



Challenges faced by Advanced Inflation Targeters: The Case of Israel

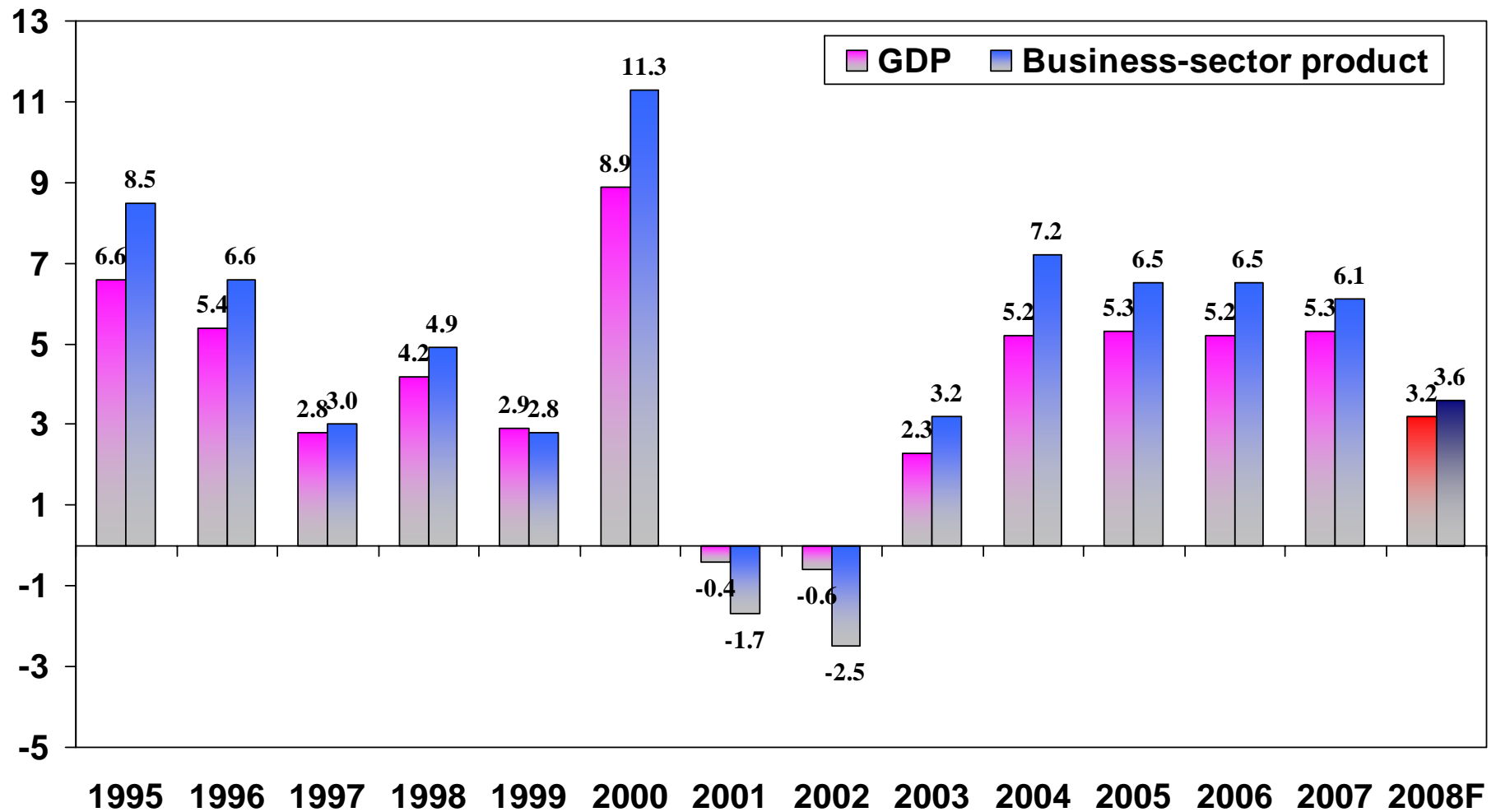
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Bank of Israel**

Prepared for a Conference at the Czech National Bank,

April 8 2008

Economic Performance of the Israeli Economy

GDP and Business-Sector Product (1995-2008*)



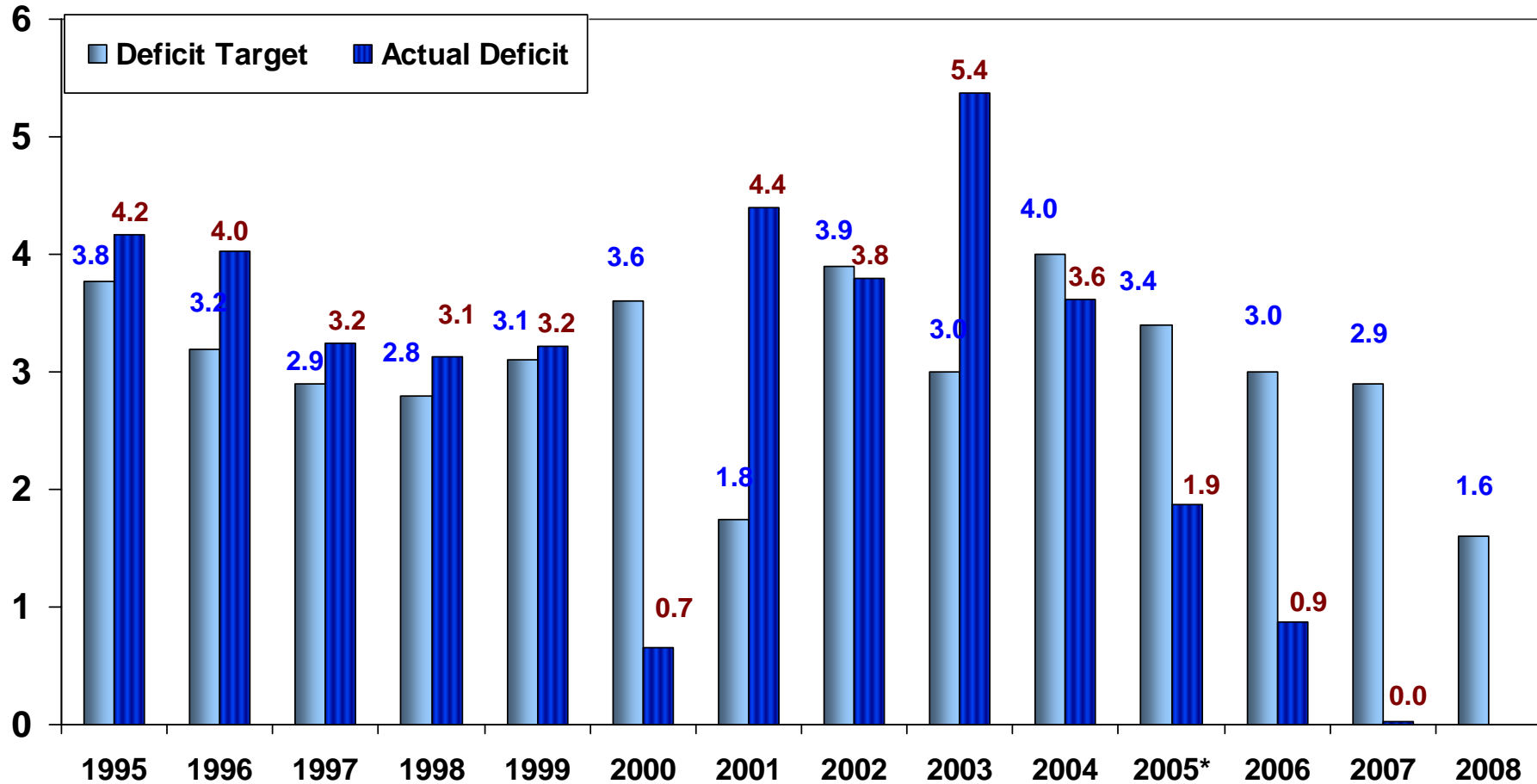
* BOI Forecast.

•SOURCE: Central Bureau of Statistics.

