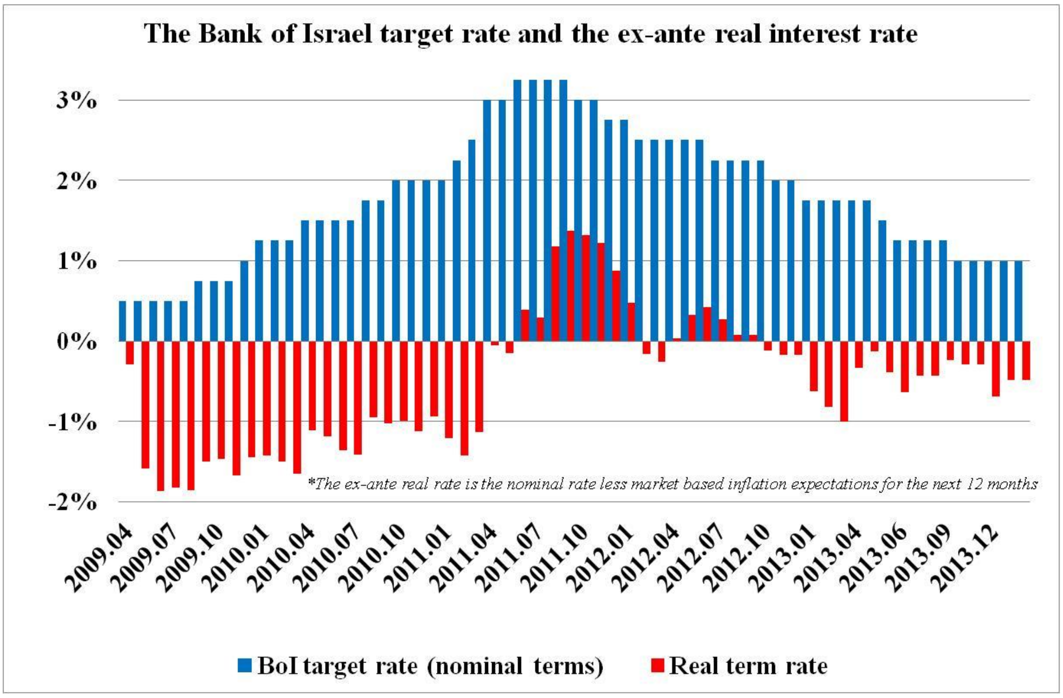
Leumi Economic Weekly

January 29, 2014

The interest rate of the Bank of Israel will remain unchanged in February against the backdrop of the increase in mortgages granted and the upgrade of the global growth forecasts

For the fifth consecutive month the Bank of Israel (BoI) will keep its interest rate unchanged in February, leaving it at 1.00%. Consequently, and also due to stable forward-looking 12-month inflation expectations (currently at 1.5%), the real interest in the economy has remained at -0.5% (see diagram). This real rate reflects a very expansionary monetary policy, and in our opinion is likely to limit any room for maneuverability by the central bank's monetary committee, due to concerns over asset price inflation.



Similar to the trend in recent months, there were actually arguments supporting an interest rate cut, while there were other arguments that opposed a cut. The factors supporting an interest rate cut included, among other things, the continuing pressures for appreciation of the shekel exchange rate vis-à-vis the US dollar and the basket of currencies (see further details below) and the consequent rise in the risks to growth in the economy, characterized in recent months by a moderate growth when looking over the long-term. Furthermore, some economic indicators published recently attest to an improvement in real activity, while other indicators attest to a freeze in activity.

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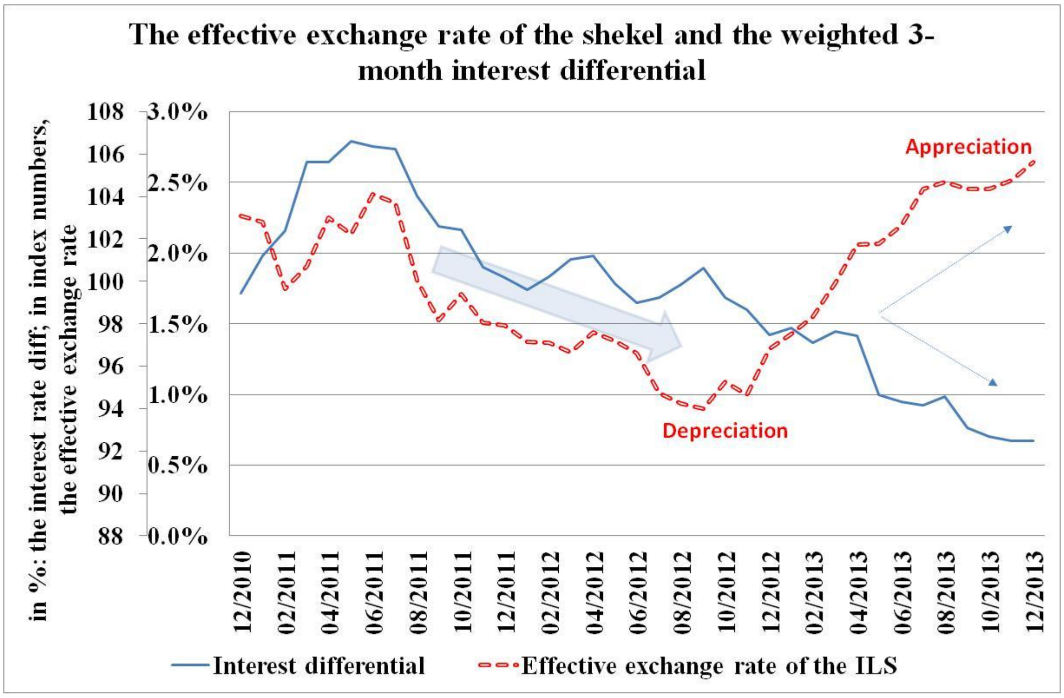
The main factors opposing an interest rate cut included the increase in mortgages granted and the rise in housing prices. New mortgages granted increased in December, after a decline in the September-November period compared to the three preceding months (June-August). However, it should be noted that the number of mortgages granted each year in December tends to be higher compared to the preceding months. In addition, housing prices increased 0.5% in October-November compared to September-October, and in total housing prices jumped 8% in the trailing 12-month period. However, it is noteworthy that in recent months the annualized rate of increase in housing prices has moderated lately. In our opinion, if the upward pricing pressures in the housing market will continue to moderate, the BoI will be able to concentrate its policies on supporting growth in the economy.

