



Bank of Israel

Annual Report
2012

MAY 2013–SIVAN 5773

Bank of Israel

Passages may be cited provided source is specified

ISSN 1565-3382

Catalogue # 601714

Typesetting by Publications Unit, Bank of Israel

<http://www.bankisrael.org.il>

Printed in Israel by Maor Wallach Printing Ltd.

17 Nisan 5773
March 28, 2013

To: The Government and the
Finance Committee of the Knesset,
Jerusalem

I submit herewith the Bank of Israel Annual Report for 2012, in accordance with Section 54 of the Bank of Israel Law, 5770–2010.

In 2012, the economy's growth rate moderated to 3.1 percent, as compared to 4.6 percent in 2011. This slowdown in growth began in the middle of 2011 and a further slowdown was recorded at the end of 2012. The moderation in growth derives primarily from the slowdown in global growth, which negatively impacted Israeli exports, and was also the result of an increase in the cost of fuel imports. The moderation in the rate of expansion in the construction industry explains about one-fifth of the slowdown in growth this year.

The slowdown in exports, accompanied by increased expenditure on fuel imports as a result of the temporary shift from natural gas to imported and more expensive fuels, not only limited economic growth, but also contributed to the shrinking of the surplus in the current account of the balance of payments. The current account was almost balanced this year, following a long period of surpluses which began in 2003.

Despite the slower rate of growth, the unemployment rate remained stable at its lowest level of the past thirty years and employment and labor force participation rates continued to rise. These developments are evidence of the increased efficiency of the labor market and the considerable flexibility of wages and work hours in Israel, which dampen the response of the unemployment rate to changes in the GDP growth rate.

Inflation in 2012 was 1.6 percent, below the center of the inflation target range (2%). Three main factors contributed to the increase in prices: the higher prices of housing services, which account for about one-quarter of the CPI; the increase in energy prices due to the temporary interruption in the supply of natural gas; and increased food prices. The prices of two CPI components declined this year as a result of measures adopted by the government—the implementation of the Trajtenberg Committee recommendations regarding kindergartens, which lowered the prices of education and culture, and the increased competition in the mobile phone industry, which lowered prices of communication.

In the capital market, stock prices increased less than in the rest of the world and although the yields on Israeli government bonds fell to a historic low, their yield spreads widened, compared to those in advanced economies. The widening of yield spreads reflected the geopolitical risks which Israel faces. The corporate bond market

this year again reflected the high level of credit risk among firms. In non-bank credit, growth was concentrated in the direct loans provided by institutional investors. This new channel is developing rapidly and it is important that its regulation be brought in line with the standards that exist in other channels.

Monetary policy supported economic activity through a measured reduction in the Bank of Israel interest rate, which began in the second half of 2011. The reductions were intended to help the economy deal with the slowdown by increasing domestic demand and by supporting the depreciation of the shekel.

The government deficit expanded this year to 4.2 percent of GDP, the result of a slowdown in the rate of increase in tax revenues that began in 2011. The expansionary fiscal policy encouraged economic activity, although as a result of the large deficit the government decided to raise taxes during the course of the year. Nonetheless, the structural deficit remained large, and reducing it is essential to continuing the decline in the public debt to GDP ratio. The reduction of the deficit and the debt will improve the ability of the government to adopt countercyclical policy during any future slowdowns and possible future crises. In addition, it will reduce the burden of interest payments on the government, which is high by international standards and which limits the government's ability to increase expenditure on civilian services.

One of the main challenges in this context will be to ensure that the government's commitments to future expenditures are in line with the expenditure rule that it sets for itself. In recent years, the gap between the two has grown, against the background of commitments due to wage agreements and public sector reforms, as well as the implementation of the Trajtenberg Committee recommendations to expand social services and a decision not to cut the defense budget.

Home prices again began to rise during the second half of the year and increased by 5 percent in real terms. The increase in prices since 2008 derives from a shortage in homes relative to the needs of the population. This shortage was in turn due to, among other things, constraints on supply, which include a shortage of land available for construction, particularly in areas of high demand, and the slow rate at which building permits are issued. Also affecting home prices were low interest rates and low alternative yields in the market, which increase the demand for homes as an investment asset as well. It is worth noting that the increase in home prices in recent years has contributed to the significant growth in building starts and in this way contributed not only to increasing the supply of housing but also the level of economic activity.

