How do Capital Flows Challenge Monetary policy: The Case of Israel

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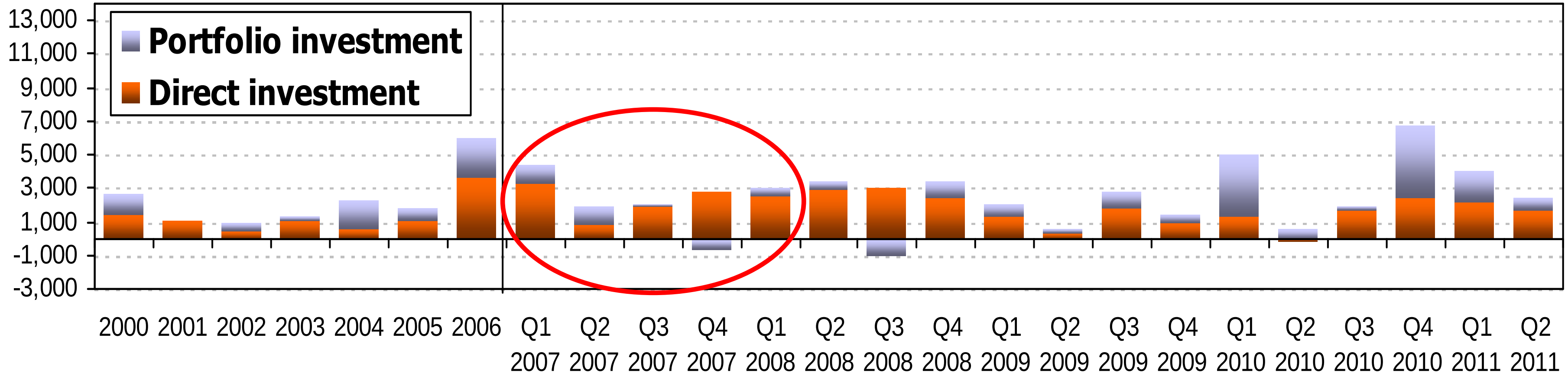
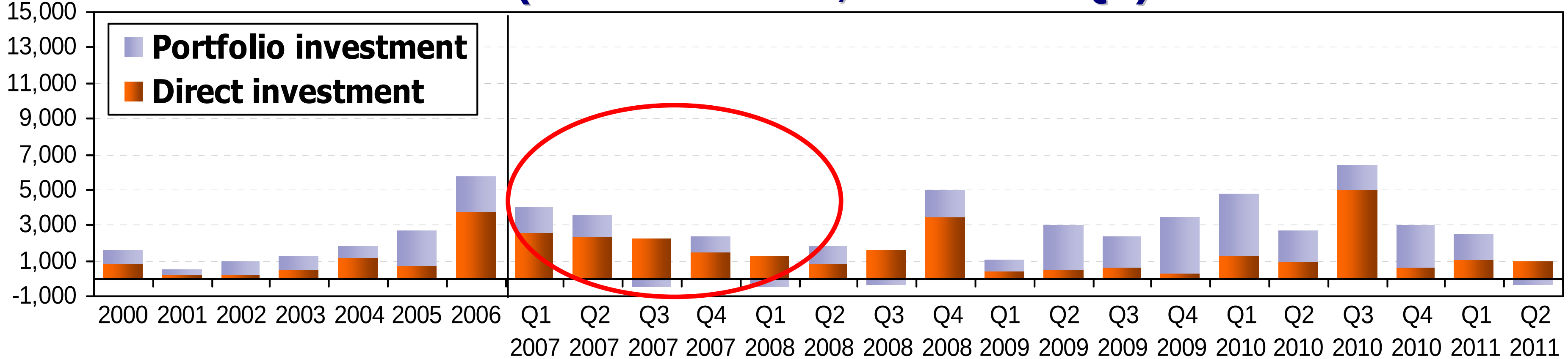
Some Basic Facts

- A Sharp appreciation of the NIS started in early 2008; was intensified by capital inflows.
- At the background--fear of a global recession with potential severe effect on an export-dependent economy.
- Starting March 08, large scale Forex purchases by BOI, following a 10 years period w/o intervention.
- According to a study (Sorezcky 2010), the intervention had a significant effect on the exchange rate.
- A more depreciated exchange rate helped in mitigating the effects of the global crisis on the Israeli economy.

