

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

I submit herewith the Annual Report of the Bank of Israel for 2009, in accordance with section 59 of the Bank of Israel Law, 5714–1954.

Israel's economy came through the global economic crisis—the worst since the 1930s—relatively well. The crisis had a more moderate effect on Israel's economy than on almost all other advanced economies. Following the contraction of economic activity at the end of 2008 and the beginning of 2009, the economy started to recover in the second quarter of 2009. The factors contributing to the moderate impact of the crisis on Israel included the economy's strong situation prior to the crisis, a conservative financial system, in particular a conservative and closely supervised banking system, and a sound economic policy.

GDP grew by 0.7 percent in 2009, the result of a 1.5 percent decline in the first half of the year and 3.3 percent growth in the second half. The rate of unemployment peaked at 7.9 percent around the middle of the year, and declined to 7.3 percent by the end of the year. Imports and exports shrank drastically, in line with the reduction in world trade. An improvement in the terms of trade led to an increase in the surplus on the current account of the balance of payments, and mitigated the effect of the global crisis on national income and domestic demand. Private consumption recovered rapidly, and by the end of 2009 had surpassed its pre-crisis level, in contrast to the development in many other advanced economies.

The crisis had a limited effect on the financial system, more moderate than on those in the advanced economies, and the banks remained stable. The profitability and capital ratio of the banking system improved during the year, the extent of share issues increased, and the issuance of corporate bonds, which had practically halted at the peak of the crisis, restarted. Nonresidents' portfolio investment increased, and the volatility and spreads in the market, which provide an indication of risk, declined gradually, and came close to their pre-crisis levels.

Monetary policy was very expansionary: the Bank of Israel reduced the interest rate to an unprecedentedly low level, as did the central banks of other advanced economies. In April 2009 it cut the interest rate to 0.5 percent, and in addition the Bank purchased government bonds on the secondary market with the aim of lowering longer term interest rates. Bank of Israel purchases of foreign currency, which had started in March 2008 with the intention of raising the level of the reserves, against the background of the appreciation of the shekel, increased greatly in the second half of 2008 and in 2009. The purpose was to prevent significant appreciation of the shekel, which makes it more difficult to export and could lead to deflation. In August 2009 the Bank halted its daily purchases of foreign currency, and has since intervened in the market on a discretionary basis to prevent the exchange rate from deviating significantly from the rate reflecting fundamental economic conditions. In the second half of the year, as the trend of economic activity changed, the Bank of Israel interest rate was increased gradually.

The inflation rate in 2009 was 3.9 percent, higher than the target range and higher than inflation rates in the advanced economies. The main reasons for the deviation from the target were the steep increase in the housing component of the price index and temporary increases in indirect taxes and water prices.

Fiscal policy reflected the operation of the automatic stabilizers: the share of public expenditure in GDP did not change, and tax revenues fell as a result of reduced economic activity. The government deficit was about 5 percent of GDP, compared with a balanced budget in 2007. The debt/GDP ratio rose moderately, to 80 percent. The high degree of fiscal credibility and declarations that those with bank deposits would not be harmed and the safety net that had been spread for those with pension savings played an important role in calming the markets.

In 2009 there were signs that the global economy was starting to emerge from the crisis. In the absence of further shocks, the global economy is expected to continue to grow in the next few years. The growth path and its inherent risks depend to a considerable extent on the longer-term effects on economic activity of the policies adopted during the crisis—which are not fully known at this stage, on the path of the return to non-crisis policies, and on the right conclusions being drawn from the crisis and on their implementation.

Israel's debt/GDP ratio increased slightly during the crisis, but it no longer appears high compared to that in other advanced countries. Nevertheless, reducing it to a lower level would make the economy more robust, strengthen its ability to withstand future crises while maintaining stability, and ease the burden of servicing the debt.

At the beginning of 2010 the government adopted a new fiscal rule which sets a ceiling on expenditure derived from long-term growth and from the reduction in the debt/GDP ratio, while keeping to deficit targets. Without more rapid growth than that in the last decades, the deficit target will be met only if the increase in expenditure is kept lower than specified in the new rule, or by a more modest reduction in taxes than envisaged in the announced downward path. A faster increase in public expenditure while evaluating and adjusting priorities can help in dealing with issues that are important for economic growth and in addressing social challenges. In this context, one of the top priorities is dealing with the educational system, in light of the poor achievements of students in the Israeli school system by international standards. Public expenditure per student is lower in Israel than in the other countries, and the allocation of existing resources should also be improved. The higher-education system too is falling behind in international ratings. Israel's economy is based on its human capital, and in order to preserve and strengthen this comparative advantage it is essential to reverse the current trends in educational achievement.

During the crisis it was important to conduct an expansionary monetary policy using all available tools in order to support economic activity and the resumption of growth. While emerging from the crisis, a gradual process of increasing the interest rate has been adopted, such that the risk to recovery is minimized, while concurrently reacting in a timely manner to the evolution of inflationary pressures. The challenge facing the Bank of Israel is to balance these considerations in an environment in which interest rates in the leading economies continue to be very close to zero.

The global crisis exposed crucial structural problems in the financial sector in the US and other countries. These problems were reflected mainly in the development of very complex financial assets together with a distorted incentive structure and lack of oversight that permitted the uncontrolled development of these assets and their markets. Thus, one of the most important lessons to be learned from the crisis is the

need to improve regulation and oversight, including intervention in the incentive structures facing market participants. In addition, the crisis has shown the necessity of relating not just to the specific risk of each asset or institution, but also to the systemic risk that could arise as a result of the failure of one of them, i.e., the need for a macroprudential policy. Discussions are being held around the world on conclusions to be drawn from the crisis, but most have not yet reached the stage of introducing practical changes; the thinking and studying process is, however, well under way.

Although the absence of complex assets, such as mortgage-backed assets, in Israel's capital market contributed to the mild impact of the crisis on the financial system, the continued development of the financial markets will enhance the efficiency of the capital market and will support economic growth. The global crisis should not serve as a reason to stop the development of Israel's financial markets, but the lessons learned from it emphatically include strengthening the supervisory system and adjusting the structure of incentives so as to minimize the risk of a future crisis. The opportunity to learn from mistakes in other countries and weaknesses in the Israeli supervisory system should be seized.

The focus of the crisis in Israel was the nonbank credit market, whose rapid development in the last few years outstripped the adjustment of the supervisory system. To reduce the risk of future crises in the corporate bond market, mechanisms should be devised that will provide incentives for companies to reduce the risk of not meeting their liabilities and that will increase their transparency vis-à-vis their lenders. Likewise, it is important to impose limitations on institutional investors who manage other people's money so that they internalize risks and thereby improve the efficiency of the relevant markets.

The new Bank of Israel Law that was passed recently creates a modern framework for the operation of the Bank in line with internationally accepted norms, and which can help it achieve its objectives. These objectives are specified and ranked in the Law: to maintain price stability, to support growth, employment and the reduction of social gaps, and financial stability. The Law grants the Bank independence in the employment of policy instruments to achieve its objectives, while maintaining transparency and accountability vis-à-vis the Knesset, the government and the public. The Law defines the framework for decision-making regarding the interest rate and monetary policy, with these decisions being taken by the Monetary Committee headed by the Governor, and administrative decisions being approved by the Administrative Council.

The new Law provides an appropriate framework for strengthening monetary policy and the governance of the Bank of Israel. It will take the active cooperation of all those—inside the Bank and outside it—whose responsibility it is to make the new framework operational, to enable the Law to achieve its ambitious goals.

Stanley Fischer

Governor, Bank of Israel