**BANK OF ISRAEL**
Office of the Spokesperson and Economic Information

May 2009

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

**The discussions took place on 22 and 27 April 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*

Preliminary indicators relating to the first quarter of 2009 suggest that the weakness in economic activity and negative growth persisted, continuing the contraction in real activity in Israel's economy recorded in the last quarter of 2008.

*The composite state-of-the-economy index*

The composite state-of-the-economy index for March showed another decline, of 0.9 percent, following the declines (month-on-month) of 1.2 percent in February, 1.4 percent in January and 1.1 percent in December. These reflect the contraction of economic activity in the last few months.

The index of manufacturing production (seasonally adjusted) increased in February by 0.1 percent, after falling by 1.4 percent in January. The index of trade and services revenue dropped by 0.5 percent in February, after showing no change in January (month-on-month changes, seasonally adjusted).

*The labor market*

The nominal wage per employee post in the business sector increased by 1 percent in January compared with its December level. The average in the three months November–January fell by 3 percent, annual rate, compared with the average in the previous three months (seasonally adjusted).

The number of employee posts (seasonally adjusted) contracted in January by 1.1 percent from its December level. National Insurance Institute data indicate that the level of employment declined by 2.1 percent in the three months November–January compared with the level in the previous three months.

The unemployment rate is rising, and reached 6.8 percent in January, compared with 6.7 percent in December, and 6.5 percent in November.

*Foreign trade*

Goods exports (excluding diamonds) increased by about 1.1 percent in March from their February level (in dollar terms, seasonally adjusted), but were some 24 percent lower than their level in March 2008.

Goods imports (excluding ships, aircraft and diamonds) declined by 1.4 percent from February to March (in dollar terms, seasonally adjusted), and were about 35 percent lower than their level in March 2008. Some of the reduction was due to the fall in fuel prices, but most was the result of the decline in demand.

*The Bank of Israel Companies Survey*

The returns from participating companies show that business activity continued to contract in the first quarter of 2009, mainly due to demand-side constraints. The leading index reflects companies' expectations of a further drop in activity in the next quarter.

## 2. Budget data

Tax revenues dropped by 16 percent in real terms in January–March compared with the level in January–March 2008, after deducting the effects of tax rate changes; this reflects the slowdown in the economy. The decline in the first quarter was particularly notable in direct taxes, which fell by a real 21 percent compared with the first quarter of 2008, and which was largely due to the sharp drop in revenues from company tax, income from capital, and land tax.

As the budget for 2009 has not yet been approved by the Knesset (parliament), the government's monthly expenditure is limited by law to one-twelfth of the 2008 budget. Assuming that government expenditure will be in line with the proposed 2009 budget approved by the government in August 2008, the budget deficit in 2009 is expected to be 5.9 percent of GDP.

## 3. Developments on the nominal side

*Inflation*

The Consumer Price Index (CPI) increased by 0.5 percent in March, above forecasters' expectations, after falling in each of the four months from November to February. The increase in the CPI was largely due to the increase in housing prices.

In the last twelve months the CPI has increased by 3.6 percent, above the upper limit of the target range.

*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") remained until mid-April at a similar average level to that prevailing in March, about 0.7 percent. After the publication of the March CPI, which was higher than the forecasts, inflation expectations increased slightly, to 0.8 percent. The Israeli forecasters expect, on average, that inflation one year ahead will be about 1.2 percent, compared with their forecasts of about 0.5 percent at the time of the interest rate discussions last month.

On average the Israeli forecasters expect that the cumulative change in the CPI from April to June 2009 will be an increase of 1.3 percent, because the April index is expected to increase by about 1 percent.

With regard to the interest rate, the Israeli forecasters expect that the Bank of Israel rate will remain unchanged for May, and that at the end of 2009 it will be about 0.75 percent.

An analysis of the slope of the *makam* yield curve shows that capital market traders expect the interest rate to be cut by 0.2 percentage points for May, and thereafter to start rising, and to be 1.4 percent a year hence.

*The makam and bond markets*

The yield on 5-year CPI-indexed bonds fell in March to an average of 1.2 percent, compared with 1.5 percent in March. The yield on unindexed 5-year government bonds dropped to an average of 3.4 percent in April, from 3.6 percent in March. The yield on one-year *makam* declined in April to an average of about 0.9 percent, from about 1.1 percent in March.

*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 0.25–0.5 percentage points higher than the US federal funds rate, and 0.75 percentage points lower than the ECB rate.

The gap between the unindexed 10-year shekel government bond yield and the 10-year US government bond yield remained almost unchanged at 189 basis points on 23 March compared with 188 basis points on 23 April.

*The econometric models*[1]

Various scenarios were examined using the Bank of Israel's econometric models, under the assumptions that GDP will contract by 1.5 percent in 2009, interest rates

[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.

will remain low around the world and will start to rise in 2010, energy prices will steady, and world trade will contract.

