Bank of Israel

October 08

Report to the public of the Bank of Israel's discussion on the interest rate held on 7 October 2008

This unscheduled discussion on the interest rate took place subsequent to the weekly discussion on the economic situation, in light of the latest developments

A. THE STATE OF THE ECONOMY

1. Developments on the real side

General assessment

In light of assessments, particularly those of the IMF, that the global rate of growth would slow and that world trade would increase by only 3 percent in 2009, and in light of the drop in prices of the financial assets held by the public and its expected effect on private consumption, the Bank of Israel revised its expectation of Israel's growth in 2009 downwards from 3 percent to 2.7 percent.

The labor market

The nominal wage per employee post in the business sector declined by 1.3 percent in July, and in the public sector by 0.7 percent. In the three months May–July the nominal wage in the business sector rose by 1.1 percent, and in the public sector by 0.6 percent (compared with the previous three months). In the last twelve months the nominal wage in the business sector rose by 4.5 percent, and in the public sector by 5.1 percent.

Foreign trade

Foreign trade prices for the second quarter of 2008 show a 7.8 percent increase in import prices, in dollar terms, and a 7.6 percent increase in export prices, compared with the first quarter. Given that the monthly foreign trade data are in current dollar terms, the implication of the relatively high increase in dollar prices is that the volume increases in imports and exports were lower than previously assessed.

Sales in retail chain stores

Sales in retail chain stores fell by 1.8 percent in August from their July level, after rising by 6 percent in June and 0.4 percent in July (seasonally adjusted).

Companies Survey for the third quarter of 2008

Reports from companies participating in the Bank of Israel's Companies Survey for the third quarter of 2008 (preliminary results based on reports from about half of the participating companies) indicate that the rate of expansion of business activity was slower than in the previous quarter.

2. Developments on the nominal side

Inflation

Since the previous interest rate discussion, on 22 September, no new data on the CPI have been received. Since the beginning of the year the CPI has risen by 4.4 percent, and in the last twelve months it has risen by 5.0 percent.

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

Inflation expectations for the next twelve months as derived from the capital markets (break-even inflation) declined from about 1.5 percent on 22 September to about 0.2 percent on 6 October; nevertheless, it should be noted that in this case expectations derived from the capital market are not a true reflection of inflation expectations because of the low volume of trade in CPI-indexed bonds in this period, due to the recent events in the capital markets. The domestic forecasters predict, on average, that inflation in the next twelve months will be 2.6 percent (compared with their previous predictions of 2.8 percent). They forecast that inflation in 2008 will be 5.1 percent, declining to 2.2 percent in 2009.

The forecasters expect, on average, that the CPI will rise by about half a percent in total in the months September–November. In the coming months inflation is expected to rise above its current level of 5 percent, and then to start on a downward trend till it returns to the target range.

Most of the forecasters predict that the Bank of Israel interest rate will not change in the next few months, and on average the forecasters predict that at the end of 2008 the interest rate will be about 4.2 percent.

At the time of these discussions, the slope of the *makam* yield curve reflected market expectations of a reduction in the Bank of Israel interest rate in the next twelve months.

The makam and bond markets

The yield on 5-year CPI-indexed bonds rose from 3.3 percent on 22 September to 4 percent on 6 October. In that period the yield on unindexed 5-year government bonds remained steady at 5.4 percent. The yield on one-year *makam* fell from 4.2 percent on 22 September to 3.4 percent on 6 October.

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

Prior to the current decision on the interest rate, the Bank of Israel interest rate was 2.25 percentage points higher than the US federal funds rate, and the same as the ECB rate.

The gap between the unindexed 10-year shekel government bond yield and the 10-year US government bond yield widened sharply as a result of the global financial crisis, from 230 basis points on 22 September to the high level of 288 basis points on 6 October—essentially the result of the decline in the 10-year interest in the US.

3. The foreign currency market and the share market

The foreign-currency market

In the period between the previous interest rate decision on 22 September and 6 October the shekel was stable against the dollar, and strengthened against the euro. On 22 September the rate was NIS 3.49 to the dollar, and on 6 October, NIS 3.47 to the dollar. On 22 September the rate was about NIS 5.10 to the euro, and on 6 October, about NIS 4.72 to the euro, a shekel appreciation of about 8 percent against the euro.