Nonresident Investment in Israel
(million dollars, 2000-2011Q2)



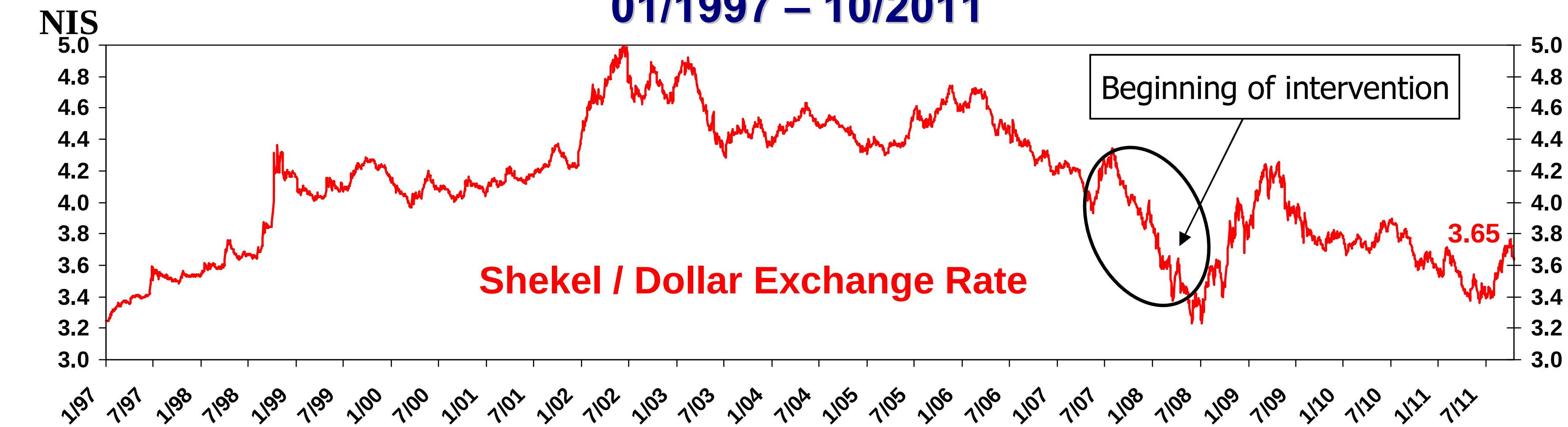
Investment of Israeli Residents Abroad
(million dollars, 2000-2011Q2)

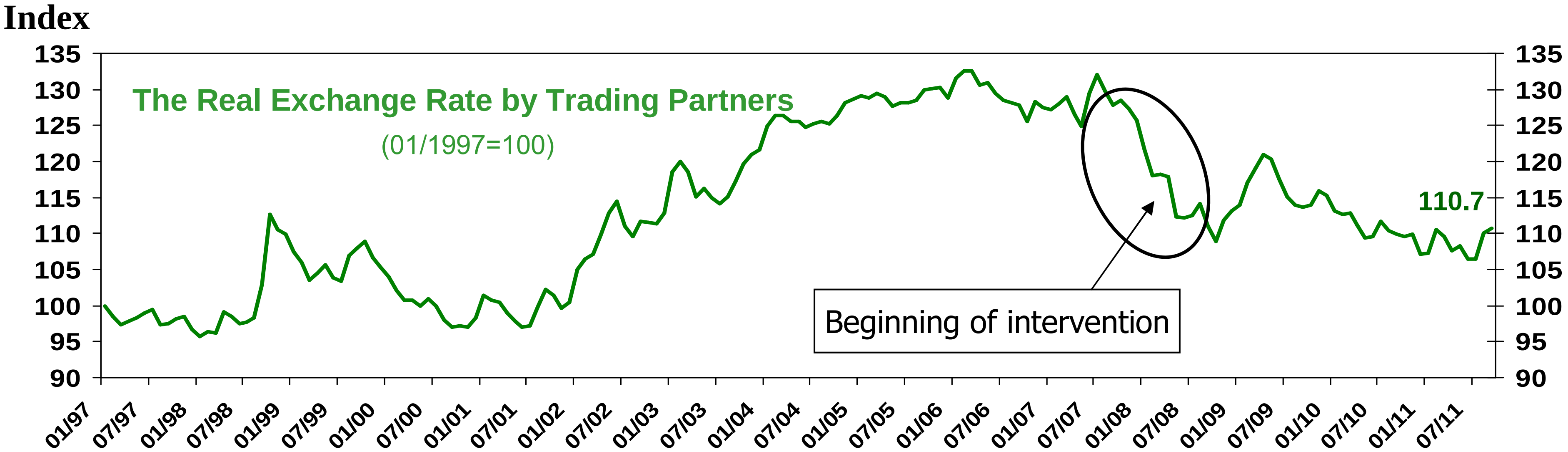


* Annual data in quarterly terms.
SOURCE: Central Bureau of Statistics, Balance of Payments.

