# Bank of Israel

# Annual Report 2021

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To:
The Government and the Knesset Finance Committee
Jerusalem

I am honored to hereby present the Bank of Israel Annual Report for 2021, pursuant to Section 54 of the Bank of Israel Law, 5770–2010.

The year 2021 was characterized by the economy's rapid recovery from the COVID-19 crisis that struck it in the previous year. This year, as well, the economy faced several waves of the pandemic, but due to the broad vaccination campaign and the marked easing by the government during the year in the limitations on activity, private consumption grew at a solid pace, even if it has not yet returned to its precrisis level. This recovery, and with it the rapid growth of Israeli exports, drove the impressive growth this year, which was high even in comparison with other advanced economies. GDP, which contracted in the previous year, increased by 8.2 percent in 2021, and the level of activity in the economy returned to its precrisis trend. However, it should be noted that the economy's recovery was uneven, and the adverse impact on the transportation, tourism, hospitality and food, and art and entertainment industries remained notable. Imports also increased by a marked rate during the year, due both to the increase in commodity imports and the increase in oil prices, so that the Current Account surplus (in dollars) essentially was unchanged.

The economy's recovery was clearly seen in the labor market. Most employees who were furloughed in 2020 returned to employment during 2021, the unemployment rate declined sharply, and at the end of the year the employment rate was already very close to its level of just before the crisis. Despite this recovery and the rapid growth in the number of job vacancies, the average wage increased by only a moderate pace. This, among other things, is because many of the people returning from unpaid leave to employment work in low-wage industries. In contrast, the wages of employees who continued working during the crisis increased at a faster pace. Most of the assistance plans for employees and employers, which were implemented last year, expired during 2021—at the original date set for that, and for relatively older workers slightly afterward. We assess that these processes will continue as long as the exit from the crisis is sustained, and therefore it is important to take advantage of the changes that occurred during the crisis to further promote steps that are expected to improve the flexibility in the labor market—expanding the ability to work remotely through digital accessibility, and more significant activity regarding professional training.

High-tech exports continued to grow at a rapid pace this year, and exports of high-tech services in particular. The importance of this sector to the economy is increasing, and it made a notable contribution to the economy's coping with the crisis. The boom in high-tech industries was reflected this year in many areas—including its contribution to tax revenues, increased demand for workers, and growth in capital raised.

The material change in the state of the economy and in dealing with the pandemic during the year was of course reflected in the fiscal aggregates as well. The marked decline of the government's expenditures on dealing with the crisis alongside sharp growth in its tax revenues led to a sharp decline in the budget deficit, from 11.4 percent of GDP in 2020 to 4.4 percent of GDP this year, and to a decline in the public debt to GDP ratio, from 71.7 percent to 68.9 percent, respectively. The sharp growth in tax revenues was notable both in comparison to the past and to other advanced economies, as well as in relation to the forecasts at the beginning of the year, and even more than compensated for the loss of revenue in 2020. However, a marked share of this is from atypical factors that are liable to ebb in the coming years. On the expenditure side, there has been a notable preference in recent years for investment in public transportation infrastructures rather than investment in roads—an important change for dealing with the transportation problem, which impacts considerably on additional areas of life and the economy, such as housing, inequality, and access to schooling.

Inflation in 2021 was 2.8 percent, the highest rate in the past decade, though considerably lower than in OECD countries. The recovery in domestic demand and the increase in global inflation, which was impacted by, among other things, a sharp increase in prices of sea transport, contributed to the increase in inflation in Israel this year. In contrast, the appreciation of the shekel worked to moderate the inflation rate.

This year, the Bank of Israel continued to conduct accommodative monetary policy in order to support economic activity in view of the continued waves of morbidity—the interest rate was kept at a level of 0.1 percent, and there were continued government bond purchases, which ended toward the end of the year. The accommodative monetary policy contributed markedly to the impressive recovery of employment and economic activity. In the second half of the year, the Monetary Committee began to reduce the extent of monetary accommodation by phasing out the use of the special monetary tools operated in response to the COVID-19 crisis. In order to moderate the appreciation of the shekel and its adverse impact on economic activity in view of the crisis, the Bank of Israel announced, at the beginning of 2021, a plan to purchase $30 billion during the year. Toward the end of the year, the shekel again strengthened sharply, and against the background of the outbreak of the fourth wave of the virus, the Bank increased the purchases beyond the amount noted. In all, the Bank purchased $35 billion during the year, and thus moderated the appreciation of the shekel.

The economy's recovery was also reflected in the amount of credit raised by the business sector. Regulatory steps taken in recent years by the Bank of Israel and the Ministry of Finance contributed to the expansion of financing sources while maintaining a low and stable level of interest rates throughout the crisis. In view of the recovery, the programs implemented last year to increase the supply of credit to small businesses were reduced this year. The special monetary loans extended to banks by the Bank of Israel for that purpose were also ended during the year, after it was evident that the financing difficulties in various industries had eased and returned to their precrisis level.

Home prices increased sharply this year, and housing market activity accelerated, as reflected, among other things, in the expansion of investment in residential construction, after it contracted the year before, and in a marked increase in the number of transactions. Against this background, households' housing debt also grew considerably. The marketing of land, which impacts on the future supply of homes, soared this year, after declining sharply in the past 2 years, among other things because of the COVID-19 crisis. Maintaining a high enough level of supply over time is essential to moderating the increase in home prices.

Currently, with the entrenchment of the Israeli economy's recovery from the crisis and the contraction in the use of the special policy tools operated in order to deal with it, policy makers have to focus once again on the fundamental problems of the economy, in order to ensure sustainable and inclusive growth by increasing labor productivity. The four channels of activity which should be focused on in this regard—and that were presented in detail in the Bank of Israel's plan that it submitted to the government with its forming—are: development of human capital; investments in physical and technological capital, and infrastructure; development of the financial system; and improving the regulation and use of technology to streamline government activity. Improving public infrastructures and human capital will require an increase in public investment for a lengthy period of time. Therefore, it is important to adjust the fiscal rules so as to allow the required level of such investment while maintaining fiscal discipline.

A. Yaron

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Governor of the Bank of Israel