An additional factor opposing an interest rate cut was the improvement in the global economic outlook against the backdrop of the increase in the global economic growth forecast of the International Monetary Fund (IMF) for the first time in two years. However, it must be noted that simultaneously the IMF lowered its growth forecasts on international trade activity and on imports by developed countries, which is not good for the Israeli economy.

The degree of effectiveness of an interest rate cut on the exchange rate of the shekel is minor

The main factors that should have supported a cut in the central bank interest rate included the 1% appreciation in the exchange rate of the shekel vis-à-vis the US dollar since the previous interest rate decision (this in contrast to the trend around the world after the dollar strengthened during this period vis-à-vis most of the main currencies), and the 1.5% appreciation vis-à-vis the basket of currencies of Israel's main trading partners. The appreciation of the shekel in the month preceding the interest rate decision was a direct continuation of the trend that began in October 2012. It is noteworthy that in recent days the nominal, effective exchange rate of the shekel reached a peak of appreciation of more than 12 years (from December 2001).



As is known, the trend of appreciation in the shekel reduces the level of competitiveness of Israeli goods and services in global markets, a situation that restricts the export sector's ability to grow, and restrains the local business sector in general as it competes with cheap imports. However, at the current interest rate level, and given that the factors behind the appreciation of the shekel are apparently insensitive to interest rate changes, the degree of effectiveness of the interest rate tool and of additional rate cuts, for the purpose of reducing the upward pressures on the shekel and of supporting economic growth, is limited.

As can be seen in accompanying diagram, throughout 2011 and the first three quarters of 2012 the interest rate differential between the shekel and the currency basket narrowed due to interest rate cuts in Israel, and this during the time in which the interest rates of Israel's main trading partners were at low levels or close to their lows. At the same time, a depreciation occurred in the exchange rate of the shekel vis-à-vis the currency basket. However, and as can be seen in the diagram, starting in the fourth quarter of 2012 there was a sharp change in the behavior of the exchange rate and a separation was created between two different variables: the interest rate differential between Israel and overseas, and the real exchange rate of the shekel.

This development included a continuing appreciation of the shekel, while the BoI continued to use the policy instruments at its disposal similar to before, despite the change in reality, such that as the central bank continued to cut the interest rate, the shekel continued a trend of appreciation over the last 14 months. In light of the separation between the trend of the shekel and the trend in the interest rate differentials, it can be assumed that other factors were and probably are still having a dominant contribution to the strengthening of the shekel. In our opinion these factors include the surplus in the current account of the balance of payments, the upward trend in direct capital inflows in 2013, and also recently an increase in financial capital inflows. Alongside these developments must also be emphasized the initiation of gas production from the Tamar reservoir during 2013.

It is well known that in order to moderate the upward pressures on the shekel the BoI has continued to purchase foreign currency, and recently the central bank has even increased the amounts purchased. In December the BoI purchased US$630m, of which US$330 were bought according to the foreign currency purchasing plans decided on in May 2013, which were intended to offset the impact of gas production on the exchange rate. According to the developments in the foreign currency market it appears the efficiency of the current foreign exchange purchases is limited in the ability to support depreciation in the exchange rate of the shekel, and the efforts being taken, which involve substantial costs, are directed primarily at preventing a continuation of the shekel's appreciation.

However, in the absence of long-term instruments at the current time for dealing with the long-term basic factors behind the appreciation of the shekel and its possible damage to growth, the BoI is expected to continue to purchase large amounts of foreign currency, and is actually likely to increase the amount it purchases in the short-term.