In the basic quarterly DSGE (dynamic stochastic general equilibrium) model, which places great weight on expectations and which uses the Bank of Israel reaction function based on the smoothing of the interest rate path, in the scenario in which the exchange rate in 2009 is between NIS 4.21 and NIS 4.25 to the dollar—the Bank of Israel interest rate declines gradually to a level of zero percent during 2009 (and even lower, to a negative 0.6 percent in the last quarter of the year, a situation that may be interpreted as reflecting monetary expansion using a variety of instruments), and in 2009 as a whole inflation is 0.8 percent.

**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, the shekel weakened by about 4.9 percent against the dollar, from NIS 4.05 to the dollar (on March 23) to NIS 4.25 (on April 24). In the same period the shekel weakened by about 2.4 percent against the euro, from NIS 5.50 to NIS 5.63 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 depreciation of about 4 percent in the period from March 23 to April 24.[2]

*The share market*

The Tel Aviv 25 share price index increased by 13 percent between March 23 and April 23, while the Dow Jones index climbed by about 2.3 percent.

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

Israel’s risk premium, as measured by the five-year CDS spread, decreased in the month to the current discussion from 2.4 percent to 1.8 percent. The risk premium of most emerging market countries also declined in this period.

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

Data on global growth continue to indicate marked and increasing weakness. In April the IMF published a forecast of negative world growth in 2009 of 1.3 percent (annual rate), compared with its previous forecast in January of positive growth of 0.5 percent. Its forecast for 2010 is for global growth of 1.9 percent, compared with its January forecast of 3 percent.

The IMF expects GDP in the US to contract by 2.8 percent in 2008, and to remain unchanged in 2010 (in January its forecasts were for a decline of 1.6 percent in 2009 and positive growth of 1.6 percent in 2010). The GDP of the eurozone is

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

expected to decline by 4.2 percent in 2009 and by 0.4 percent in 2010 (compared with the January forecasts of a 2 percent contraction in 2009 and 0.2 percent growth in 2010). The IMF expects that in the Japanese economy GDP will drop by 6.2 percent in 2009, and that it will show growth of 0.5 percent in 2010 (the January forecast was for a contraction of 2.6 percent in 2009 and 0.6 percent growth in 2010). In April the IMF published its expectations regarding the emerging market economies—a growth rate of 1.9 percent in 2009 and of 4 percent in 2010 (compared with the forecast in January of 3.3 percent and 5 percent respectively).

The downward revision of the IMF forecasts between January to April was expressed very clearly in the expectations of world trade: The April forecast was for a slump of 11 percent in world trade in 2009 (compared with its January forecast of a 2.8 percent decline, and an increase of 0.6 percent in 2010 (compared with its previous forecast of 2 percent).

Representatives of the G7 countries met in April, and announced that they expected economic activity in their countries to start to recover later this year, but that growth would remain weak. They noted that the latest data indicated a slowdown in the rate of economic deterioration and that there were signs that the situation was stabilizing.

In the US the investment houses expect, on average, that the Fed interest rate will stay at its current level (of zero to 0.25 percent) till the end of 2009. The ECB cut the interest rate in April by 25 basis points to 1.25 percent, and the investment houses expect further reductions.

In light of the fact that in some countries the headline interest rate is close to zero, central banks are turning to additional policy instruments in order to pursue an expansionary policy

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

In the narrow-forum discussion, four members of management make recommendations to the Governor regarding the appropriate rate of interest for the economy. In the discussion of the interest rate for May, all recommended that the Governor leave the interest rate unchanged at its current low level, and that he continue to operate the non-standard tools that the Bank was employing.

The participants in the discussion stated that it was important that the Bank continue to support economic activity and increase liquidity in the financial markets by using various tools. This, given the average assessments of the Israeli forecasters that at the end of 2009, inflation (measured over the previous twelve months) would be close to the lower limit of the target range, and inflations expectations for a year ahead derived from the capital market were below the lower limit of the range.

The participants noted that the cuts in the Bank of Israel interest rate in the last few months had eased the cost of credit. It was pointed out, however, that the expansionary effect of a further reduction in the rate could be expected to have less of an effect than the cuts instituted hitherto. This is the case because banks are maintaining the banking spread (the difference between the interest they charge on interest and the interest they pay on deposits), and in the current situation their ability to reduce the interest they pay depositors is limited, as the rate is close to zero.

