market

Labor market data which became available this month indicate stability in employment for January. Labor force survey data indicate a decline of 0.3 percentage points in the unemployment rate, to 6.5 percent, in January, with a decline of 0.2 percentage points in the participation rate. There was a slight decline as well in the unemployment rate among the main employment ages of 25–64, to 5.5 percent. Unemployment data are consistent with figures of the Israeli Employment Service, which reported a decline in the number of unemployed and laid off workers in January. Employers' expectations in various industries reported in the Business Tendency Survey for February present a mixed picture for the changes in the number of employed people in the coming 3 months. This was in line with the decline of 7 percent in February in the number of available posts. Nominal wages increased by 1.3 percent and real wages increased by 0.9 percent in the fourth quarter, based on seasonally adjusted data. Health tax receipts by the National Insurance Institute, which provide an indication of nominal wage payments, were 5.4 percent higher in December–February than in the corresponding period of the previous year, reflecting a slowdown compared with an average year over year increase of 6.4 percent in the preceding 3 month period.

Budget data

In February, the government operated without an approved budget framework and in accordance with the law allowing it to spend 1/12 of the overall 2012 budget each month in 2013 (including debt repayments), until a budget framework is approved. The cumulative deficit from the beginning of the year is about NIS 1.3 billion, about NIS 4.1 billion greater than the seasonal path consistent with the deficit of 3.6 percent of GDP derived from the fiscal rule and tax rates set in law. An examination of the spending commitments for 2013 made in past years indicates that in order to abide by the expenditure rule, the government must reduce the commitments by about NIS 13 billion (about 1.3 percent of GDP). Even after such cuts, this is still a real expansion of about 4.5 percent compared with the 2012 budget. Deviation in the government deficit is liable to lead to increased interest rates in the economy.

2. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) for February remained unchanged, in line with forecasts. The rate of increase in the CPI over the past 12 months remained essentially unchanged compared to recent months, at 1.5 percent.

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

Forecasters' inflation projections for the next twelve months, as well as inflation expectations based on over-the-counter CPI futures contracts offered by banks, were 1.8 percent on average, similar to their level last month. Inflation expectations for the next twelve months calculated from the capital markets (breakeven inflation), seasonally adjusted, remained stable at 2 percent. Inflation expectations for short terms (2–3 years) were unchanged at 2.4 percent, while expectations for the medium term declined slightly from the previous two months. Expectations for longer terms declined from 2.4 percent to 2.3 percent, continuing the marked decline of last month (from 2.8 percent to 2.4 percent). Expectations for the Bank of Israel interest rate one year from now derived from the Telbor (Tel Aviv Inter-Bank Offered Rate) market, and expectations based on the average projection of forecasters, are for an interest rate of 1.6 percent and 1.75 percent, respectively.

The monetary aggregates

In the twelve months ending in February, the M1 monetary aggregate (cash held by the public and demand deposits) increased by 12.9 percent, and the M2 aggregate (M1 plus unindexed deposits of up to one year) increased by 6.9 percent.

The credit market

The outstanding debt of the business sector declined by 0.3 percent in January, from NIS 779 billion to NIS 776 billion. Total outstanding credit to households increased in January by 0.3 percent, to NIS 386 billion. The total volume of new mortgages granted in February was NIS 3.9 billion, similar to January. The balance of housing debt was NIS 271 billion in January, an increase of 7.1 percent compared with January 2012. Interest rates on new mortgages taken out in January remained unchanged. The decline in the LTV ratio for housing loans continued in February, against the background of directives issued by the Supervisor of Banks. There was also a decline in the proportion of mortgages granted to finance homes purchased for investment purposes. The decline in the average LTV ratio and in the proportion of mortgages for investment purposes apparently indicate the increasing influence of constraints imposed by the Banking Supervision Department.

The housing market

The housing component of the CPI (based on housing rents) declined by 0.4 percent in February. In the twelve months ending in February, it increased by 2.5 percent, compared with an increase of 2.9 percent in the twelve months to January. Home prices, which are published in the Central Bureau of Statistics survey of home prices but are not included in the CPI, increased in December–January by 1.7 percent, after increasing by 1.1 percent in November–December. The rate of increase in home prices continues to rise. In the twelve months ending in January, home prices increased by 8.6 percent, compared with an increase of 6.7 percent in the twelve months to December.

There were 39,794 building starts in the 12 months ending in December, and this is expected to continue to support a high level of stock of homes. With that, the number of building starts in 2012 was about 13 percent lower than in 2011. In addition, the rate of properties marketed by the Israel Lands Administration has declined sharply.