Budget Deficit*

(percentage of GDP, 1995-2007)

%

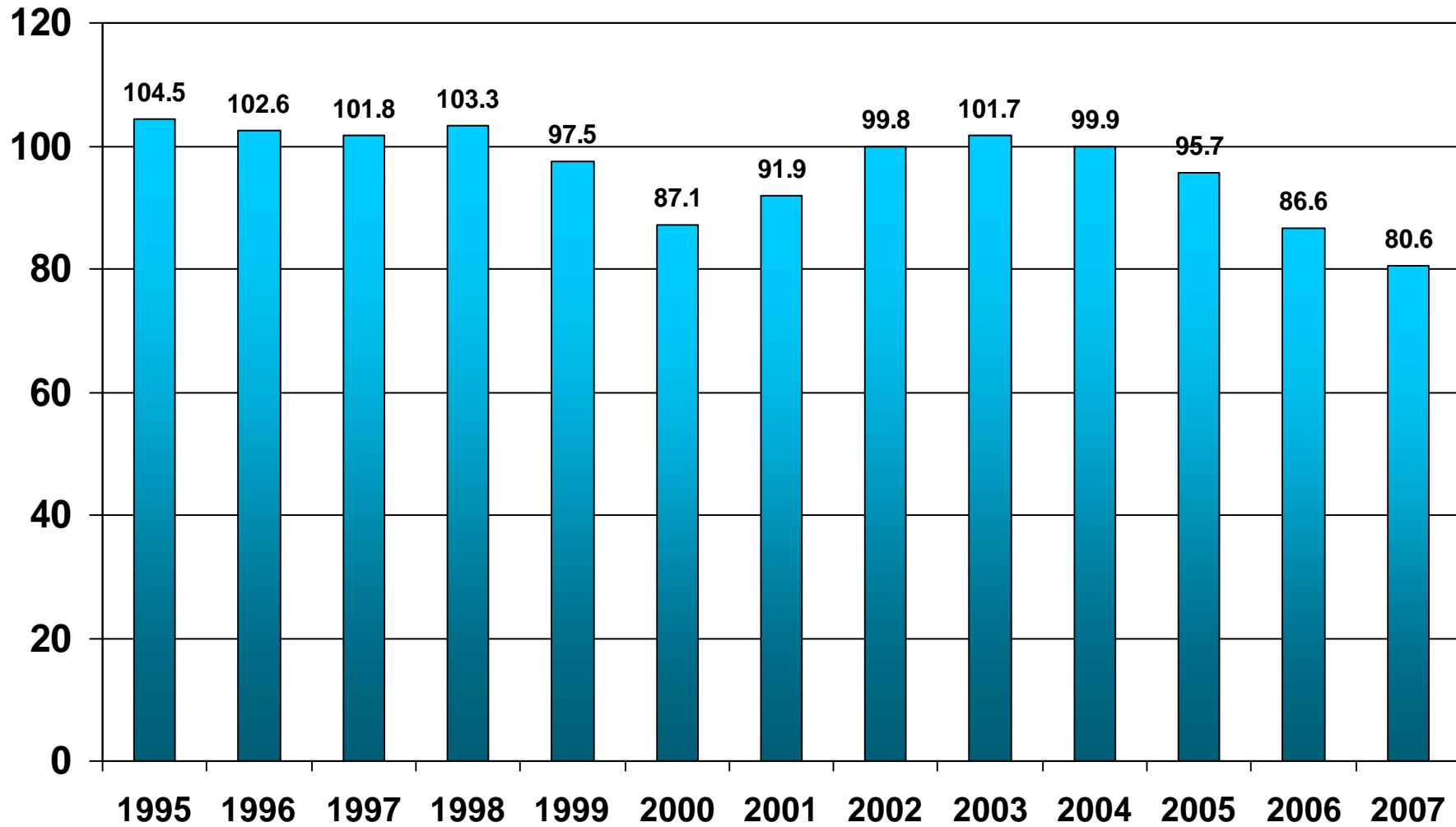


*Percent of GDP; excluding credit extended. Until 1996, domestic deficit; from 1997, total deficit.

*The data from 2000 refer to the deficit excluding the Bank of Israel's profits.

Public Sector Debt, Percentage of GDP, 1995-2007 (year-end)

%



Rate of Unemployment

1995-2007 (Annual)