The Nominal and the Real Exchange Rates

01/1997 – 10/2011





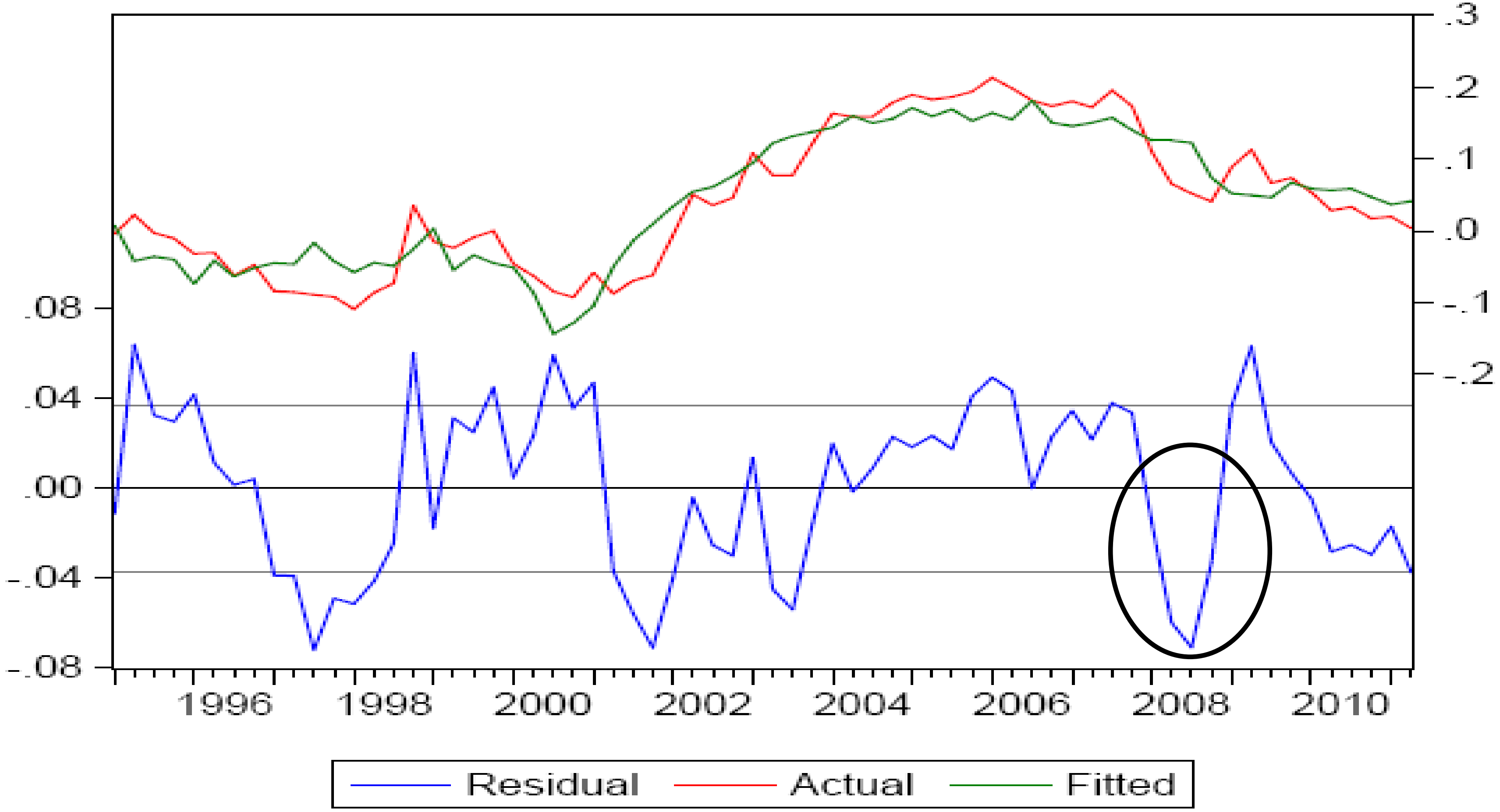
- The NIS/$ chart is on a daily basis, while the real exchange rate chart is on a monthly basis.

