Bank of Israel

8.5.06

Report to the public of the discussions in the Bank of Israel prior to the setting of the interest rate for May 2006

The discussions took place on 24 April 2006

General

The process by which the Governor makes the monthly interest-rate decision consists of discussions at two levels—a more general discussion in a larger forum, and a subsequent discussion in a smaller forum. In the broad discussion the relevant background economic conditions are presented; these include developments, real and financial/monetary, in Israel's economy, and developments in the global economy. Participants in this discussion include the Governor, the Directors of the various economic departments in the Bank (the Research Department, the Monetary Department, the Foreign Currency Department, and the Foreign Exchange Activity Department), and economists from the different departments who prepare and present the material for discussion.

In the narrow forum, the department heads present their recommendations regarding the interest-rate decision, and following a discussion of the possible courses of action, the Governor makes his decision.

I. THE BROAD DISCUSSION

1. Developments on the real side

General

The data indicate continued relatively rapid growth in the economy, following the pattern evident in 2005 (when GNP rose by 5.2 percent). The most recent data come mainly from the Companies Survey for the first quarter of 2006. They indicate that growth is continuing and becoming more broadly based, and that companies expect the expansion to persist in the next quarter. The current indicators show a continuation of the upward trend in sales of the retail chain stores and in tourism, in trade and services revenue, in the index of manufacturing production, and in the number of employees. The considerable increase in tax revenue, particularly direct taxes, is consistent with the continued expansion of economic activity.

The Companies Survey

The Companies Survey indicates that the expansion of economic activity, which spread to all the principal industries, continued to become more firmly established in the first quarter of the year. The increased activity included both domestic sales and exports. Construction companies reported increased building activity in the first quarter, after a constant level of activity in the previous three quarters; they expect the upward trend to continue in the next quarter.

In the manufacturing, transport and communication industries companies reported a shortage of skilled workers.

Indicators of economic activity
Economic growth in recent months was reflected by the most recent data on several other indicators, including the composite state-of-the-economy index, which rose by 0.3 percent in February. The index of sales in the retail chain stores continued to reflect the positive trend it has shown during the last three years. The positive trend in the seasonally adjusted index of trade and services revenue persisted in January, although the rate of increase moderated. The seasonally adjusted index of manufacturing production rose slightly in January, and this taken together with the positive trend data indicates that the expansion shown by this index has become more firmly established in the last few months. The index of tourist bed nights also showed a rise in February, continuing the positive trend evident in the last few months.

Imports and exports
Trend data for the first quarter of 2006 indicate a decline in exports, despite the fact that the seasonally adjusted index of manufacturing exports was 3.3 percent higher in February than in January. The trend data indicate that imports remained steady, with imports of raw materials and consumer goods rising and those of capital goods falling, following two years of acceleration in imports of inputs (from the second quarter of 2003).

Labor market data
The latest data on the labor market show a continuation of the upward trend in employment in January (an increase of 2.9 percent from January 2005). At the same time there was a moderate rise in the nominal wage, while the real wage per employee post has been declining for seven months. Hence, at this stage of rising demand and the gradual narrowing of the output gap, the upward pressures on wage costs are not yet reflected in real wages.

2. Budget data

The budget performance since the beginning of 2006 is consistent with an annual deficit below the ceiling of 3 percent of GDP. Between January and March 2006 there was a cumulative budget surplus of NIS 7.8 billion (excluding credit). This surplus reflects the continued acceleration in tax revenues, and a contractionary level of expenditure below the seasonal path. In the absence of an approved budget, the monthly expenditure ceiling is determined on the basis of one-twelfth of the previous year's budget. Tax revenues rose by 12.8 percent in real terms in the first quarter of the year relative to those in the first quarter of 2005 (after making adjustments for legislative changes and differences in the timing of tax receipts).

3. Economic developments, nominal

Inflation

In the first three months of 2006, the CPI rose by 0.6 percent; in March it rose by 0.3 percent, the top of the range of economists' forecasts. In those three months CPI inflation exceeded the Bank's forecasts. In the last twelve months the CPI rose by 3.6 percent, and the wholesale price index by 7.6 percent, the latter reflecting price increases in most of the principal industries.