The Bank of Israel Research Department staff forecast

This month, the Bank of Israel Research Department updated its macroeconomic forecast. According to its projection, the inflation rate over the next 4 quarters will be 1.7 percent, the Bank of Israel interest rate, which was 1.75 percent when the forecast was formulated, is expected to remain at that level in the coming year, and GDP, following the beginning of natural gas production from the Tamar field, is expected to grow by 3.8 percent in 2013 (similar to the previous forecast). Excluding the effect of natural gas production from Tamar, growth is projected to be 2.8 percent. In 2014, growth, impacted by the expected recovery worldwide, is forecast to accelerate to 4.0 percent (3.3 percent excluding the effect of natural gas production from Tamar). Gas production requires a small number of workers, so that the developments expected in employment and unemployment will primarily be affected by growth of GDP excluding gas production.

3. The foreign currency and stock markets

The foreign exchange market

From February 24, 2013, through March 20, 2013, the shekel appreciated by about 0.84 percent against the dollar, and by 2.9 percent against the euro. In terms of the nominal effective exchange rate, the shekel appreciated by about 1.95 percent during the period. The shekel's strength against the dollar during the month was in contrast to the dollar's trend worldwide.

The capital market

From February 24, 2013, through March 20, 2013, the Tel Aviv 25 Index increased by about 2.3 percent. Yields on government bonds increased moderately, and the yield differential between 10-year Israeli government bonds and equivalent 10-year US Treasury securities widened by about 5 basis points, to 209 basis points. *Makam* yields increased slightly along most of the curve by up to 6 basis points, with one-year yields increasing to 1.66 percent during the period. Israel's sovereign risk premium as measured by the five-year CDS spread was unchanged at 122 basis points. The Tel-Bond 60 Index increased moderately by about 0.1 percent over the period. Spreads in the corporate bond market widened for companies with lower ratings.

4. Global economic developments

The global macroeconomic picture was mixed in the past month. In the US, macro data continued to be mostly positive, and indicated continued recovery in the economy, despite the fiscal tightening measures which went into effect in the beginning of the year and in March. With that, the consequences of those measures, together with the debt ceiling issue, present a risk to the continued process of improvement, as already expressed in the decline in the consumer confidence index there. In the eurozone, macro data continued to be weak and indicated continued recession. Against this background, the European Commission and the ECB recently revised their eurozone growth forecasts for 2013 downward, with neither entity forecasting positive growth until 2014. In China, recent macro data indicated some loss of momentum in the growth rate. In the eurozone, there were two factors in the recent month which increased concern of a return of the debt crisis in Europe—election results in Italy which raised doubts about continued implementation of reforms in the country, and developments in Cyprus. Over the period, stock market indices of advanced economies increased. Oil and metals prices declined during the period, and agricultural commodity prices were stable. Monetary policy at most central banks did not change during the past month, and interest rates in major economies remained low, with expectations for accommodative monetary policy to continue.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR APRIL–MAY 2013

Main points of discussion

The six 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 April–May 2013, the Committee members voted unanimously to keep the interest rate unchanged at 1.75 percent.

The discussion focused on the following main issues: (1) the inflation environment; (2) the level of economic activity; (3) the fiscal situation; (4) the foreign exchange market, and (5) the housing market.

The Committee discussed the inflation environment—actual inflation and expectations for the coming year are around the midpoint of the target range. There was agreement among Committee members that the current inflation environment does not pose a limitation on reducing the interest rate should that be necessary.

Committee members agreed that an analysis of macroeconomic data and the results of surveys indicate an improvement in economic activity in the first quarter of 2013. With that, it is still too early to tell if results of the current quarter are a positive turning point in the level of economic activity which is expected to continue to expand, or if it is a temporary correction following weak growth in the previous quarter due to one-time circumstances, including, among other things, operation Pillar of Defense. As support for the viewpoint that we are at a turning point, it was noted that the effect of security occurrences on the economy's activity was relatively constrained, and thus it is difficult to attribute the entire improvement in economic activity to a correction following operation Pillar of Defense. Furthermore, indicators of private consumption and survey results signal optimism about expected developments. Yet in contrast, there were no major changes in the global economy in recent months, particularly in world trade, which would support a change in trend, thus it is possible that the increase in exports is a correction and not a turning point.