Increases in home prices and mortgage volume increase the risk that mortgage activity poses to the banking system. In order to reduce this risk, the Supervisor of Banks imposed additional limitations on housing loans towards the end of 2012 and in early 2013. These limitations, together with the macroprudential measures adopted in previous years, strengthen the resilience of the banking system to shocks. These measures also reinforce the ability of monetary policy to fulfill its role in encouraging

economic activity without being constrained by risks originating in the construction industry.

The emphasis on the economy-wide role of monetary policy has proved itself by helping the economy deal successfully with the global crisis and slowdown in recent years. If the Bank of Israel, in an attempt to moderate the increase in home prices, had maintained a higher rate of interest, it would have led to an additional appreciation of the shekel which would have hurt exports, and would have also led to lower investment in the economy. As a result, economic growth would have been slower and unemployment higher. A higher rate of interest would also have reduced the demand for housing and, as a result, the number of building starts. Dealing with the problems in the housing market should be accomplished primarily through macroprudential measures, to the extent that this concerns the stability of the banking system, and through measures that increase the supply of homes, in particular a prudent expansion in the supply of land available for building.

Looking forward, the economy faces a number of structural challenges:

- As mentioned, the government must reduce its high structural deficit and set up a mechanism which will ensure that future commitments to expenditure are in line with the expenditure rule.
- Efforts must continue to further integrate Arabs and the ultra-Orthodox in the labor market.
- Labor productivity in Israel is low relative to other advanced economies and increasing it is essential to increasing the long-term rate of growth. This can be accomplished by expanding government efforts of previous years to improve the education system, physical infrastructure and the business environment, as well as increasing competition in the economy.
- The cost of living should be reduced, an issue that was the focus of the social issues protest. Increasing competition in the economy will contribute to achieving this goal as well.
- There are numerous potential benefits to the economy from the natural gas reservoirs. At the same time, they also present some complex challenges—how to spread the use of the profits over time and how to minimize the damage to the tradable sector's competitiveness and to future growth by establishing a "sovereign wealth fund", which should be done at the earliest opportunity; and how to find the right balance between the advantages in exporting the gas and the need to ensure long-term supplies to the local market.



Stanley Fischer
Governor of the Bank of Israel

CONTENTS

Chapter 1 <i>The Economy and Economic Policy</i>	1
1. Main Developments.....	2
2. The Global Environment.....	6
3. The Israeli Economy.....	10
a. Real activity.....	10
b. Price developments.....	12
c. The financial markets.....	14
d. The housing market.....	17
4. Economic Policy.....	19
a. Monetary and macroprudential policy.....	19
b. Fiscal policy.....	21
5. Additional Matters.....	22
a. The long-term effects of Israeli gas.....	22
b. The social protest and government policy.....	26
Chapter 2 <i>GDP, Uses and the Principal Industries</i>	33
1. Main Developments and Background Conditions.....	34
a. Global developments and their influence on the Israeli economy.....	35
b. Domestic background conditions and economic policy.....	38
2. Supply, Demand, and Equilibrium.....	40
a. Aggregate demand: Uses.....	40
b. Aggregate supply: Sources.....	45
c. Equilibrium: The output gap and the real exchange rate.....	48
3. Saving, Investment and the Current Account.....	50
<i>Box 2.1</i> Labor Productivity in Israel from an International Perspective.....	51
4. Principal Industries.....	57
I. Main developments.....	57
II. Developments in selected industries.....	60
a. Manufacturing.....	60
<i>Box 2.2: The Cellular Telecom Reform</i>	65
<i>Box 2.3</i> Infrastructure Investment and Main Projects.....	70
b. Construction and the housing market.....	72
Chapter 3 <i>Monetary Policy and Inflation</i>	87
1. Monetary Policy.....	88
a. Policy measures.....	88
2. The Fundamentals and their Effect on Monetary Policy.....	90
a. Inflation and the monetary regime.....	90