Inflation expectations and forecasts

Inflation expectations for the next twelve months derived from the capital market decreased to 1.9 percent in the first half of April, from 2.1 percent in March and 2.2 percent in February. Forecasters' one-year inflation expectations stood at 2.2 percent in March and April, with the range of their forecasts narrowing in April to between 1.6 percent and 2.5 percent. Inflation expectations one year forward derived from the capital market and those of forecasters have been close to the midpoint of the target range for more than a year.

Inflation expectations for more than a year forward range from 2.2 percent in two years' time to 2.6 percent in ten years (both in annual terms).

Expectations and forecasts of the Bank of Israel's interest rate

Most forecasters expect the interest rate for May to rise by 0.25 of a percentage point. The forecast rate for twelve months hence is 5.7 percent on average, ranging from 5.5 percent to 6 percent. The yield structure indicates that a 0.8-percentage-point rise is expected in the short-term interest rate during the next twelve months.

The policy-rate differential between Israel and abroad

Since January 2006 the interest-rate differential between the Bank of Israel rate and the Federal Reserve rate has stood at a quarter of a percentage point. Both the Bank of Israel and the Federal Reserve raised the interest rate in April by a quarter of a percentage point. The differential between the Bank of Israel rate and the ECB rate is 2.5 percentage points.

Expected real interest rate

The expected one-year real interest rate rose in April to its highest level in the last two years, 3.2 percent, from 2.8 percent in March.

The short- and longer-term interest rates

In March 2006 yields on 12-month Makam[1] rose to 5.7 percent, up from 5.6 percent in March. In the government bond market yields rose by 0.1 percentage points across the board.

The yield gap on 10-year government bonds between Israel and abroad

The yield gap between 10-year Israel government bonds and 10-year US government bonds declined to 1.7 percentage points in April, down from 1.8 percentage points in March, with Israeli rates exceeding those in the US.

The money supply

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[1] Short-term bills issued by the Bank of Israel for purposes of monetary management.

In March the money supply increased at an annual rate of 20 percent, reflecting a similar rate of increase in the cash held by the public and in their current accounts. The rise in the money supply exceeded the rise expected from econometric equations of the demand for money.

The econometric models
Alternative scenarios examined using the econometric models of the Research Department and of the Monetary Department show that the narrowing of the output gap, together with the rise in prices of inputs and the rise in the dollar interest rate abroad are affecting the rate of inflation at the current rate of interest, and that a rise in the interest rate is required in order to achieve the annual inflation target of between 1 percent and 3 percent in 2006.

4. The foreign currency market and the share market

General
The financial markets in Israel continued to show stability. Since the beginning of April the NIS strengthened against the US$ by 2.6 percent, and share prices have risen during April.

The foreign currency market
From the last policy-rate decision on 26 March 2006 until 20 April 2006 the NIS strengthened by 2.3 percent against the dollar, by 0.3 percent against the euro, and by 1.7 percent against the currency basket. The NIS exchange rate is affected by changes in the value of the dollar, and by domestic factors. Over the last month the NIS first weakened, and then strengthened. Around the period of the general election in Israel domestic investors increased their positions in favor of the dollar. The NIS weakened, and reached 4.715 to the dollar. This trend reversed a few days after the election, and the NIS started strengthening towards its current level of NIS 4.56 to the dollar. The strengthening of the NIS was the outcome of increased sales of foreign currency by nonresidents, via their investments in shares and bonds and via derivatives. On the other hand, households and institutional investors continued investing abroad.

The share market
Around the time of the election the indices fell by about 4 percent, and a week after the election they had recovered to their pre-decline level. Since the beginning of April share prices have gone up, and the Tel Aviv 100 index has risen by 4.9 percent.

5. Israel's financial risk and risk premium, surveys by foreign investment houses

Israel's risk premium, as measured by the Credit Default Swap (CDS) spread, increased slightly this month to 35 basis points. The CDS spread also increased in other emerging market economies.

Foreign investment houses believe in the continuation of relatively rapid economic growth in Israel, and note the positive macroeconomic data on Israel's economy and its strength. In some surveys of foreign investment houses there is a belief that the real exchange rate of the NIS is undervalued, and most foreign banks expect the NIS to continue gaining strength, based on the macroeconomic data on the economy, the expected interest rate in Israel, and the dollar's global weakness. The optimism of foreign investors toward the NIS is reflected in the net sale of dollars and purchase of NIS in the past month. Although the level of uncertainty has apparently abated, many foreign investment houses note that the possibility of government budget overspending could pose a risk to Israel's capital markets and to the NIS. In addition, the possible deterioration in the geopolitical situation constitutes a risk factor that could weaken the NIS. On the other hand, the continued weakening of the dollar globally could contribute to the continued strengthening of the NIS.