%

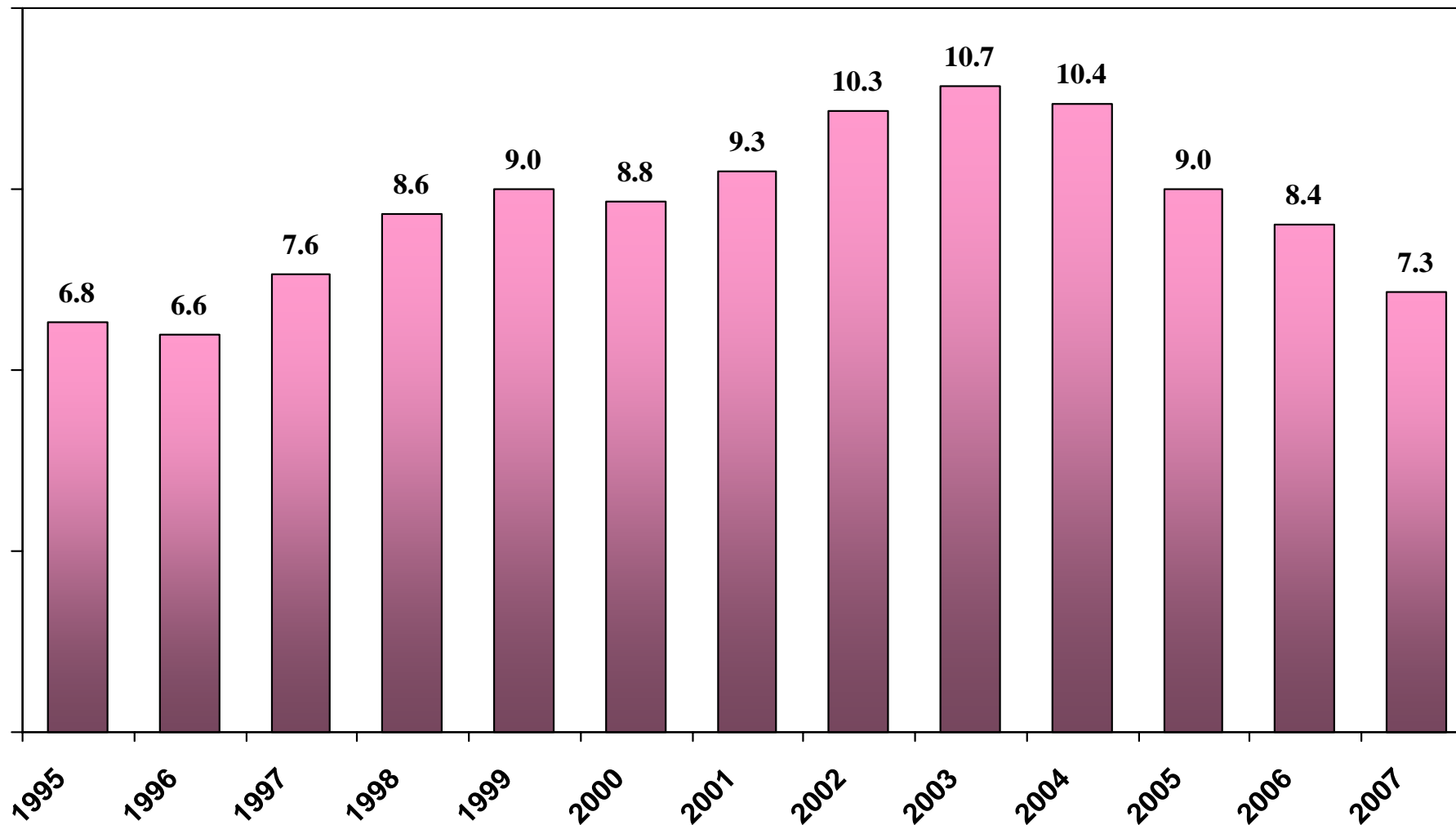
12

9

6

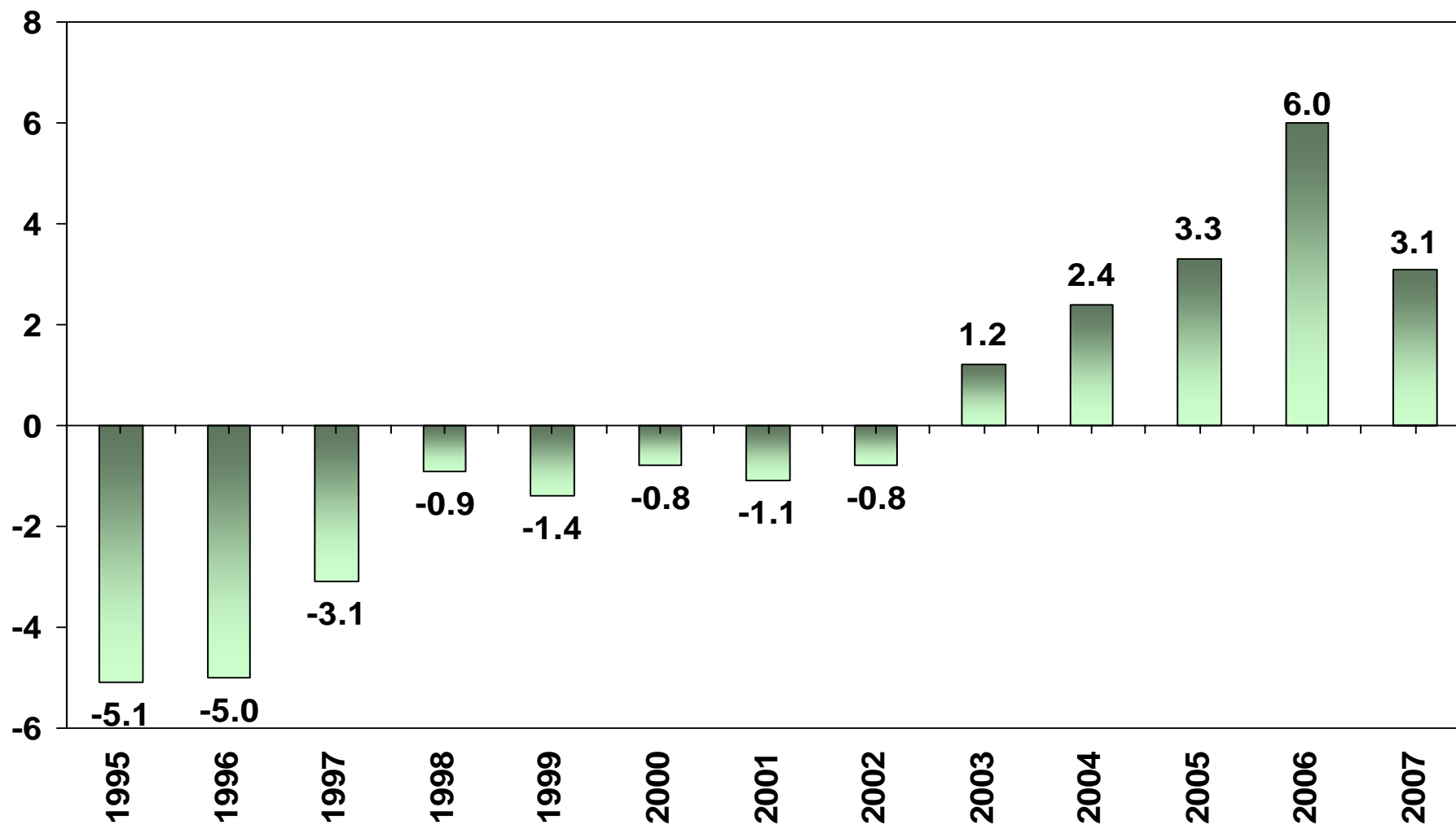
3

0



SOURCE: Based on Central Bureau of Statistics Labour Force Survey.

Current Account of Balance of Payments as Percentage of GDP, 1995-2007 (Annual)

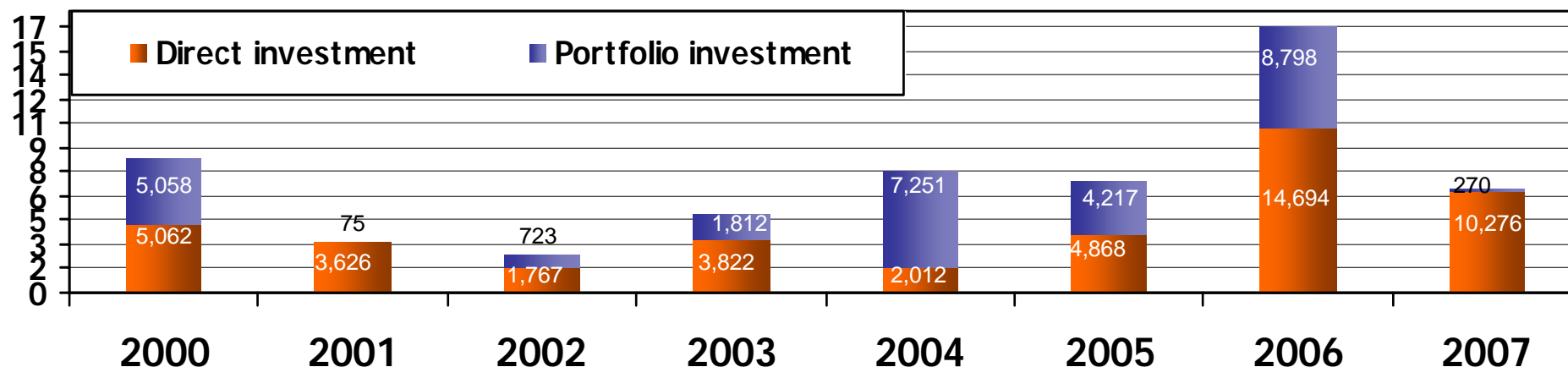


•SOURCE: Balance of Payments, Central Bureau of Statistics.

Investment in Israel by Nonresidents

%

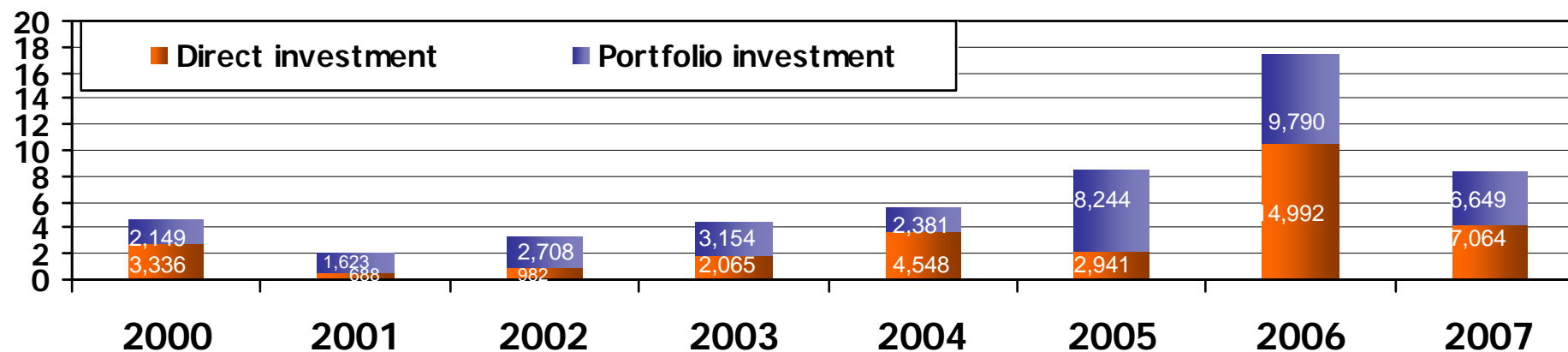
(as percentage of GDP, 2000-2007)



Investment of Israeli Residents Abroad

%

(as percentage of GDP, 2000-2007)

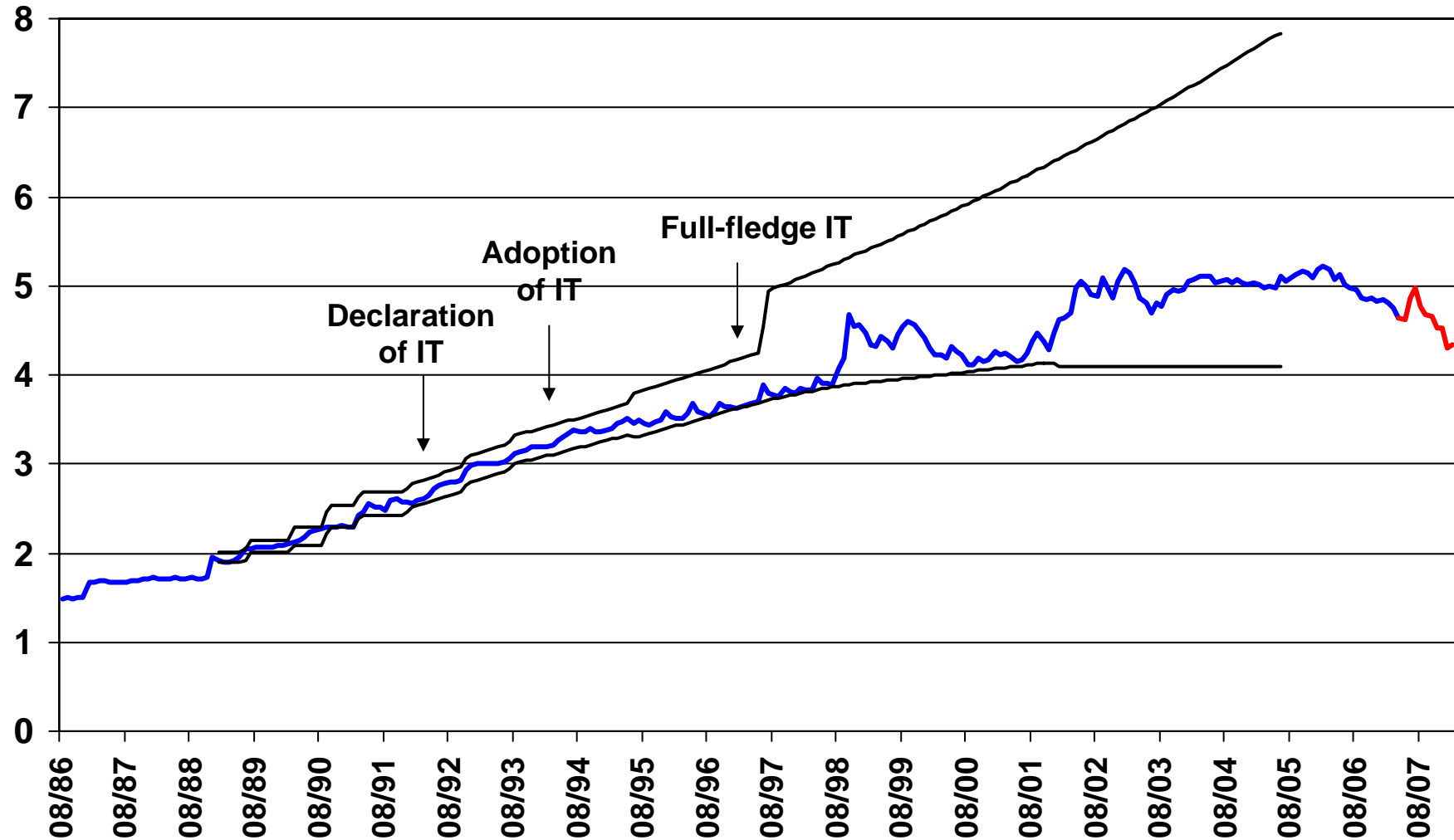


SOURCE: Central Bureau of Statistics, Balance of Payments.

