BANK OF ISRAEL
Office of the Spokesperson and Economic Information

May 3, 2021

Report on the Bank of Israel's discussions prior to deciding on the interest rate

The discussions took place on April 18 and 19, 2021.

General

The Monetary Committee sets the interest rate in a process that includes two discussions—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 the real and financial-monetary developments in Israel's economy, and developments in the global economy. Participants in this discussion include the members of the Monetary Committee, senior representatives from the various departments of the Bank, and economists from the economic departments (Research and Markets), who prepare and present the material for discussion.

In the narrow forum—which consists of the Monetary Committee and a representative of the Markets Department—the Research and the Markets Departments present their views of the main considerations that should guide the setting of the monetary policy. An open discussion on monetary policy follows, which ends with a vote on the level of the interest rate. According to Section 18(c) of the Bank of Israel Law, 5770–2010, the decision on the interest rate is reached by majority vote of the members of the Monetary Committee who participate in the voting.

A summary view of the economic situation available at the time of the Committee's discussion is presented in the notice regarding the interest rate decision, which was published on April 19, and in the data file that accompanied the notice.

THE NARROW-FORUM DISCUSSION

The members of the Monetary Committee participating in the discussion decide on the appropriate rate of interest. After the discussion, it was decided to keep the interest rate unchanged at 0.1 percent. Five Committee members supported the proposal to keep the interest rate unchanged, and one Committee member supported the proposal to reduce it to 0 percent.

The discussion focused on the expected path of inflation and the monetary policy required in that regard; as well as the state of the labor market—where there is a high rate of broad unemployment at the same time as considerable difficulty for employers to recruit workers; the high growth rates expected against the background of the notable easings in coronavirus limitations, together with the expected lengthy recovery until the economy matches the level of GDP and employment that would have been expected had the crisis not occurred; the stabilization of the exchange rate; the decline in financial market spreads and an easing in the financing constraints in the credit market; and the improvement of the global economy, particularly the US.

Main points of discussion

The Committee discussed the increase in the inflation environment reflected in the year over year inflation rate entering positive territory, CPI readings for February and March being higher than expected, as well as in rising inflation expectations. The Committee discussed the question of whether the recent rise in prices is only a transitory correction to the low price levels during the course of the crisis. The Committee was of the opinion that it is too early to determine that, and that developments in inflation should continue to be followed going forward, but it assessed the probability of an outbreak of inflation to be low. The various indices of inflation expectations have been on an upward trend for several months, reflecting the expectation that inflation will return to the lower part of the target range in the coming months. The increase in inflation expectations could be explained by the upward trend of actual inflation, the economic recovery in Israel and the improvement in the global economy as well as the rise in inflation expectations worldwide, the increase in global commodity prices, the accommodative monetary policy, as well as the stabilization of the exchange rate in view of the Bank of Israel's intervention policy.

Since the last interest rate decision, the exchange rate has been stable—the shekel appreciated by 1 percent in terms of the effective exchange rate and against the euro, and weakened by 0.4 percent against the dollar. At the end of 2020 and in the beginning of 2021 there was a sharp appreciation due to the strengthening of foreign currency flows into the economy. This was against the background of the increase in direct investments in Israel, foreign-exchange sales by institutional investors against their capital market profits, an increase in investment by nonresident entities in Israeli government bonds, and the growth in the current account surplus, part of which was impacted by transitory factors. The Monetary Committee's decision on the purchase program for 2021 at an unprecedented scope of $30 billion supports the continued exit from the crisis and the return of inflation to within the target range. The Committee declared that it will continue to comply with the program as announced and will even expand it to the extent necessary, in accordance with the economy's conditions and development.

According to the forecast by the Research Department—which this time presented only one scenario—GDP is expected to grow by 6.3 percent in 2021 and by 5 percent in 2022. These rates are faster than the pre-coronavirus crisis growth rates and reduce to a large extent the output gap created at the GDP level due to the contraction in 2020. This forecast reflects the optimism due to the decline in morbidity, the reduction of limitations and the relatively rapid opening of the economy, as well as the pace of expansion of activity, which are made possible by the high effectiveness of the vaccinations. The current forecast for the level of GDP is slightly higher than in the scenario of rapid vaccinations that the Department published in January. The main factor that contributed to the higher forecast is the higher level of activity at the end of 2020. As a result, despite the 2021 growth forecast not changing, the level of GDP at the end of 2021 is expected to be higher than what was expected in the previous forecast, and this is true for the GDP level in 2022 as well. At the same time, the level of GDP at the end of 2022 is still expected to be slightly lower (a gap of about 1.4 percent) compared with its expected level had the crisis not occurred.