6. Developments in the global economy

General

Growth in the global economy, both in the developed and developing worlds, remains strong. The most recent forecasts from the IMF in April 2006 increased the forecast global growth in 2006 from 4.3 percent to 4.9 percent. Inflation in most economies is relatively moderate and is even expected to fall slightly during 2006 and 2007. However the recent sharp rise in prices of oil and commodities poses a danger of inflationary pressures.

US

Macroeconomic data published this month attest to strong and firmly based economic activity and reflect a considerable rebound in growth in the first quarter after the slower growth in the fourth quarter of 2005. Investment houses believe that the rate of growth in the first quarter of the year will be much higher than the potential rate of growth, and will reach 4.8 percent. The cooling off of the real estate market after a period of considerable acceleration constitutes the major risk to the sustained relatively rapid growth in the US economy.

Private consumption, which in recent years was the central engine of growth in the American economy, continues to rise while at the same time, the rate of private saving remains in negative territory and the Consumer Confidence Index has risen to a level not seen for four years. The labor market continues to demonstrate strength as unemployment dropped to 4.7 percent, a level quite near the estimated full-employment rate. The expansion of the business sector also continued, supported by high company profitability, growth in orders and positive business confidence, particularly in manufacturing.

From its interest-rate statement, the US Federal Reserve is still concerned about inflationary pressures resulting from the continued narrowing of the output gap and developments in prices of oil and other commodities. Recent rises in oil prices to $72.50 a barrel, against the background of a crisis with Iran together with fuel price rises in the US, constitute an inflationary threat. Likewise, commodity prices also continue to rise. Federal funds futures contracts factor in a rise of 25 basis points in the Fed's meeting scheduled for May 10, 2006, and a 50 percent chance of an additional 25 basis-point rise in June, which would bring the Fed funds rate to 5.25 percent. However, most investment houses expect the wave of interest-rate increases to come to an end in May with the rate at 5 percent. In the international forex market, the dollar is generally expected to weaken against the euro in the coming year and to approach an exchange rate of $1.30 to the euro.

Europe

Recently published macroeconomic data support the ECB's estimate that the rate of growth in Europe in the first quarter of the year will rise. Growth in Europe has been gathering speed and is expected to strengthen in the first half of 2006 while local demand recovers gradually, against a background of an expected improvement in the labor market. The global economy remains strong and continues to support the export sector.

Based on the positive figures, investment houses expect average growth of 2.4 percent in the first quarter compared to growth of 1.2 percent in 2005:IV. They also expect average growth of 2.2 percent for the year 2006.

Inflation fell in March to an annual rate of 2.2 percent. The ECB expects inflation in the short term to remain above 2 percent, with upside risks due to developments in oil prices and the expected rise in indirect taxes in Europe. The investment houses on average expect inflation to fall below 2 percent only in 2006:III.

As anticipated, the ECB left the interest rate unchanged this month at 2.5 percent. The market has factored in a rise in interest of 25 basis points at the ECB's June meeting (instead of in May). In addition, as can be seen from its interest rate discussion, the ECB has begun a process of monetary tightening that over time would result in a neutral interest rate. In this light, the markets and investment houses expect a more aggressive tightening than was first envisaged, and the investment houses estimate that the interest will eventually reach 3.25 percent while the markets factor in an interest rate of 3.5 percent.

Japan

Recently published macroeconomic data attest to a continued broad economic revival. Forecasts for growth are positive and the economy is expected to continue recovering. The investment houses predict an average growth rate of 2 percent in 2006:I and growth of 3.1 percent for the year 2006.

The CPI and core inflation for February continued to rise by 0.4 and 0.5 percent, respectively, in annual terms. The producer price index also continued to rise, particularly in light of the sharp increase in commodity prices worldwide. Inflation expectations remain positive. Investment houses expect inflation in Japan to remain positive throughout 2006.