•A rise in the index indicates depreciation.

•The figure for the last month 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.

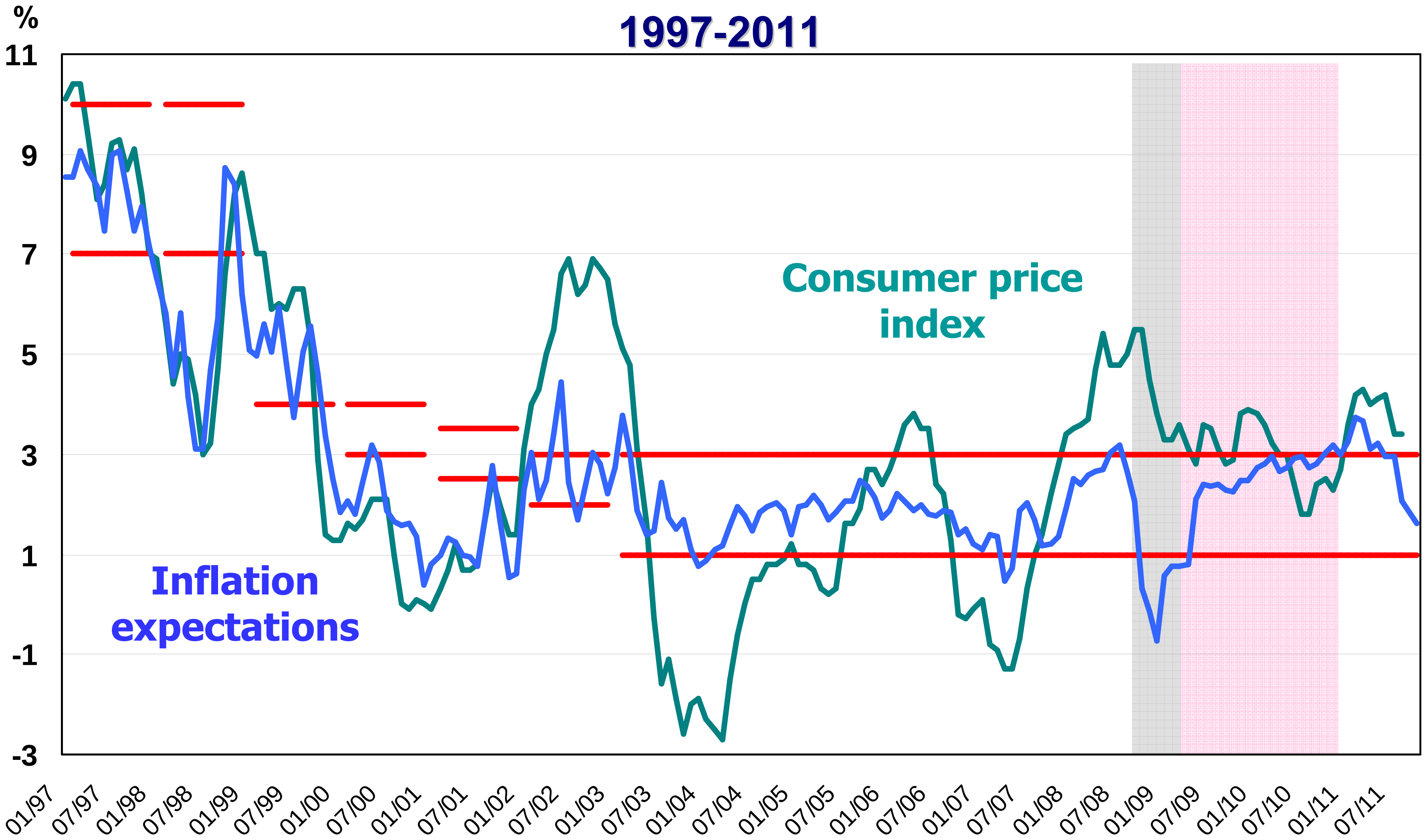
SOURCE: IFS and Bank of Israel