Monetary Policy Regime

NIS/Currency-Basket Exchange Rate

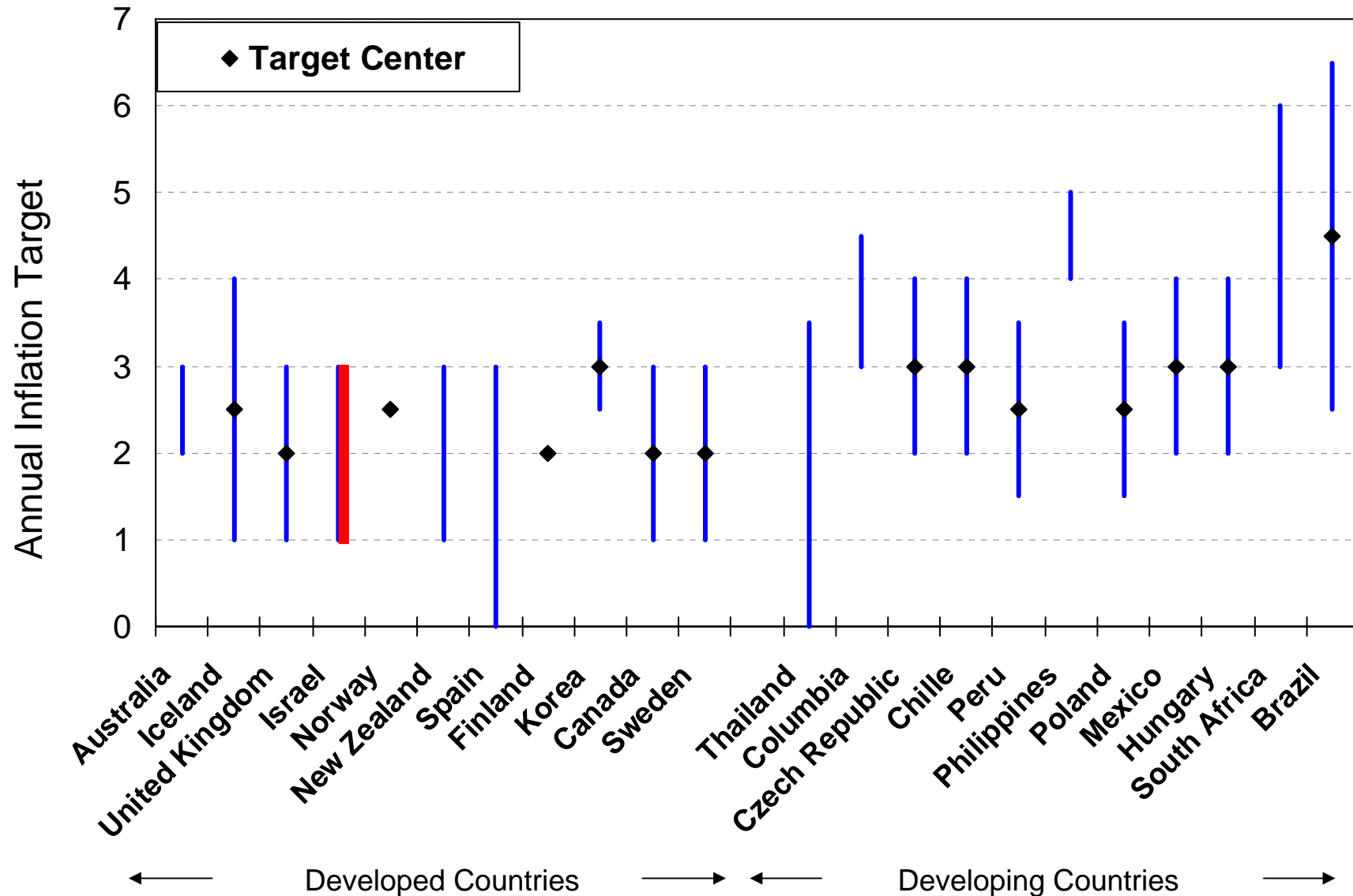
NIS



Inflation and Inflation Targets

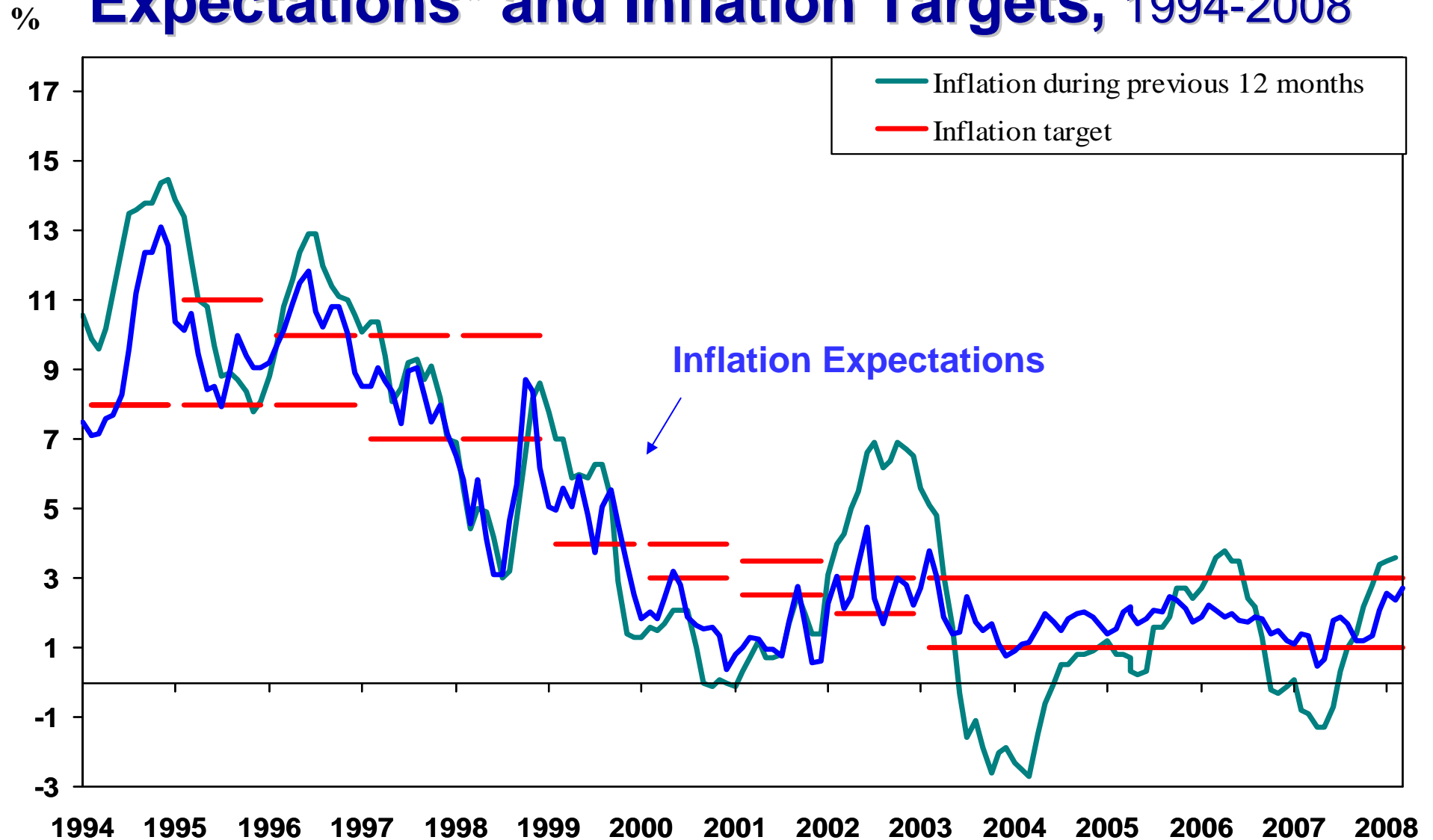
| | Inflation Targets |
|------|-------------------|
| 1992 | 14-15 |
| 1993 | 10 |
| 1994 | 8 |
| 1995 | 8-11 |
| 1996 | 8-10 |
| 1997 | 7-10 |
| 1998 | 7-10 |
| 1999 | 4 |
| 2000 | 3-4 |
| 2001 | 2.5 - 3.5 |
| 2002 | 2-3 |
| 2003 | 1-3 |
| 2004 | 1-3 |
| 2005 | 1-3 |
| 2006 | 1-3 |
| 2007 | 1-3 |