Committee members discussed developments in fiscal policy as well. Members expressed their concern about a negative impact on fiscal credibility as a result of not meeting deficit targets in the coming two years. The negative impact is liable to be expressed in an increase in funding costs of the government debt in the future. This concern derives from, among other things, the fact that the deficit in 2012 was, for the most part, structural, in a year in which the level of economic activity, as evidenced by the low unemployment rate, was not far from its potential level. Over-commitments in 2013, relative to the government's expenditure rule, total around NIS 13 billion. In order to meet the deficit target and the expenditure rule, the new government will have to significantly reduce its expenditures, and at the same time, increase its revenues. Committee members noted that even if such a cut is implemented, fiscal policy will not be restraining, since it reflects a real increase of 4.5 percent in expenditures relative to the 2012 budget.

The discussion also covered the foreign exchange market and the appreciation of the shekel in recent months. The Committee noted that the recent months' appreciation brought the exchange rate to a level slightly more appreciated than the level it was in the summer, before the depreciation it experienced in light of the security-related tensions.

Committee members agree that the rate of increase of home prices in recent months continues to be high, and that signs of moderation of activity in the market for homes are not seen, based on updated figures. With that, it was noted that home prices have not yet been fully affected by the most recent measure of the Supervisor of Banks which requires banks to increase their capital buffers in respect of mortgages. Committee members emphasized that monetary policy is limited in its ability, on its own, to affect this market, through its effect on demand for homes. Thus, the new government will need to adopt measures to expand the supply (accelerating planning processes and increased marketing of land, primarily in areas in demand), as well as possibly to restrain demand (such as taxation measures).

Following the discussion, the six members of the Monetary Committee voted on the Bank of Israel interest rate for April–May 2013. All Committee members supported keeping the interest rate unchanged at 1.75 percent.

The decision to keep the interest rate for April–May 2013 unchanged at 1.75 percent is consistent with the Bank of Israel's interest rate policy, which is intended to entrench the inflation rate 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.

In its announcement, the Bank highlighted the following main considerations underlying the decision to keep the interest rate unchanged at 1.75 percent:

- The inflation environment reflected in increased actual prices and expectations for one year ahead remains stable. Inflation over the previous 12 months was 1.5 percent, and forecasters' inflation projections for the next year are 1.8 percent, on average.

- Updated indicators of economic activity in February point toward continuation of the signs of improvement which began to be seen in January, but it is still too early to determine if this is a positive turning point. According to the Research Department's staff forecast, GDP growth is expected to be 3.8 percent in 2013, and 4 percent in 2014. Excluding the effects of natural gas production from "Tamar" drilling, GDP growth is expected to be 2.8 percent in 2013 and 3.3 percent in 2014.

- One of the sources of uncertainty regarding developments in the economy is the government's fiscal policy. An examination of the budget commitments which are already in place indicates that in order to abide by the expenditure rule, the government must reduce commitments this year by about NIS 13 billion (about 1.3 percent of GDP). Even after such a reduction, the budget would reflect a real expansion of about 4.5 percent compared with the 2012 budget. Deviation in the government deficit is liable to lead to increased interest rates in the economy.

- The global macroeconomic picture is mixed. There are signs of recovery in the US economy, while in Europe, the slowdown continues. With that, it appears that the there has been a decline in the probability of a crisis occurring, a development which has reduced the high level of uncertainty that prevailed in the past year.

- In terms of the effective exchange rate, the shekel continued its appreciation this month, following its strengthening in recent months.

- The rate of increase in home prices continues to rise, and in the 12 months which ended in January, home prices increased by 8.6 percent, compared with an increase of 6.7 percent in the 12 months which ended in December.

- During the past month, the expansionary policies of major central banks continued, and interest rates in those economies remained near zero. The accommodative policies of central banks in major advanced economies, based on their announcements, are expected to continue during the rest of the year.

The Bank of Israel will continue to monitor developments in the Israeli and global economies and in financial markets, particularly in light of the continuing high level of uncertainty in the global economy. The Bank will use the tools available to it 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 keep a close watch on developments in the asset markets, including the housing market.

The decision was reached and published on March 24, 2013.

Participants in the narrow-forum discussion:

Members of the Monetary Committee
Prof. Stanley Fischer, Governor of the Bank of Israel, Chairperson
Prof. Alex Cukierman
Dr. Karnit Flug, Deputy Governor of the Bank of Israel
Prof. Reuben Gronau
Prof. Rafi Melnick
Mr. Barry Topf, Senior Advisor to the Governor on Monetary Policy Issues

Other participants in the narrow-forum discussion:
Mr. Andrew Abir, Director of the Market Operations Department

Prof. Nathan Sussman, Director of the Research Department
Mr. Eddy Azoulay, Chief of Staff to the Governor
Dr. Yossi Saadon, Advisor to the Governor and Bank of Israel Spokesperson
Mr. Itamar Caspi, Economist in the Research Department
Ms. Esti Schwartz, Secretary of the Monetary Committee