The share market

In the period between the previous interest rate decision on 22 September and 6 October the share market in Israel fell, against the background of shocks and high volatility in markets around the world. In that period the Tel Aviv 25 share price index dropped by about 15 percent.

4. Israel's financial risk, the sovereign risk premium

Israel's risk premium, as measured by the five-year CDS spread, increased significantly, from 115 basis points in mid-September to 125 basis points at the beginning of October. The risk premium in most emerging markets also increased significantly this month, in light of the global financial crisis.

5. Global economic developments

In the period since the last interest rate decision on 22 September the global financial crisis worsened significantly. Due to the dire situation in the global financial system following huge losses and the credit squeeze, on 20 September the US administration announced a plan for the US Department of the Treasury to buy from the private sector $700 billion of problem assets, such as mortgages and mortgage derivatives; despite the approval of the plan, however, it has not yet eased the situation in the financial markets.

Moreover, the leading central banks throughout the world (in the US, Europe and Asia) were continuing to inject huge quantities of liquidity to the markets, in order to reduce the spread between the central bank interest rate and the interbank rate.

The problems in the financial sector together with the expected global economic slowdown had made the markets nervous again. Share prices were falling steeply world wide, the various risk indices were rising, and financial spreads were widening to record levels.

With regard to inflation, despite the fact that it continues to be higher than desired and expected in the advanced economies, it is expected to fall in light of the reduction in commodity prices, particularly oil prices, and the expected economic slowdown.

At the time of this discussion, the Fed was expected to reduce the interest rate at the end of October from its current level of 2 percent. The ECB, too, hinted in the last few days at the possibility of a cut in its interest rate. The Bank of England was also expected to reduce its interest rate from its current level of 5 percent in the next few months.

B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION ON 7 OCTOBER 2008

In the narrow-forum discussion, five members of the management made recommendations to the Governor regarding the appropriate rate of interest. In the discussion, three of them recommended reducing the interest rate by half a percentage point (with effect from 12 October) to 3.75 percent, one member of management recommended not to reduce the rate at this time, and one member recommended cutting the rate by one percentage point.

The member of management recommending not to reduce the interest rate argued that although the events in the financial markets in the last few days did increase the probability of a slowdown and an easing of inflationary pressures, the developments could be reviewed at the next regular scheduled date for the decision and the appropriate steps taken then. Bringing forward the decision to reduce the interest rate by a few weeks would not have a significant effect on activity.

The member of management recommending a one-percentage-point reduction in the interest rate put forward the view that the main purpose of the decision was to support financial stability, and it was best to send a very clear message that the Bank of Israel would do everything necessary in that area.

The three members of management recommending a reduction of half a percentage point noted that inflationary pressures in Israel were expected to ease significantly, against the background of the continued fall in world commodity prices and the expected slowdown in growth. Inflation expectations and inflation predictions of the Israeli forecasters are currently within the target range.

It was pointed out in the discussion that the current situation in the global economy, since the deterioration of the financial crisis, has increased the probability of a slowdown in growth in the near future. A reduction in the interest rate would help the economy meet the challenges it is facing.

It was also stated that reducing the interest rate at this point would serve to enhance the functioning of the financial markets, and was of special importance at this point in time in light of the latest developments and the sharp rise in volatility in the financial markets around the world and in Israel. The world’s major central banks were expected to reduce their interest rates in the next few months.

Taking all the above into consideration, the Governor decided to reduce the interest rate by half a percentage point to 3.75 percent with effect from 12 October.

The Bank of Israel emphasizes that this decision to cut the rate of interest is consistent with the Bank’s aims to support economic growth and financial stability, as long as inflation is expected to converge to the price stability range.

The Bank of Israel will continue to closely monitor Israeli and worldwide economic developments, and will act to achieve price stability and to support the stability of the financial system. Subject to this, the Bank will continue to support the attainment of a range of macroeconomic objectives, in particular employment and growth.

The decision was made and published on 7 October 2008.

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/Financial Division, Research Department
Mr. Barry Topf, Director of the Market Activity Department
Mr. Balfour Ozer, Member of Management
Dr Ohad Bar-Efrat, Advisor to the Governor and Head of International Affairs
Mr. Gaby Fiszman, Chief of Staff to the Governor
Mr. Eddy Azoulay, Chief of Staff elect to the Governor
Dr. Yossi Saadon, Bank of Israel Spokesperson