Inflation Targets in the World



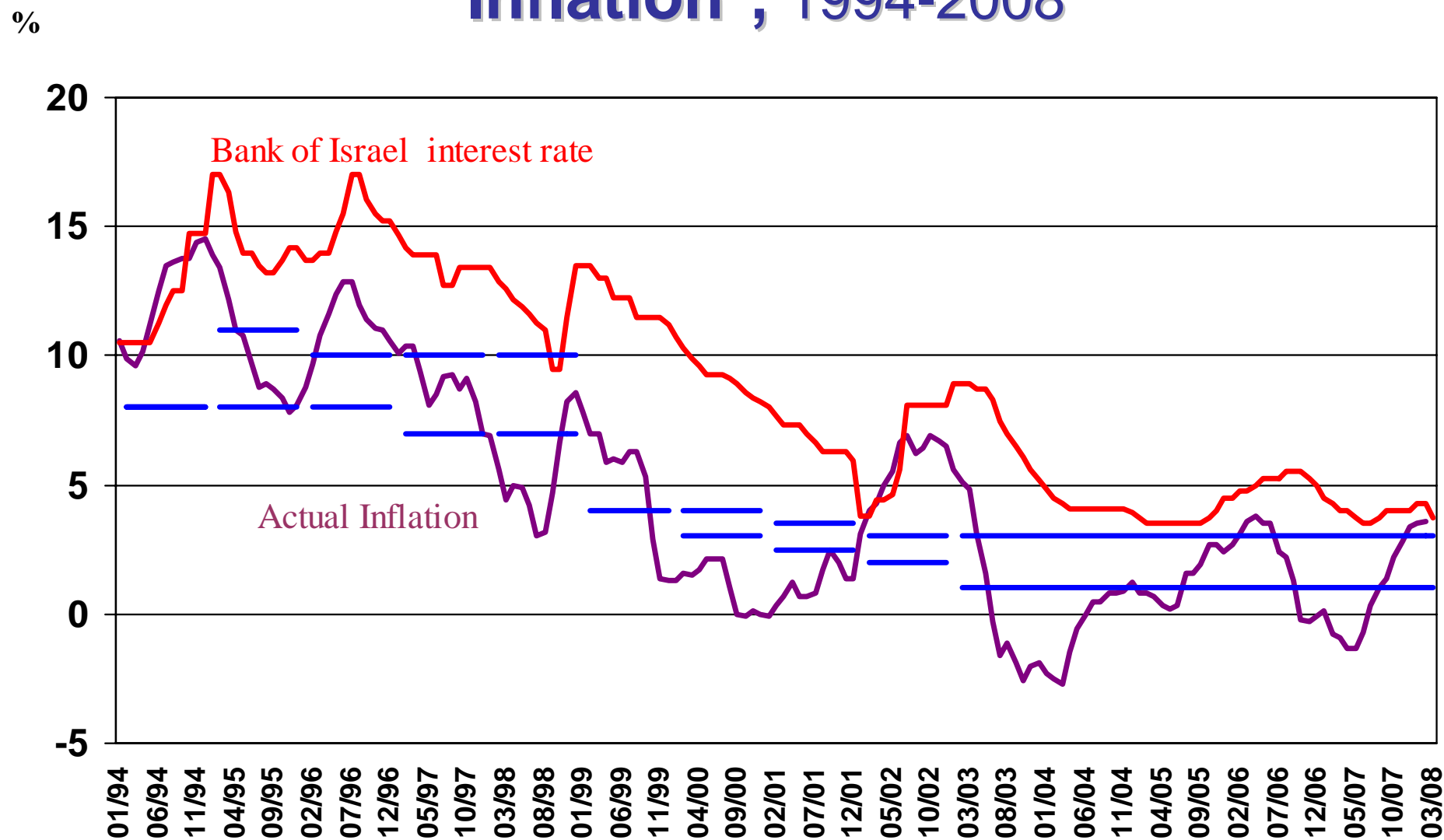
Monetary Policy

Rate of Inflation in Last 12 Months, Inflation Expectations* and Inflation Targets, 1994-2008



*For 12 months, as derived from the capital market.

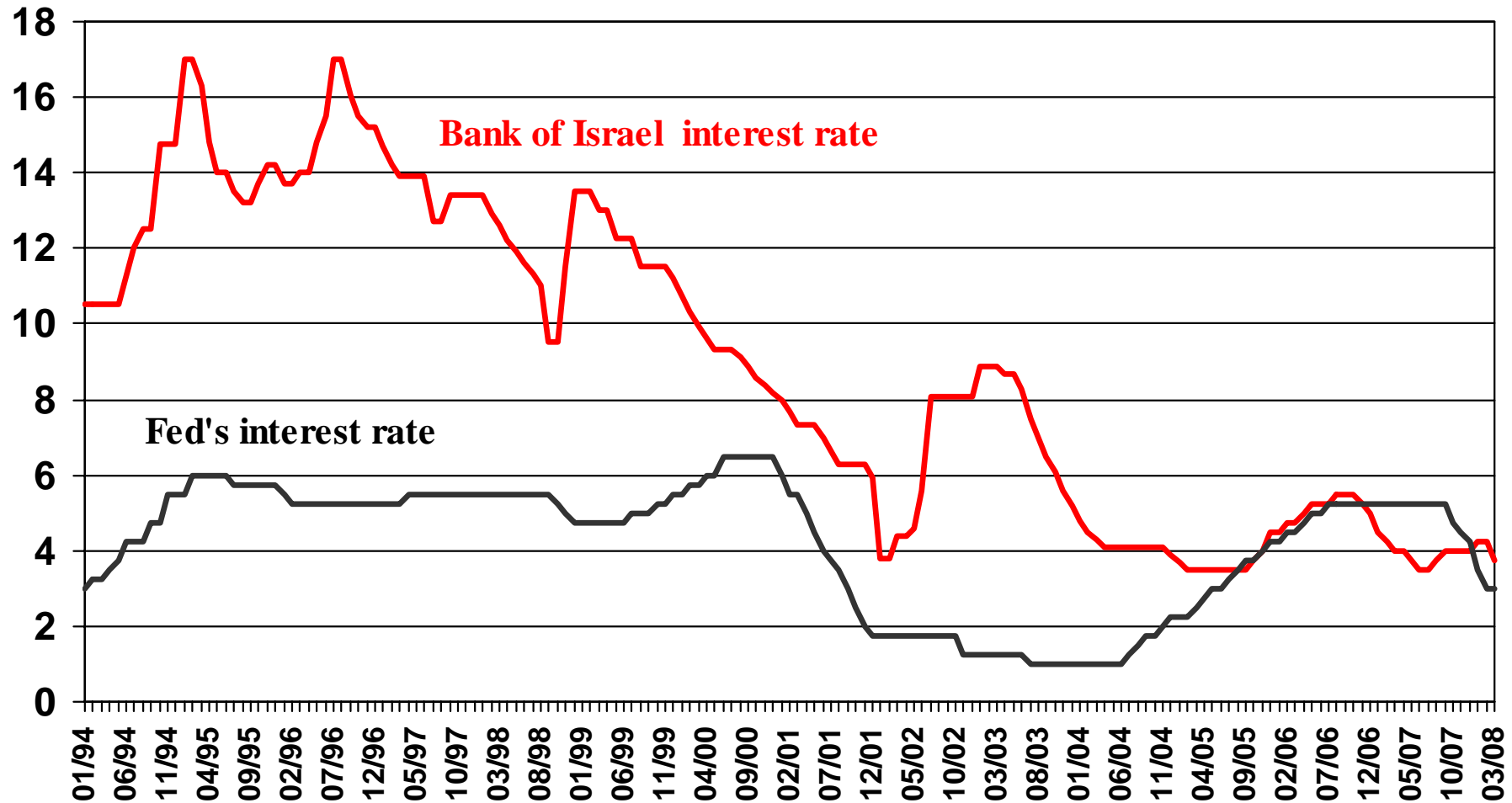
Bank of Israel Interest Rate, and Actual Inflation*, 1994-2008



*In last 12 months.

Bank of Israel Interest Rate, Inflation Expectations*, and the Fed's interest Rate, 1994-2008