b. Domestic economic activity	93
c. Developments abroad.....	94
d. The exchange rate and the foreign exchange market.....	96
e. The housing market.....	98
3. Analysis of Monetary Policy	100
a. Real yields and monetary policy	100
b. The Taylor Rule and the monetary interest rate.....	102
4. Prices.....	104
a. Inflation and its components	104
b. Background factors in price developments.....	107
c. Monetary aggregates.....	111
d. Sources of change in the monetary base.....	114
Chapter 4 The Financial System and its Stability	117
1. Main Developments in the Domestic Financial System in 2012 and an Assessment of Its Stability	118
a. Main developments.....	118
b. Assessment of the financial system's stability and the risks to which it is exposed	125
c. Macroprudential policy in Israel.....	131
<i>Box 4.1</i> Factors which affected the trading volume decline in TASE-traded stocks	133
2. Asset Prices And Credit	138
a. Stock prices.....	138
b. Credit to the non-financial private sector and the corporate bond market.....	139
3. Financial Institutions	148
a. The banks	148
b. The insurance companies	152
<i>Box 4.2</i> "An Inescapable Network of Mutuality": The Similarity Between Investments of Institutional Investors, and its Consequences	156
4. Payment and Settlement Systems	160
Chapter 5 The Labor Market.....	165
1. Main Developments	166
2. The Demand For Labor.....	170
3. The Supply of Labor: The Working Age Population and the Labor Force	174
a. Israeli workers.....	174
b. Non-Israeli workers	177
4. Employment and Wages.....	177
<i>Box 5.1</i> The Effect of Education on the Labor Force Participation Rate in Israel	179

TABLE OF CONTENTS

a. Employment and wages in the business sector	182
<i>Box 5.2</i> The contribution of small businesses to employment	186
b. Employment and wages in public services	190
5. Unemployment.....	192
6. Government Policy in the Labor Market	197
Chapter 6 <i>The General Government, Its Services and Their Financing</i>	201
1. Main Developments from an International Perspective.....	202
2. The Total Deficit and the Cyclically Adjusted Deficit	205
3. Public Expenditure.....	209
4. Public Revenue	212
5. Fiscal Discipline and the Fiscal Rules	215
a. The two-year budget	215
b. Sweeping cuts	216
c. The fiscal rules	217
d. The government's commitments for the next few years.....	220
6. The Government's Services and Objectives	221
a. Education	223
b. Health.....	224
7. The Public Sector Debt	226
a. The public debt-to-GDP ratio.....	226
b. The cost of debt financing.....	227
c. The composition of the debt	228
d. The term to maturity of the outstanding debt	229
<i>Box 6.1</i> The Fiscal Multiplier	230
<i>Box 6.2</i> Budgetary Performance in Israel's Local Authorities	235
Chapter 7 <i>The Balance of Payments</i>	241
1. Main Developments in 2012	242
a. The Current Account.....	243
b. The Financial Account.....	249
c. The Exchange Rate	255
d. The Composition of the Economy's Assets and Liabilities vis-à-vis the Rest of the World	256
2. Selected Issues in the Current Account and Foreign Trade	257
a. The Natural Gas Reserves and Their Effect on the Current Account	257
b. Characteristics of Israeli Exports.....	260
c. Goods Exports to Asia	263
d. The Countries that Compete with Israeli Exports.....	266

Chapter 8 <i>Welfare Policy Issues</i>	269
1. Introduction.....	269
2. Employment and wage policy and its effect on welfare	274
3. Employment and wages prior to retirement.....	283
4. Well-being indices around the world and in Israel.....	289

TABLES

Chapter 1 <i>The Economy and Economic Policy</i>	
1.1 Main Developments in Israel and Around the World, 2009–12	3
1.A.1 Israel: Basic Economic Data, 2004–12.....	30
1.A.2 Basic Economic Data: International Comparison, 2004–12	31
Chapter 2 <i>GDP, Uses, and the Principal Industries</i>	
2.1 Indicators of Economic Activity, 2004–11	35
2.2 Sources and Uses, 1996–2012	41
2.3 Developments During the Year, 2011 and 2012	42
2.4 Supply of Business Sector Product, 1999–2012.....	47
2.5 Savings, Investment and the Current Account as a Share of National Income, 2011 ... and 2012	51
2.6 Background Conditions for Activity in Industries, 2008–12.....	57
2.7 Features of the Principal Industries	59
2.8 Developments in Industrial Production, Domestic Sales and Sales for Export, 2011 ... and 2012	61
2.9 Industrial Production and Exports in Selected Industries.....	64
2.10 Construction Industry Data, 2001–12.....	73
2.11 The Inflexibility of Supply – “Production” Stages of Land Planned for Construction, and Average Required Time Estimate (Years).....	76
2.12 Fiscal Policy Measures Taken to Increase Supply.....	78
2.13 Composition of Employees in the Construction Industry, 2000–12.....	80
2.14 Indicators of Productivity in the Construction Industry, 2001–12	81
2.15 Financing of the Real Estate and Construction Industry, 2009–12	82
2.16 Change During the Year in Home Prices and Housing (Rents) in the Current Price Cycle (percent)	85
Chapter 3 <i>Monetary Policy and Inflation</i>	
3.1 Interest Rate Decisions Since the Monetary Committee was Appointed	89
3.2 Main Indicators of Inflation and Monetary Policy, 2007–12.....	91
3.3 Price Developments, 2007–12.....	105
3.4 Import Prices, the Exchange Rate and Consumer Prices, 2007–12.....	109