Given its objective of supporting economic activity, the Bank continues to pursue an expansionary policy, and in addition to the low level of interest, it is making active use of two additional tools. First, it is buying government bonds on the Tel Aviv Stock Exchange. By buying medium- and long-term government bonds on the secondary market the Bank is directly helping to lower longer term interest rates, and thus to boost economic activity. These purchases are at a rate of about NIS 200 million a day. The Bank is also continuing its purchases of about $100 million of foreign currency a day, in the context of its planned increase in the foreign exchange reserves. All the injection deriving from the purchase of bonds and foreign currency would be sterilized so that the interest rate decided upon would not be affected.

At the end of the discussion, the Governor decided to leave the interest rate unchanged for May, at 0.5 percent, and to persist with the other policy tools, with the intention of continuing to encourage economic activity.

The Bank stressed the following points in its announcement of the interest rate decision for May:

- Inflation in Israel is low—last month the probability that inflation will return to within the target range by the end of the year increased, and the risks of deflation receded. From the aspect of the achievement of the inflation target, no change to the interest rate is needed.
- The effect of the low rate of interest combined with the other instruments that the Bank is using is evident in the easing of the cost of credit, and this policy helps to encourage economic activity. The data indicate further contraction of activity, but there are early signs that may point to a moderation in the rate of decline.

The Bank of Israel will continue to monitor Israeli and worldwide economic developments and will act to encourage employment, growth and financial stability, and to achieve the price stability target.

The decision was made and published on 27 April 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

Dr Ohad Bar-Efrat, Advisor to the Governor and Head of Information and International Affairs Division

Mr. Eddy Azoulay, Chief of Staff to the Governor

Dr. Yossi Saadon, Bank of Israel Spokesperson

## Appendix: Major Global Economic Developments

### US

The Fed press release in April stated that "…the economy has continued to contract, though the pace of contraction appears to be somewhat slower." Unlike the financial markets that apparently show that the worst of the crisis has passed, the real economic data , with production, employment and private consumption heading the list, indicate continued weakness.

The data that came as a positive surprise in April were those relating to housing: house sales increased, as did the number of mortgage confirmations, and the confidence index of the US construction industry. One of the main reasons for this partial recovery was the interest rate on mortgages that dropped to unprecedentedly low levels following the start of implementation of the program to buy $1.1 trillion of agency mortgage-backed securities (MBS) and agency debt. That said, the stock of houses for sale continues to increase, as did the rate of foreclosures, and the number of building starts published in April indicated a decline.

The labor market continued to show serious deterioration: payroll employment is falling (since the outbreak of the crisis the US economy has lost about 5.1 million jobs) and the unemployment rate has increased to 8.5 percent.

The enormous scale of the support programs are expected to help the economy at least in the short term, but the budget deficit is expected to climb to about 12 percent of GDP. The large amount of credit flowing into the economy is likely to cause inflation in the future, and this month references were made to an exit strategy for moving away from monetary expansion. Thus Fed Chairman Ben Bernanke stated at a conference on credit held in April that "…the Fed must retain the flexibility to withdraw its record cash injections to restrain prices."

### Europe

In February manufacturing production in the eurozone fell by 18.4 percent compared with February 2008, and orders slumped by 34 percent. Unemployment reached an unprecedented 8.5 percent, and does not yet reflect the full severity of the situation. Germany, for example, has a special mechanism that enables companies to send workers home for a limited period, at the expense of the government, without having to fire them formally.

Somewhat surprisingly, in the field of corporate bonds European companies are ahead of their US counterparts, and some of the more solid among them have issued bonds in the last few months to in advance of the expected government bond issues.

The ECB reduced the interest rate in April by 25 basis points to 1.25 percent. In an address to the European parliament, ECB President Jen-Claude Trichet stated that the economic crisis in Europe was worsening. European inflation continues to be lower than expected and lower than desired, so that the ECB is expected to reduce the interest rate again at its next meeting.

### Japan

Japan's economy is experiencing difficulties worse even than those suggested by the economic data reported in the rest of the world. Japan's total exports in February were about half of those in February 2008, factory orders have plunged by about 85 percent, and manufacturing output by 35 percent (annual figures, compared with February 2008).

The OECD forecasts that Japan's GDP will contract by 6.6 percent in 2009, and that the debt/GDP ratio will surge to 197 percent. Against this background the Bank of Japan announced that it was expanding its planned purchases of corporate bonds, and the government announced additional incentives totaling more than $150 billion (about 3 percent of GDP) which will be focused on infrastructure projects, creating jobs and injecting liquidity into the markets.

**The emerging markets**

The decision of the heads of the G20 to increase the budget of the IMF significantly is likely to calm the concern regarding liquidity problems in the emerging market economies.

Information received regarding the Chinese economy is mixed: data on profit in manufacturing and consumer confidence indices have dropped to their lowest levels ever, but other data were surprisingly positive. Of special note was the surge in new loans advanced in March. The World Bank expects China's economy to recover from the crisis in the second half of 2009, thus helping to stabilize the whole Asian economy.