Nadine Baudot-Trajtenberg: Main developments and challenges in achieving the inflation target in Israel in recent years

Remarks by Dr Nadine Baudot-Trajtenberg, Deputy Governor of the Bank of Israel, at a conference, organized by the Bank of Canada, Ottawa, 17 September 2017.

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Accompanying slides

"I should like to thank the organizers of the conference for inviting me to participate and share with you Israel's experience with inflation targeting, and particularly our recent experience which is not unlike that of many other small open economies except perhaps in a more accentuated form: solid growth, rising wages, strong currency and inflation not only below its target but mostly in negative territory for 3 consecutive years.

As a general background, let me recall that Israel saw a decade of hyperinflation in the 70's and early 80's, followed by a decade of disinflation policy that targeted a gradually diminishing inflation rate, while the present day 1%-3% range for top line inflation has been effective since 2003. Though 12 month inflation has at times variated out of this range, it did so mostly for short periods of time due to fluctuations of the exchange rate. This was the case until approximately 3 years ago, when inflation fell systematically below target for now more than 3 consecutive years. Note that medium and long term inflation expectations have continued to be well anchored within the target band, thus giving credence to monetary policy.

The importance of price stability, was reiterated in the renewed Bank of Israel Law in 2010, where it states that the Bank's first role is to maintain price stability, while supporting economic growth and financial stability. The Bank is given what appears to be ample room to attain its target, 24 months, allowing it to "look through" temporary shocks, or onetime events that are expected to have short-lived impact on inflation, thus pushing it out the range fleetingly. Or so we thought. But first, let me zoom out and give you the broad outline of macro data the MPC took in to construct its view of economic developments.

Over the past few years, while many of Israel's trading partners were faced with a financial crisis and coping with a protractedly underperforming economy, Israel's economy was growing steadily, and is now at close to its potential growth rate, supported by a continued rise in labor rate participation (particularly of women), growth in employment across sectors, and rising real and nominal wages which have emboldened private consumption expenditures. Of course, the data underlying this picture, does not come in smoothly, and aside from the labor market data that were consistently strong, we had plenty of fluctuations, including significant revisions of quarterly national account data and despite a robust current account surplus, we faced a clearly underperforming export sector. The lull in export was in part due to the slowdown in world trade, but we were keenly aware of the continuing strengthening of the shekel, beyond what we could estimate would be the normal adjustment reflecting the relatively good performance of the Israeli economy.

So unemployment was at an all-time low, wages were rising and yet inflation remained low, compelling us to dig deeper into its sources in order to disentangle its underlying "core" trend, from a series of exogenous shocks that pushed inflation down. These were many and varied, from importing "deflation" from abroad, to decreasing energy prices, to successive reduction in administered prices such as water, electricity, children daycare, a cut in VAT, to welcome structural reforms that enhanced competition in industries such as communication. These came in addition to a backdrop of social protests concerned about the cost of living that increased the public's price awareness and changed consumer habits enhancing competition in the retail sector, particularly with the increased use of internet buying. This phenomenon is

shared by other countries, but there is ample evidence that the **level of prices** in Israel is higher than its other advanced countries, thus leaving more space for price reductions through enhanced competition and consumer savvy.

Throughout this period, of now about 3 years, all forecasts and market expectations systematically underestimated the downward forces on prices, and thus overestimated forthcoming inflation.

The discussions in the MPC reflected our challenge of on the one hand allowing for a welcome reduction in the level of prices, and on the other maintaining the overall price stability environment – a hard won anchor that allows for the good functioning of the economy.

We lowered the Bank of Israel's rate as inflation was dropping, to reach 0.1% in March of 2015 when 12 month inflation reached what turned out to be its lowest point at –1%. In addition, whenever the shekel appeared to embark on what we viewed as excessive momentum not justified by fundamentals, we intervened in the FX market, and still do so, not only because of its impact on prices but also to avoid the unwarranted impact on export industries, particularly of goods which tend to be more sensitive to the exchange rate. One could look at it as the QE of small open economies.

A year passed, and still the inflation rate was below target and still in negative territory and we observed that the same forces were at play, and expected to continue to be due to the global economic and monetary environment and because of our own domestic conditions. It was clear that we needed to show our patience with the price environment. We did so by introducing non-conditional forward guidance – there were clearly too many elements behind the low inflation to allow us to turn some into conditions – which we reiterated more recently, and in our view was correctly interpreted by the market.

Patience has its virtue but must not be confused with inaction, the BoI has been patient with inflation to return, but quite active to ensure that the crucial broader environment of price stability remains intact. Inflation expectations of the medium and longer term are still well anchored within the target range bestowing credibility to the monetary policy.

To conclude in the spirit of this forward looking conference, I would draw 3 points from the recent Israeli experience.

First, protracted periods of below target inflation do not entail an automatic loss of monetary policy credibility. For the latter to be maintained, we need to better understand, and better explain, how the transmission mechanisms operate – through short term interest rates, long term rates, exchange rate and asset prices. This will lead us to use more tools and more targeted tools when available.

Second, the Israeli experience does not lead to the need of changing the inflation target: an important anchor for the economy must not be amenable to easy change unless there is strong evidence that it is no longer at the appropriate level. Inflation in Israel is also strongly impacted by global inflation, and while the debate on changing the inflation target is also taking place globally, there is no reason for Israel to be a pioneer in this change, if the change takes place.

Third, monetary policy must take into account financial conditions as signaled daily, if not hourly by the markets, but as upholder of a necessary and crucial nominal anchor it must be able to withstand noise and remain forward looking. This in turn requires the Central Bank to engage in discussions and better explain its interpretation of sometimes contradictory data on the one hand, and to withstand "flavor of the day" pressures. "