The Committee expressed concern over the state of the labor market, and the slow recovery expected in it, as in 2022 as well the broad unemployment rate is expected to be 6 percent, higher than its level just before the crisis. The return of the unemployment rate to its low levels of just before the crisis is expected to take a long time. The government's policy regarding employment could also have an impact in this regard. The Committee noted that the broad unemployment rate is high, yet at the same time employers have considerable difficulty in recruiting workers, as seen in the Business Tendency Survey conducted by the Central Bureau of Statistics as well as in the record number of job vacancies. With the recent opening of industries that were closed for a prolonged period of time, such as the restaurants and leisure industries, an adjustment process is expected between demand for work and the supply of work, which can last for some time. At the same time, the Committee noted the concern that government policy does not create enough incentives for workers to return to the labor market.

The increase in the pace of vaccinations worldwide is aiding the global economic recovery. The International Monetary Fund revised its growth forecast upward for all the major regions. World trade continues to grow and its level is higher than before the crisis. The inflation rate increased in all major regions, but core indices remained lower than central bank targets. Monetary policy at the major central banks continues to be very accommodative. The US is showing signs of significant economic recovery, as a result of the rapid distribution of vaccines, a reduction in restrictions, and the launch of a fiscal program at a significant scope of 8.5 percent of GDP, alongside a planned tax reform that, if implemented, is expected to have a global impact. In contrast, in Europe there is an increase in morbidity that has led the major countries in the eurozone to announce a renewal of the lockdown policy.

Most Committee members assessed the current extent of monetary accommodation, through its various tools, to be sufficient for now, particularly in view of the additional tools being adopted. The Committee will design its policy so that it will continue to provide macroeconomic support for exiting the economic crisis, and to ensure that the credit market continues to function with low and stable interest rates and that the supply of credit remains adequate. In February and March, for the first time since the crisis began, the average level of the difficulty reported by companies in recruiting workers declined, and returned to the levels observed just before the crisis in all industries, except for the hotels industry, among other reasons due to the policy steps taken by the Bank of Israel and the Ministry of Finance.

Five of the Committee members were of the opinion that the interest rate should be left unchanged at 0.1 percent. These five Committee members thought that the low level of the interest rate supports a recovery of economic activity and a gradual return of inflation to the target range, particularly in view of the Bank of Israel using additional tools in the credit market and in the foreign exchange market. One Committee member voted in favor of reducing the interest rate to 0 percent. He believed that an interest rate lower than 0.1 percent is more appropriate due to the intensity of the crisis and the unusually intense impact on the employment level.

The Committee noted that the opening of the economy and the return to normal life in Israel are expected to support continued rapid growth in the coming year. However, there are still challenges to economic activity—in view of the health risks in Israel and abroad—and the adverse impact on the economy, and particularly on the labor market, is expected to be prolonged. The Committee will therefore continue to conduct very accommodative monetary policy for a prolonged time, using a range of tools as necessary, including the interest rate tool, in order to continue to support the attainment of the policy targets and the recovery of the economy from the crisis, and to ensure the continued orderly functioning of the financial markets.

Participants in the narrow-forum discussion:

Members of the Monetary Committee:
Prof. Amir Yaron, Governor of the Bank and Chairperson
Mr. Andrew Abir, Deputy Governor of the Bank of Israel
Prof. Reuben Gronau
Prof. Moshe Hazan
Prof. Zvi Hercowitz
Prof. Michel Strawczynski

Other participants in the narrow-forum discussion:
Ms. Dana Orfaig, Research Department
Mr. Tal Biber, Head of the Markets Division, Markets Department
Dr. Golan Benita, Chief of Staff to the Governor
Mr. Uri Barazani, Spokesperson of the Bank
Mr. Arad May, Secretariat of the Monetary Committee
Ms. Shulamit Nir, Research Department
Mr. Yoav Soffer, Advisor to the Governor
Mr. Daniel Shlomiuk, Spokesperson's Office