FEER and Actual REER



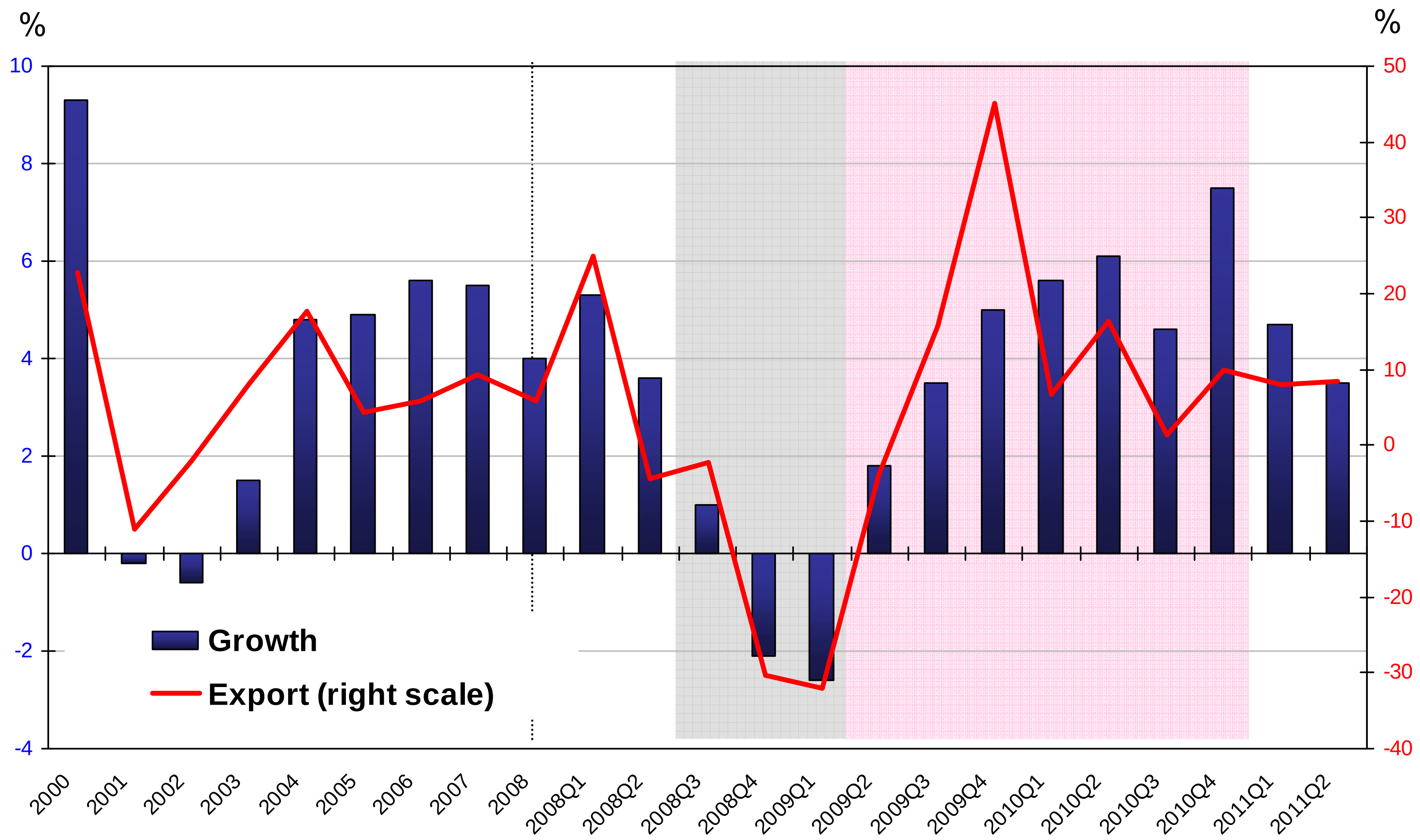
SOURCE: Bank of Israel

Inflation Over Past 12 Months, Inflation Targets and Inflation Expectations from the Capital Market