%

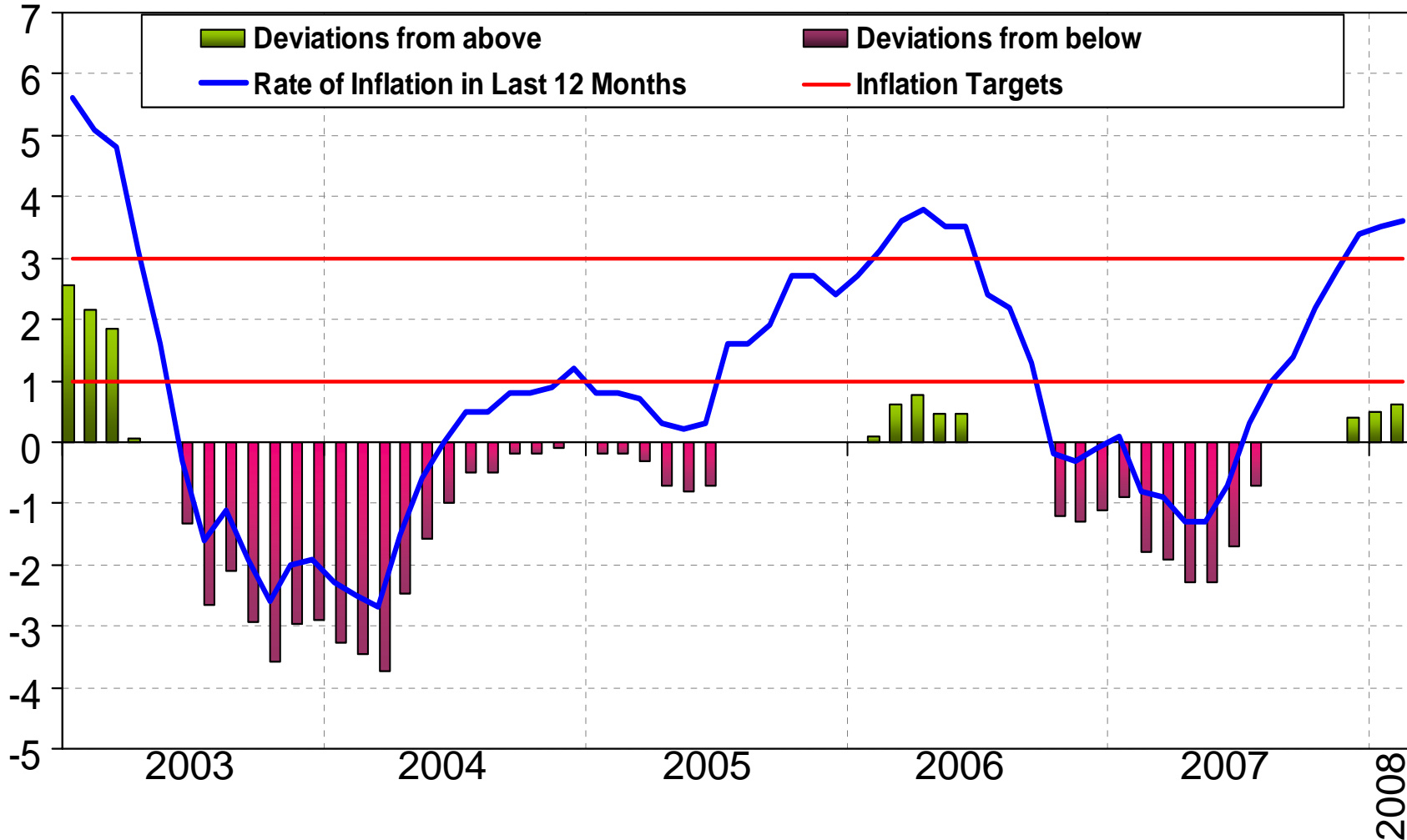


*For 12 months, as derived from the capital market.

Challenges

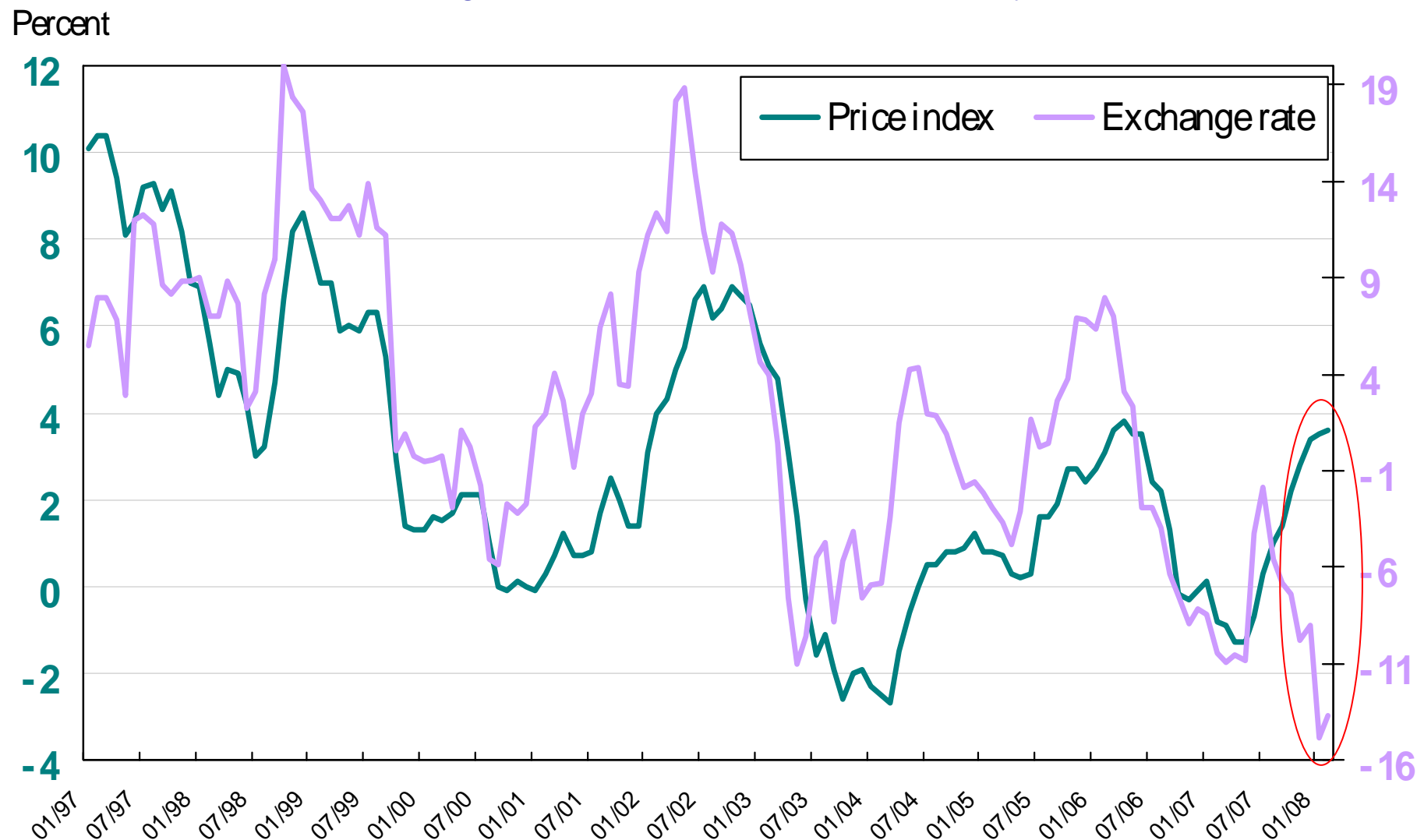
Rate of Inflation in Last 12 Months, Inflation Targets and Deviations from Inflation Targets, 2003-2008

%



Price Index and Shekel/Dollar Exchange Rate

(Rate of change over 12 months, up to February 2008)



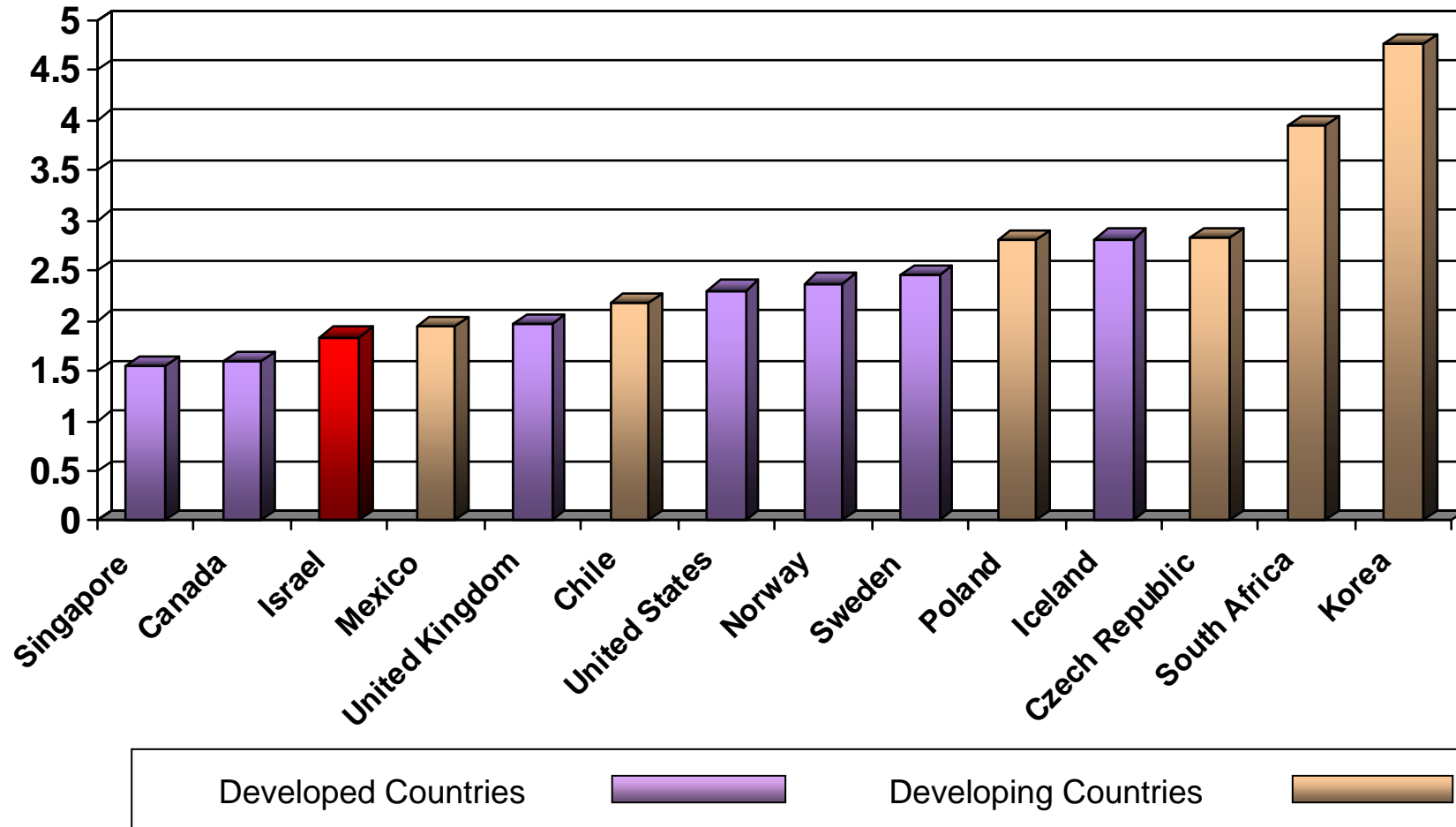
Pass-Through from Exchange Rate to Prices: International Evidence and the Israeli Experience

| | Over 1 Quarter | Over 1 Year |
|---------------------|----------------|-------------|
| Developed Economies | 0.05 | 0.1 |
| Emerging Markets | 0.15 | 0.2 |
| Israel | 0.3 | 0.5 |

In the second half of 2007 the Pass-Through has dropped sharply.