Last month, the central bank announced a gradual easing of its quantitative monetary expansion policy of the past five years. Though this does point to a tighter monetary policy, the process is expected to be gradual and protracted. The investment houses expect that the central bank will raise interest rates only in 2006:IV. The markets have now factored in a rise of 0.25 percentage points by the end of 2006:III. In light of these expectations, together with the positive economic data, longer-term yields have continued to rise, with 10-year yields rising by some 50 basis points since the end of January to 1.95 percent.

II. COMMITTEE DISCUSSION ON THE INTEREST RATE FOR MAY 2006

In the discussion in the narrower group, the participants stressed the relatively high inflation in the past 12 months, beyond the upper limit of the inflation target range, particularly in light of the CPI figures for the first quarter which were also above expectations. These price rises are consistent with the continuing gradual contraction in the output gap.

Inflationary pressures appear to come primarily from the demand side, though there is also pressure on prices from the supply side, in light of higher input prices, particularly for energy. The wholesale price index rose in the past 12 months at a relatively high rate and this could reflect price rises that have yet to work their way through into the CPI.

The discussion participants noted that some rise in interest was required to restore inflation gradually to within the target range. This would be a continuance of the interest rises in the past few months and takes account of the time lag between implementation and effect. Despite the rise in the interest rate, according to forecasts, inflation over the past 12 months will exceed the target for a number of months, until its expected return to within the range in mid-2006. This expectation is based in part on an expected increase in the Bank of Israel rate, as reflected in the term structure of interest over the rest of the year.

In the course of the discussion, the participants related to several subjects, some of them in greater detail.

The unemployment rate, though relatively high, is on a downward trend which is expected to continue. The gradual reduction of excess capacity in production—which results from demand expanding faster than the expansion in supply—creates upward pressure on prices. The narrowing output gap exerts pressure on prices both through demand, directly influencing prices of goods, and through pressure on wages leading to higher production costs. It was noted that up to now, unit wage costs had not risen though there were indications that in some industries the shortage of skilled workers had increased. Given the narrowing surplus production capacity, the probability was growing that growth in the economy would find expression in rising prices.

Until the Knesset approves the budget for 2006, government spending follows the law on the absence of an approved budget, whereby monthly expenditure is limited to one twelfth of the previous year's budget. This rule dictates a tight budgetary policy for the period until the new budget is approved. Participants expected that the fiscal framework for the rest of the year would remain relatively restrictive.

In recent weeks the NIS strengthened against the dollar and the currency basket, together with an expectation that interest will rise slightly in the major world economies. The strengthening of the NIS against the dollar was influenced by both local and global factors, though the weakening of the dollar globally was the main force behind the strengthened NIS against the US$. At a more fundamental level, the prevailing estimate was that long-term players were continuing to bring considerable amounts of long-term capital into the economy. The inflow of long-term capital into the Israeli economy can be explained by increasing flows of capital into the emerging markets in general and by the strength of the Israeli economy in particular. The strengthening of the NIS acts as a counterbalancing force against inflationary pressures.

In summary, an environment of inflation higher than the 12-month target together with persistent upward pressures on prices were the primary factors underlying the discussion. In the discussion, views were that the interest rate should be raised this month in order to reduce gradually the inflationary environment and to return it to its target. The factors expected to push prices up this coming year and which supported the argument for raising the interest rate this month were the continued gradual narrowing of the output gap and the rise in energy prices. Against this, the strengthening of the NIS in the forex market moderates the upward pressure on prices.

In the light of the above considerations, the department directors each recommended that the Governor raise the interest rate for May by 25 basis points. The Governor decided to raise the interest rate for May by 25 basis points to 5.25 percent.

The decision was made and announced on April 24, 2006.

<u>Those present at the discussion:</u>
Prof. Stanley Fischer, Governor of the Bank of Israel
Dr. Karnit Flug, Director of the Research Department
Dr. Edward Offenbacher, Director of the Monetary Department
Mr. Balfour Ozer, Director of the Foreign Exchange Activity Department
Barry Topf, Director of the Foreign Currency Department
Dr. Ohad Bar-Efrat, Advisor to the Governor
Mr. Gaby Fiszman, Advisor and Chief of Staff to the Governor
Ms. Tamar Ramot- Niska, Economist
Ms. Rimona Leibowitz, Deputy Spokesperson