TABLE OF CONTENTS

TABLES (continued)

3.5	Rates of Change in the Monetary Aggregates, 2007–12	112
3.6	Sources of Change in the Monetary Base, 2007–12	115
Chapter 4 <i>The Financial System and its Stability</i>		
4.1	Main Stability Indicators of Israel's Financial System, 2009–12 (percent)	120
4.2	Distribution of Non-Financial Private Sector Credit by Type, of Lender, 2008–12	139
4.3	Gross Security Issues by the Business Sector, by Type of Security, 2008–12	145
4.4	Bank Performance Indices, 2008–12	149
4.5	Concentration of Credits, by Loan Size and Industry in Selected Years	152
4.6	Maximum Management Fees by Savings Track	154
4.7	Concentration in the Zahav RTGS System, 2008–12 (percent)	163
Chapter 5 <i>The Labor Market</i>		
5.1	Principal Labor Market Variables, 2011 and 2012 (percent, seasonally adjusted) ...	166
5.2	Principal Labor Market Indicators, 2008–12 (average increase or decrease compared to the previous year, percent)	167
5.3	Principal Labor Market Indicators, 2008–12 (annual averages, thousands)	169
5.4	Job Vacancies in the Business Sector, by Industry	171
5.5	Employed Persons by Selected Industries, 2009–12	178
5.6	Employee Posts and Wage per Employee Post, by Selected Industries, 2009–12 ...	185
5.7	Employee Posts and Real Wage per Employee Post, by Sub-Sector in Public Services, 2010–12	191
5.8	Indicators of Labor Market Flexibility	194
Chapter 6 <i>The General Government, Its Services and Their Financing</i>		
6.1	The Main Components of Revenue and Expenditure of the General Government, 2003–12	204
6.2	Central Government Deficit, Revenue and Expenditure, 2007–12	205
6.3	Components of the Deviation from the Government's Original Budget for 2012 ...	206
6.4	Rates of Nominal Increase of Public Expenditure in Israel, 2003–12	209
6.5	Changes in Public Revenue and Expenditure, by Category, 2003, 2007 and 2012 ..	211
6.6	The August 2012 Tax Increases	215
6.7	Components of the Increase in the Gross Public Debt, 2009–12	226

TABLES (continued)

Chapter 7 *The Balance of Payments*

7.1	The Balance of Payments, Main Indicators, 2003–12	242
7.2	Surplus in the Current Account of Selected Countries (percent of GDP)	243
7.3	Savings, Investment and the Current Account as a Percentage of National Income, 2001-12	244
7.4	Distribution of Israel's Goods Exports by Destination, 2005–12 (percent)	247
7.5	Trade in Computer and Communications Services, 2004–11	248
7.6	Import Data by Economic Destination, 2010–12	249
7.7	The Financial Account, 2011 and 2012	250
7.8	The Distribution of Fuel Uses, Other Than Natural Gas, in Israel (Including Allocations to the Palestinian Authority), 2005–12 (percent)	258
7.9	Exports, GDP, Employment and Wages in Export-Intensive Industries, 2012.....	261
7.10	The Distribution of Israeli Exports by Destination, and the Ratio Between it and the Distribution of Global Imports, 2011-12	264
7.11a	Israeli Exports and Imports by Emerging Countries in Asia in 2011 and their Rate of Change from 2007 to 2011, by Selected Product Groups.....	265
7.11b	The Weight of Israeli Exports to Emerging Countries in Asia by Selected Product Groups, the Share of Those Countries' Imports out of Global Imports, and the Ratio Between Them (percent).....	265
7.12	Countries Competing with Israeli Exports, by their Share in Various Competitiveness Indices (percent).....	266

Chapter 8 *Welfare Policy Issues*

8.1	Indicators of Inequality and Poverty, 2003 to 2011	271
8.2	Employment Rate and Average Wage Income, by Population Groups Among Those Aged 25-67, Selected Years	273
8.3	Poor and Non-Poor Households, by Number of Wage Earners, Demographic Characteristics, Income and Education	281
8.4	Effect of Being in the Treatment Group Compared to Being in the Control Group on Marginal Continuity in the Labor Market, by Gender and Salary Group	288