

5 Nissan, 5772
March 28, 2012

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

I submit herewith the Annual Report of the Bank of Israel for 2011, in accordance with section 54 of the Bank of Israel Law, 5770–2010.

In 2011, Israel's economy grew by 4.7 percent, similar to its growth rate in 2010. The rapid growth in investment in the business sector and residential construction was notable. Growth was expressed in, among other things, the continued decline in the unemployment rate to 5.6 percent—its lowest level in more than three decades—and was accompanied by a relatively rapid contraction in the current account surplus.

The growth rate was not uniform during the year: in the first quarter, the rapid growth which characterized the economy since the middle of 2009, in its recovery from the global crisis, continued. Thereafter, during the rest of the year the growth rate moderated against the background of the debt crisis in Europe, which led to slower growth world wide, and increased geopolitical concerns and uncertainty. The growth slowdown was evident in, among other things, the decline in exports, the slowdown in the growth of private consumption, and the slower growth of investments in the business sector in the final quarter of the year.

These developments were evident as well in the moderation of the inflation rate and inflation expectations during the year. The Consumer Price Index increased during the year by 2.2 percent—at the beginning of the year the inflation rate and inflation expectations were above the upper bound of the target range, and toward the end of the year they declined toward its lower bound. Most prominent were the increases in rents, at 5.1 percent, and in energy prices, 9.2 percent, including electricity prices, which were affected by disruptions in the supply of natural gas.

Monetary policy during the course of the year responded to changes in activity and in inflation: at the beginning of the year, the Bank of Israel interest rate was increased at a relatively rapid pace, and reached 3.25 percent. These increases were necessary due to the increase in prices and inflation expectations, which reflected among other things strong demand, as well as the continued increase in home prices. In September, the Bank began to lower the interest rate, in light of developments in Europe and the slowdown in the pace of growth of activity and inflation.

Since the end of October, interest rate decisions have been made by the six-member Monetary Committee, three of whom are from outside the Bank. This

committee was established under the new Bank of Israel Law of 2010, and the start of its work is an important milestone in the history of the Bank and the way it sets its monetary policy.

At the beginning of the year, the Bank continued purchasing foreign currency, and also adopted macroprudential measures related to short-term capital flows—imposing a reserve requirement on nonresident investors' foreign exchange derivative transactions, and a reporting requirement on certain transactions. These steps were intended to moderate extraordinary movements in the exchange rate, primarily excess appreciation, which negatively impacts exports, and to reduce the threats to stability inherent in large short-term capital flows. Over the course of the year, in light of the decline in short-term capital inflows, the Bank reduced these purchases, and in August they halted completely.

This year, a broad social protest broke out, which placed on the public agenda a range of important issues affecting wide sections of the public, issues that need to be handled in a thorough and careful manner. The protest emphasized the increase of food prices and various other aspects of the cost of living, including the increase in home prices and rents, the cost of childcare and education for young children, and issues of income distribution. Following the protest, the government appointed the Committee for Economic and Social Change (the Trajtenberg Committee), and later adopted many of its recommendations, and even began the implementation of some of them, with a focus on working parents of young children. Among other things, tax benefits were increased for families with young children, and it was decided to expand compulsory free education to 3-4-year-olds. It was also decided to reduce the customs duties on a range of products. The government had begun to deal with some of the issues even prior to the protest, specifically the rapid increase of home prices and high level of concentration in the economy. Some of the recommendations have a marked impact on the budget, and it is important to ensure, as the Committee stated, that their implementation does not breach fiscal discipline or increase the deficit.

Although the government adopted the Committee's recommendations in principle, they have not been implemented "en bloc." Since the changes approved in taxation, and primarily in expenditure, are not fiscally balanced, significant adjustments will be required, especially ahead of the budget for 2013, in order to prevent an increase in the deficit. It should be noted that the solution to some of the issues raised by the protest does not involve significant budget expenditure; rather, it mainly requires appropriate regulation—particularly to increase competition and reduce concentration in the economy, areas in which much complex work remains to be carried out.

