Karnit Flug: A peek into the Monetary Committee room

Main points of address by Dr Karnit Flug, Governor of the Bank of Israel, at the opening of the "Aharon Institute for Economic Policy" at the Herzliya Interdisciplinary Institute, Herzliya, 16 March 2014.

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I am very happy to be participating at this event. The economic discourse on matters of policy in Israel is sometimes shallow, and there is no doubt that policy research can enrich it. That is why this institute is important. At the Bank of Israel, we certainly know how to value high-quality economic research that supports making good policy decisions.

In this lecture, I will try to provide "a peek into the Monetary Policy room". The name of the lecture was taken from an article written a few years ago by Prof. Rafi Melnick – "A peek at the Governor's Office". Prof. Melnick doesn't need to peek, since he is a member within the Monetary Policy room. I will try to illustrate the economic thinking and analysis that stand behind policy decisions, thereby perhaps providing direction for the type of policy research this institute can undertake, thereby deepening and enriching the economic policy discourse, at least in this area.

The Bank of Israel's policy goals are derived from the Bank of Israel Law. The tools available to the Bank are, of course, the interest rate and the Bank's ability to intervene in the foreign exchange market. In recent years, the Bank of Israel has also used the authority of the Supervisor of Banks to take measures in order to reduce the risks in the mortgage market.

In the process of making decisions on the interest rate, we discuss the situation assessment of a number of relevant issues, in the global economy and in the domestic economy. For instance, in the most recent interest rate decision, we discussed developments in the global economy. We distinguished between the positive growth in leading indicators, mainly in the advanced economies, and some weakness and disappointment in the emerging economies. Global growth forecasts show a very gradual recovery – the entrenchment of growth in the US with continued stagnation in the European economy. A very important variable for the Israeli economy is global trade, and it is expected to recover and to support economic activity in Israel. We looked at US data, and saw weakness in the labor market data there, although the argument was raised that it is a temporary weakness due to the weather. In general, data in China and in the US indicated weakness, mainly in manufacturing, and we also saw a negative turnaround in the real estate industry in the US, which was one of the growth engines there in the recent period. In other words, the global picture is mixed – a slight improvement in the advanced economies, and a less positive picture in the emerging economies.

We also look at monetary developments around the world. We saw a continued decline of inflation, and the International Monetary Fund even recently indicated concern of deflation in Europe. In the emerging markets, mainly those with a current account deficit, we saw rapid depreciations, and in some of those countries, the interest rate was raised in order to deal with these depreciations. In contrast, the tapering process in the US continued, but both the US and Europe announced that the low interest rate would remain for a prolonged period.

In the domestic economy, we saw weakness in the growth rate. National Accounts data showed a slowdown in business sector product, which for the past two quarters has grown by about 1.6 percent. This is roughly the growth rate of the population, meaning that this is a weakness in terms of growth of economic activity. We saw improvement in manufacturing and in exports of the high technology industries, but weakness continues in the low technology industries, both in exports and in manufacturing for the domestic market. We saw weakness in the labor market. While the labor market aggregates seem quite positive – the historically low unemployment rate, and high employment and participation rates – we see that most of the positions were created in the public services and not in the business sector. The wags of Israeli workers alone are at a standstill, but when foreign and Palestinian workers are included, there is a slight increase in wages. Consumer confidence and business sector confidence indices also indicate weakness. So the labor market aggregates seem positive, but a deeper look at the developments in the various industries – wage and work hours data – show weakness in the labor market.

Of course, we also look at inflation data. The January CPI reading showed a decline of 0.6 percent, and in general, inflation in the past year is below the target range. The core inflation indices also indicate very moderate inflation, close to the bottom of the target range, and expectations of inflation in the future are quite moderate. In other words, the inflation environment is below the center of the target range, which supports lowering the interest rate. The exchange rate is in an appreciation trend – we saw a sharp appreciation at the beginning of 2013 and moderation in the trend in recent months.

Another area that we have been dealing with a lot recently is the housing market. The volume of activity, transactions and mortgages, is very high, housing prices continue to increase, and there is significant growth in the volume of building starts and building completions. Should it continue at appropriate levels, this growth is expected to lead to moderation in the volume of homes, although we still do not see this moderation. We also look at various indicators that deal with financial stability.

Beyond the collection of data that I have presented here briefly, we use a macroeconomic model in order to assess the developments in the market, and to discuss the effects of various policy scenarios on activity in the market, inflation, and so forth. The framework in which we assess such scenarios is a very complex model, called the DSGE model, which is used by many central banks operating within an inflation targeting regime. This model combines the connections between the various economic units in the market and the economic variables, both nominal and real, within one coherent framework. The model enables us to make simulations and examine what the effect would be of alternative policy paths, as well as exogenous shocks, on inflation and on economic activity. We look at the various transmission channels, as reflected in the model, from the Bank of Israel interest rate and the other economic variables to the target variables – inflation and the volume of economic activity.

As such, this is the conceptual framework on the basis of which we make policy decisions. If we glance at the discussions during which we made the interest rate decision for March, we looked at a decline in the inflation environment, a slowdown in GDP and business product growth, weakness in the labor market, the cumulative appreciation of the shekel, and slow and moderate recovery within a low inflation environment and monetary accommodation in the global market. All of these considerations supported monetary expansion, meaning a reduction in the interest rate. Against these considerations, there is, of course, the housing market and the continued increase in home prices. In this context, I will mention that there are other tools available to the Supervisor of Banks in order to reduce the risks in this market, and we have used these tools.

So, this is the policy decision process that we employ at the Bank of Israel. We can think of various issues that studies written by the researchers at this institute can deal with, to help in making policy decisions. For instance, I mentioned the labor market and the low unemployment rate, and despite this, the sense of weakness in the labor market. We can ask to what extent the current unemployment level that we see is structural unemployment, to what extent it is frictional unemployment, and in the context of developments in the labor market, what is the correct monetary policy.