Volatility of the Exchange Rate in Israel and in Developed and Developing Countries

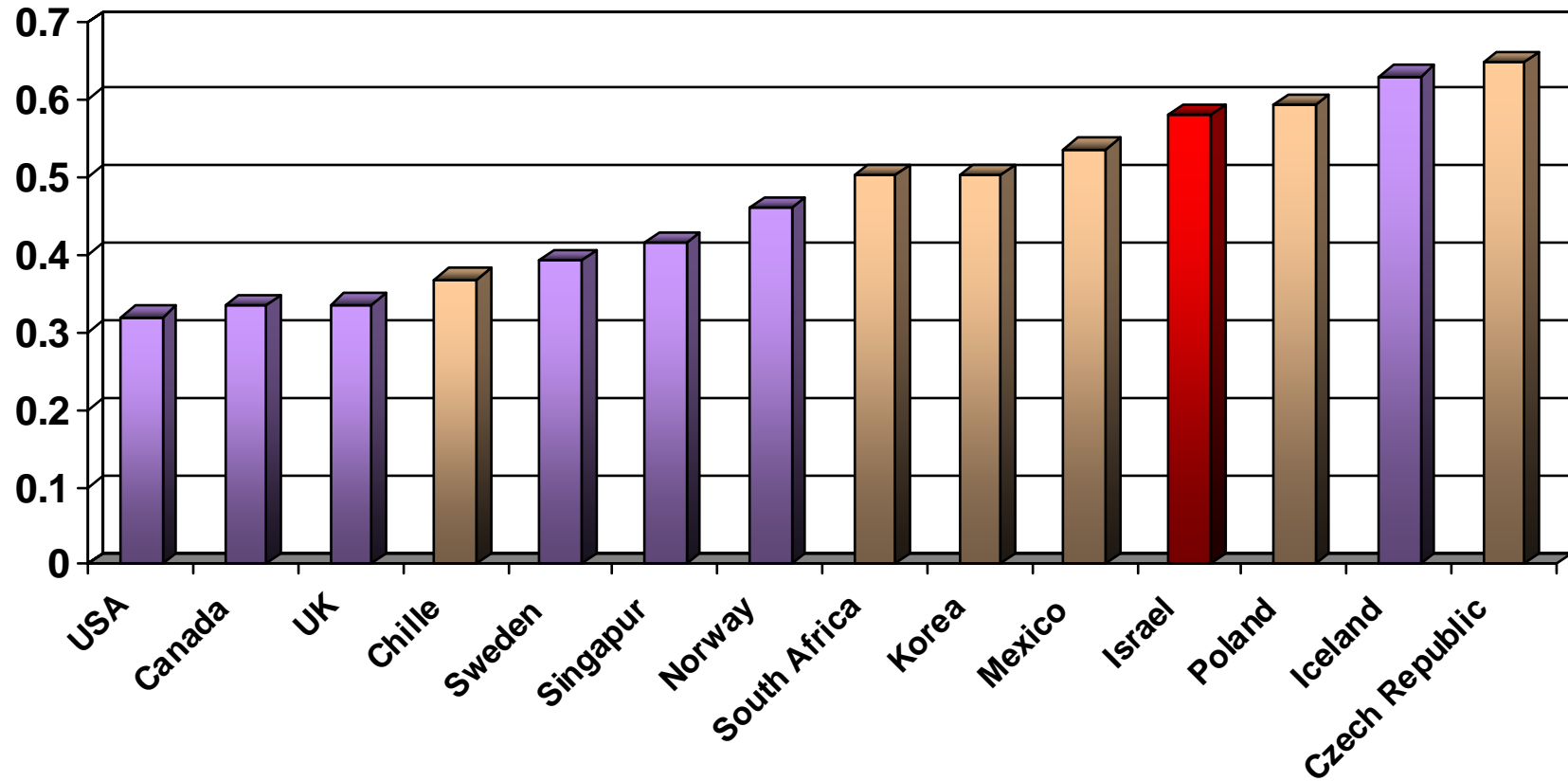
1997-2007



^a SD of monthly depreciation against the US\$. For US - US\$ against synthetic €

Volatility of Inflation in Israel and in Developed and Developing Countries

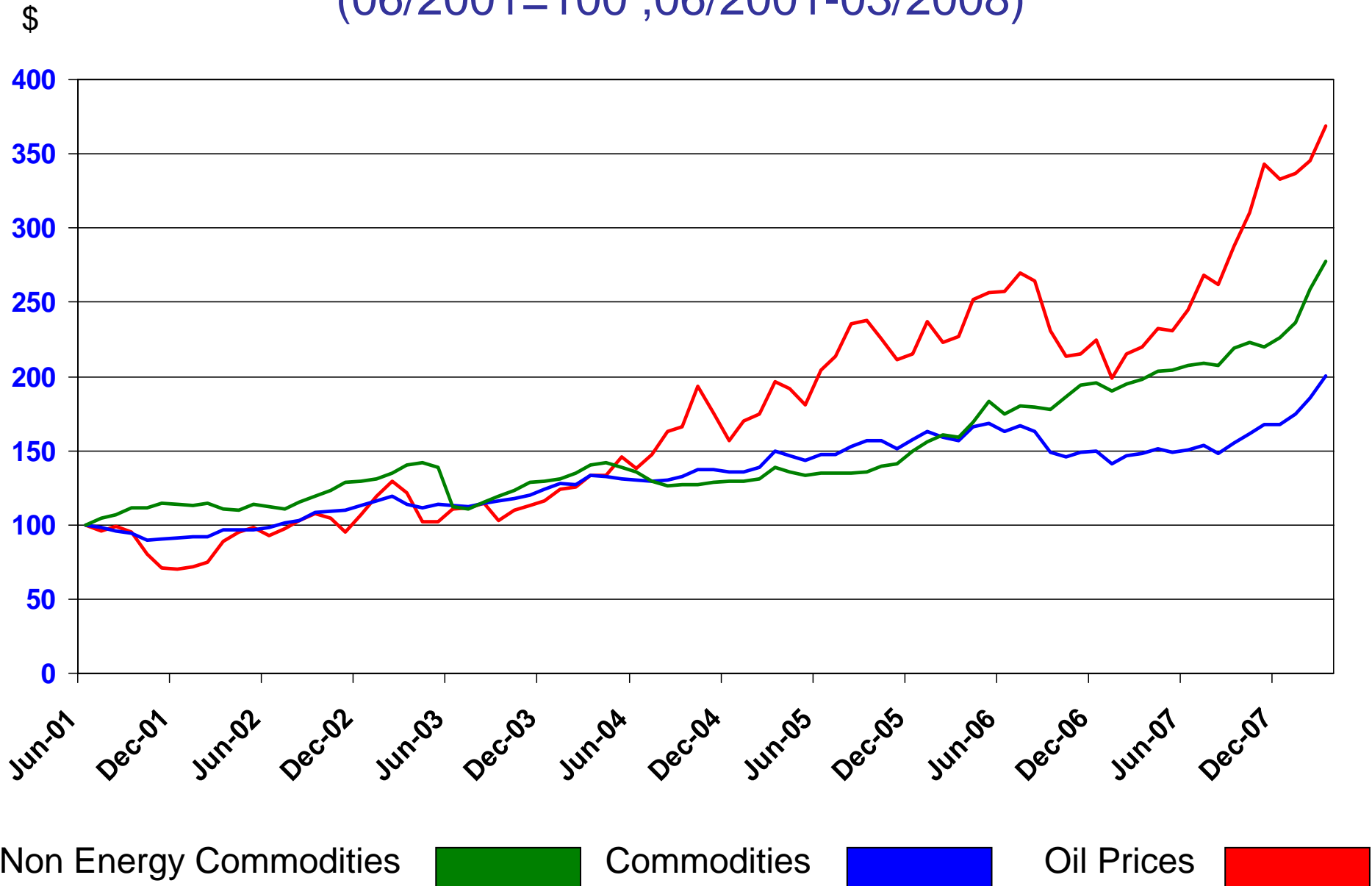
1997-2007



Developed Countries Developing Countries

Commodities and Oil Prices

(06/2001=100 ,06/2001-03/2008)



Index of Real Exchange Rate by Trading Partners (01/1997-03/2007)



•A rise in the index indicates depreciation.