SOURCE: Research Department, Bank of Israel

GDP Quarterly Annualized Growth Rates



Foreign Exchange Market Policy

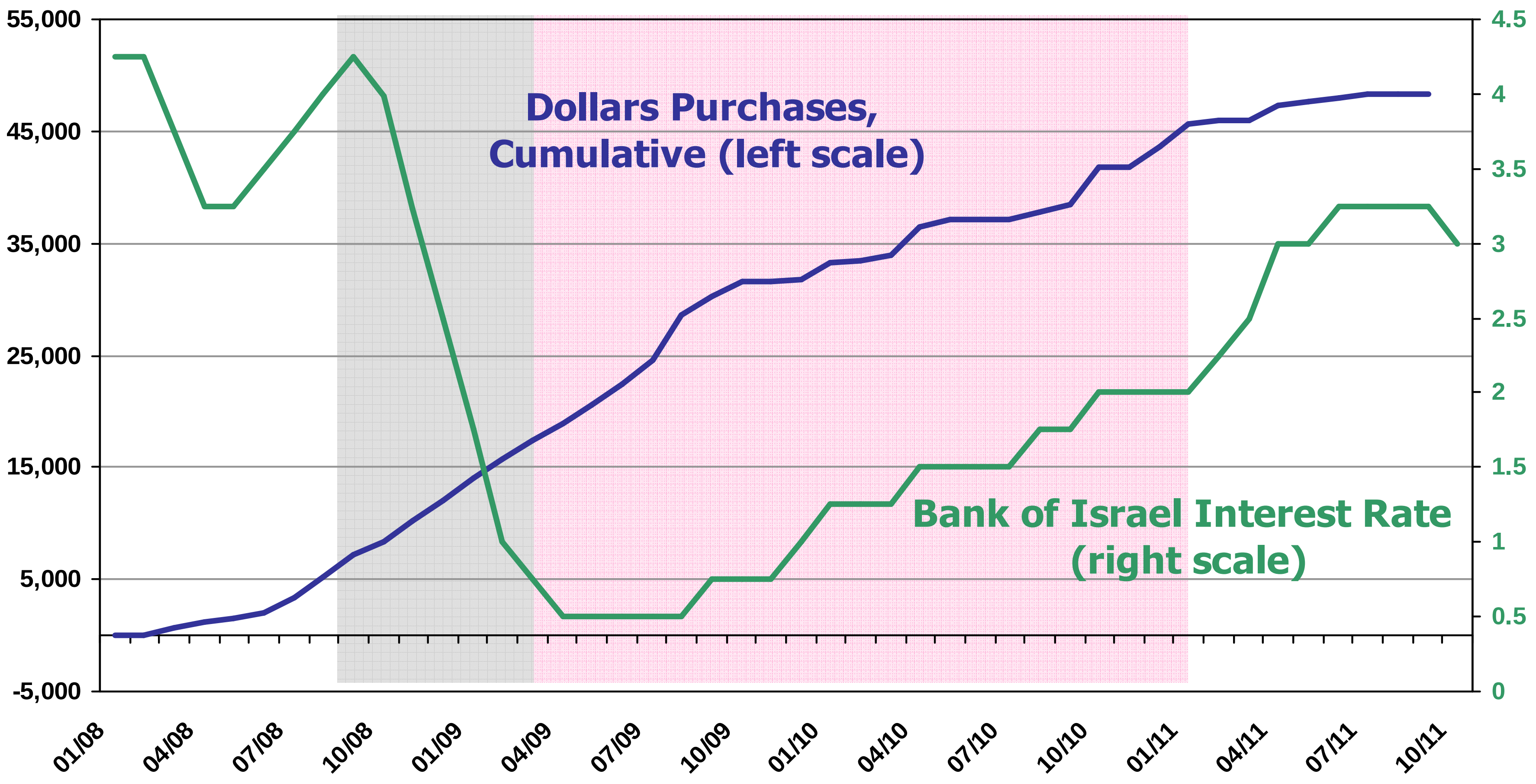
- The BOI began **purchasing foreign exchange** at a daily rate of $25 million in March 2008; in July 2008 the purchases were increased to $100 million per day.

- On August 10, 2009 the Bank of Israel announced that it would **stop** the daily purchases but that it would intervene in the FX market in the case of fluctuations in the exchange rate that do not match fundamental underlying economic forces.

- January 2011:A Reporting requirement was imposed of activities in the foreign exchange derivatives market and the *Makam* (ST BOI Bonds) and short-term government bond markets.

- January 2011: Imposition of a reserve requirement on foreign exchange derivative transactions by nonresidents.

Foreign Exchange Purchases and Bank of Israel Interest Rate, 2008-2011



SOURCE: Bank of Israel

Concluding Remarks

- Large capital (in)flows do challenge monetary policy in small open economies.

- The challenge is intensified during periods in which **competitiveness/growth** considerations and **inflation** considerations call for different policies.

- FX MKT intervention and some capital controls may be useful in discouraging ST flows, thus mitigating the effects on the Exchange rate.

- There is an asymmetry between the feasibility of tackling inflows and outflows.

Thank you