At the beginning of the year, the rapid increase of home prices, which began at the end of 2007, continued, but the pace of increase slowed markedly over the course of the year. Toward the end of the year prices even declined slightly. This change in the development of prices derived both from a decline in demand as well

as an increase in supply, which was reflected in a notable increase in the number of building starts during the year. Several measures introduced by the government contributed to the changes in supply and demand, as did the increase in the interest rate and the limitation imposed by the Supervisor of Banks on the share of the variable-interest-rate component of a mortgage. The limitation is a macroprudential measure which is intended to reduce the risk to borrowers and to the stability of financial institutions—a risk inherent in future interest rate increases which would increase the repayment burden on borrowers.

After two years of rapid recovery from the crisis of 2008–09, risks increased in the domestic financial system in the second half of 2011. This was primarily due to a worsening of the debt crisis in Europe, a slowdown in exports, and political changes in the region. The deterioration was seen in a decline in share prices and in corporate bond issues, and in an increase in risk premiums on those bonds, and it negatively impacted the profits of banks and insurance companies. In the second half of the year, the growth of the supply of credit to the business sector decelerated. In the corporate bond market the volume of problem loans which needed to be restructured increased, the financial situation of business groups deteriorated, and banks' exposure to the construction industry increased. With that, the ratio of private sector debt to GDP is low relative to the past and to the world, the foreign exchange reserves are at a high level, the bond market has the infrastructure for restructuring debt, and the payments and settlements system has been improved. Recently, in accordance with Basel III guidelines, the Bank of Israel increased the minimum core capital ratio for banks in Israel. The banks are expected to increase their capital gradually, in a manner that will be consistent with the growth of the economy.

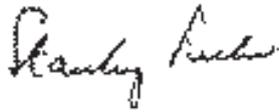
The budget deficit this year, 3.3 percent of GDP, slightly exceeded the 3 percent target. Public debt continued to decline, reaching 74 percent of GDP. However, this is a small decline when taking into account the rapid growth of the economy this year. The expenditure and tax paths deriving from existing government decisions do not allow a significant decline in the debt or the deficit in the next few years. Moreover, several multi-year programs adopted by the government will increase expenditure considerably, in excess of the legally determined ceiling, so that significant adjustments in the budget will be required in order not to exceed the ceiling. In addition, the process of setting the defense budget should be improved. Toward the end of the year, it was decided to cancel the framework for tax reductions planned for 2012–16, a decision which will contribute to continuing reductions in the ratio of public debt to GDP.

Looking to the future, it is important to note expected demographic developments, including an increased share of the elderly in the population and an increased share in the working age population of ultra-Orthodox Jews, whose participation rate in the labor market is low, and of Arabs, whose integration into the labor market should be improved. These developments will have notable effects

on the future growth rate, as well as on the scope of public expenditure and the ability to finance it. This situation highlights the need to increase the integration of the sectors mentioned into the labor market, first and foremost by improving their education and making it more compatible with the requirements of the labor market, and the need to boost the growth of labor productivity. Improved infrastructure, first and foremost in the mass public transport systems, and in public transportation in general, is expected to help increase productivity, and improve the quality of life.

The gas discoveries off the coast of Israel are expected to yield significant revenues to the economy. It is important to spread the use of those revenues wisely over time, through a designated fund, as recommended by the team for setting up a fund for gas profits; this is to minimize the negative effects that are liable to accompany a too-rapid use of the profits (“Dutch disease”), as well as to produce an appropriate intergenerational distribution of the proceeds.

In summary, the economy this year faced significant difficulties, which intensified during the year, but dealt with them successfully. With that, looking forward a number of developing challenges stand out: in the near future there will be a need to deal with budgetary pressures, which stem to a large extent from defense needs; in the longer term, the main challenges to economic growth in Israel are related to the demographic trends noted above, as well as problems in the education system.



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