•The figure for March 2008 is calculated from spot exchange rates known for the half-month, our forecast CPI from the monthly model, and an extrapolation of inflation in the countries whose currencies are in the currency basket.

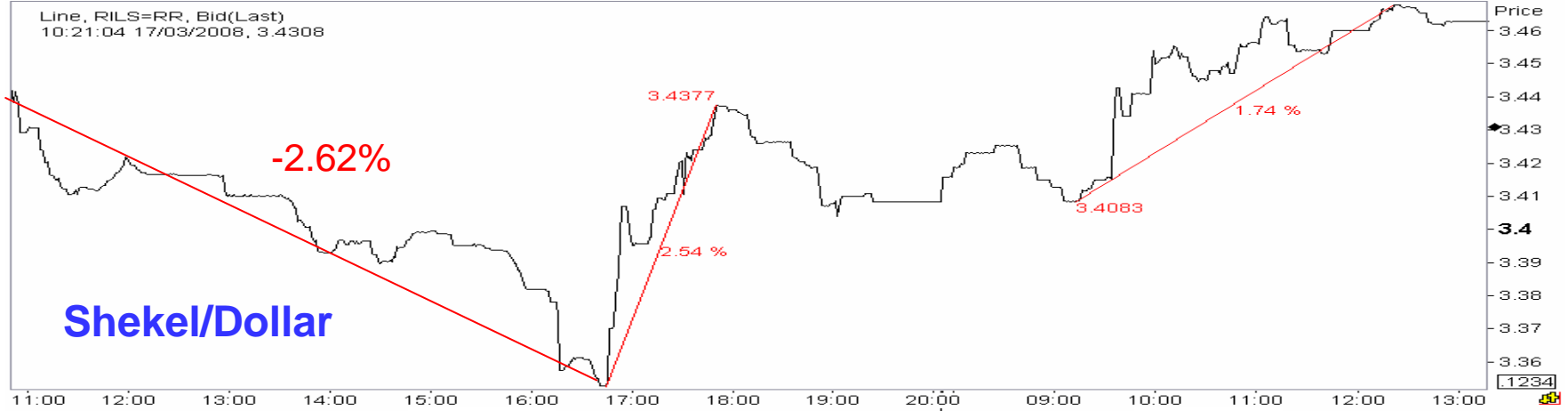
•SOURCE: IFS data. For November 2007 to March 2008, Bank of Israel calculations.

Most Recent Developments:

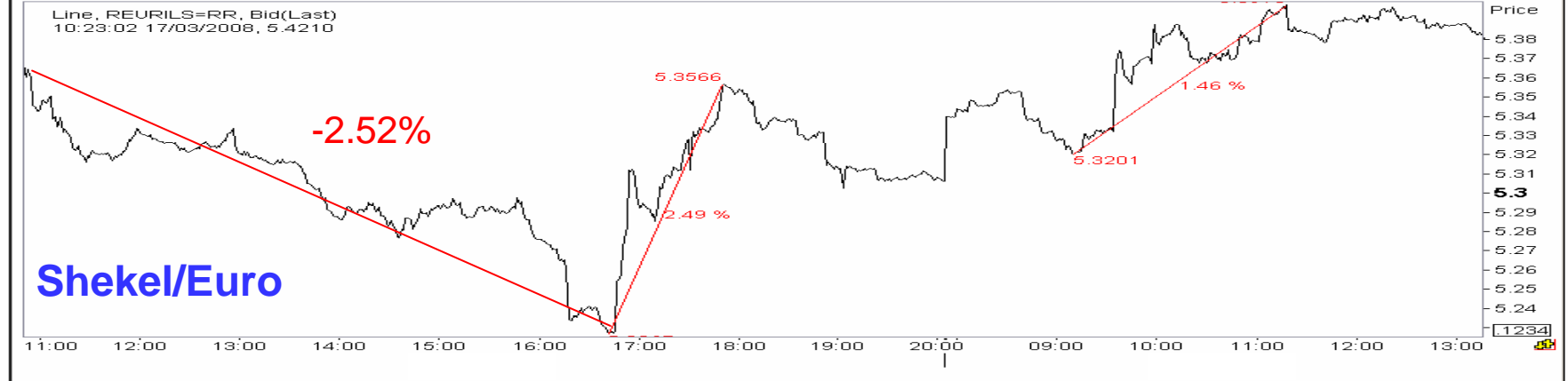
- A two day intervention (during 13-14/03/08) in FX market where the Bank of Israel purchased FX due to disorderly sharp appreciation of the NIS.
- An announcement of the intention to purchase FX at an amount of some 25 million US\$ per day over the next 2 years aimed at raising FX reserves to a more adequate level of 35-40 billion US\$.
- Two consecutive reductions of interest rates for March and April by 0.5% each

March 13-14, 2008

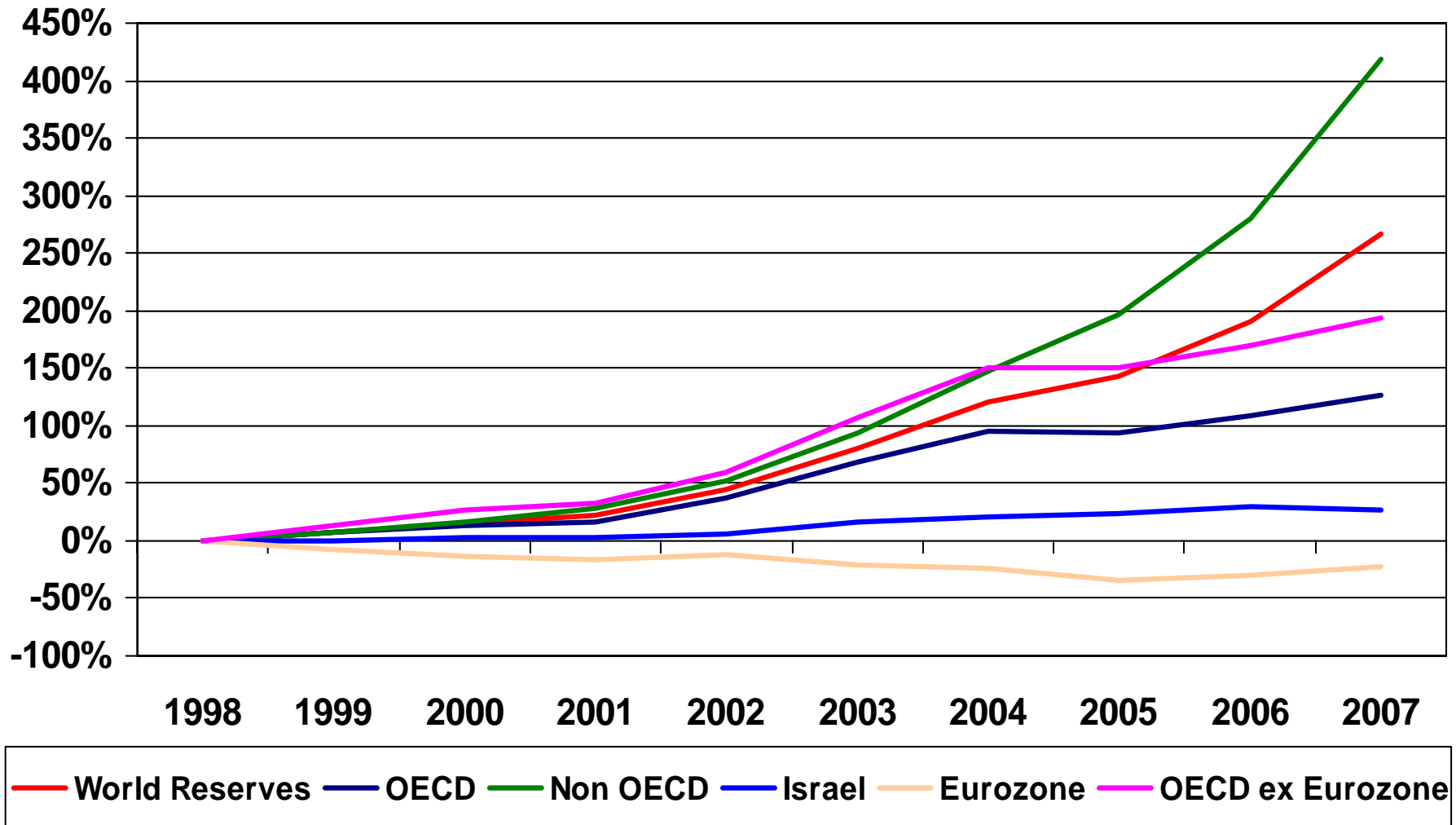
Tick RILS=RR



Tick REURILS=RR



The Change in Foreign Exchange Reserves (\$,1998 - 2007)



Source: IMF

Final Comment

- During the Inflation Targeting Regime we had high volatility of inflation and frequent episodes where inflation was outside the target range.
- However, expectations for inflation were always, in recent years, within the inflation target range.
- Thus, by anchoring expectations within the price stability range, inflation targeting has provided a stable environment to economic agents .

Thank You