The interest rate is expected to begin to climb in the second half of 2014

In the near term, a number of contrasting factors exist that will influence the monetary policy of the BoI. On one hand, the strength of the shekel and the risks to growth that accompany it, and this in an environment of moderate economic growth and low inflation, support an interest rate cut. On the other hand, the improvement in the global economic outlook, together with concerns regarding asset price inflation, primarily in the housing market, does not support any additional interest rate cuts.

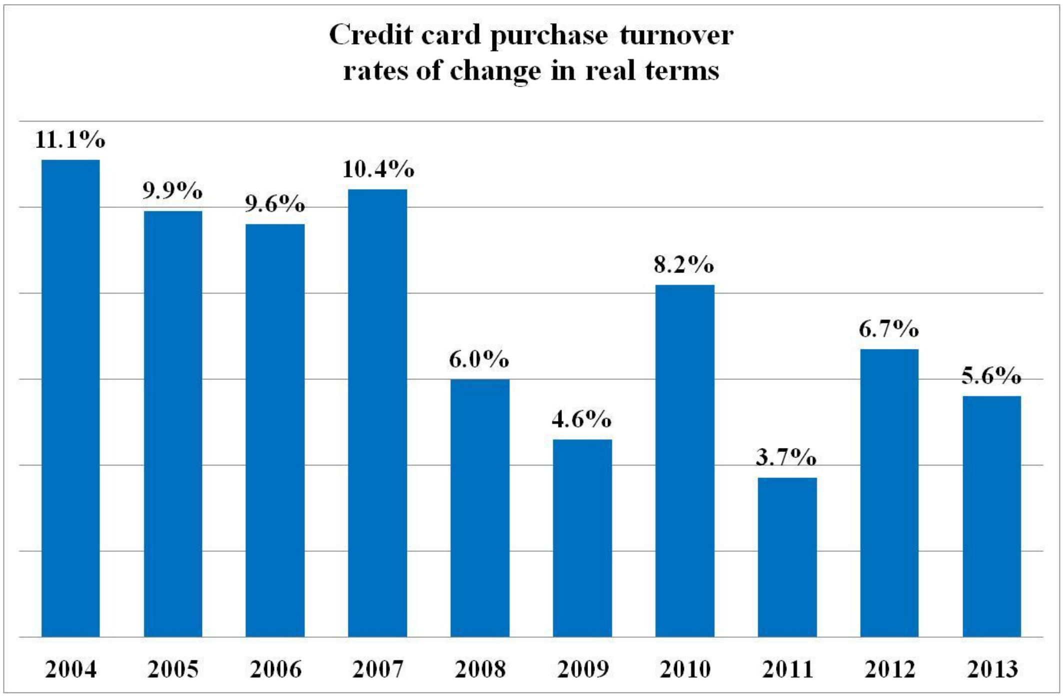
In the event there will be no meaningful changes in the underlying economic conditions, then the BoI will likely leave interest rates unchanged in the coming months. However, if there will be an additional substantial appreciation of the shekel, together with a freeze or a certain decline in real activity originating from exports and industrial production in the coming months, then the BoI will still likely cut its interest rate 25 bps, despite the limited impact at the current interest rate levels on the exchange rate of the shekel and support for economic growth.

Looking over the longer-term, we expect the BoI rate will likely start to climb, moderately and gradually, during the second half of 2014 against the backdrop of the forecast improvement in the rate of growth among Israel’s main trade partners during the year, and also against the backdrop of estimates for rate hikes in a number of developed economies around the world. However, the timing and the rate of hikes will be determined by the developments in real activity – primarily those that are expected for 2015, according to which the market will operate at an increasingly stronger rate from mid-2014 onwards, and developments in the risks to growth and in the inflation environment in the economy. Furthermore, developments in the monetary policy of the US and in the world in general, will have an influence on the timing of the initiation of the BoI's interest rate hikes.

A slowdown in the rate of increase of credit card purchases in the fourth quarter of 2014

Total credit card purchases increased 5.6% in real terms in 2013 (unadjusted data). This is a low rate of increase compared to that in 2012, yet is close to the average from recent years. It can be seen in diagram that the rates of growth of credit card purchases in 2008-2013 fell compared to the rates of growth seen in the years 2004-2007. This trend has been affected by the global economic crisis over recent years, similar to the trend of moderation in the rates of GDP growth. An analysis of developments in credit card purchases in recent quarters also indicates a certain moderation in the growth of purchases in the fourth quarter compared to the third quarter (according to data excluding seasonality), against the backdrop of a moderation or stability in credit card purchases in a number of notable sectors, among them being books, office equipment and advertising, department stores, furniture, as well as government and municipal services. On the other hand, in the fourth quarter there was an increase in the purchases of computers and software, communication equipment and services, and also in tourism and flight services.

In light of the positive correlation between total credit card purchases and private consumption, the slowdown in the growth of credit card purchases in the fourth quarter of 2013 is likely to indicate a certain slowdown in the growth of private consumption in the fourth quarter compared to the third quarter. Looking forward, we estimate the rate of growth of private consumption is likely to moderate in 2014 compared to 2013 against the backdrop of the restrictive fiscal policy implemented last year and the pessimism among consumers against the backdrop of employment insecurity in the economy.



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