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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 2022, pursuant to Section 54 of the Bank of Israel Law, 5770–2010.

The year 2022 was characterized by two main processes that began in 2021, in view of the rapid recovery from the effects of the COVID-19 pandemic: rapid growth, alongside increased inflationary pressures. The inflationary pressures began with international supply shocks, that were then joined by domestic demand pressures that increased during the year. As the negative effects of the pandemic subsided, other factors appeared that had a negative impact on the economy. These included the war in Ukraine.

GDP grew rapidly this year, by 6.4 percent, further to the high growth of 8.6 percent in 2021. The level of GDP during 2022 was higher than the level derived from its trend of the years prior to the COVID-19 crisis. This growth was based on the rapid increase in private consumption, exports, and investment—mainly in residential construction. In the area of private consumption, the rapid growth of services consumption was prominent, in view of the removal of all activity restrictions on the proximity services industries. The significant savings that households had accumulated since the beginning of the COVID-19 crisis did not erode this year. Such erosion would have led to an even greater increase in private consumption. The rapid growth of exports continued to rely mainly on the export of high-tech services, but in the last two years, there has also been strong growth in goods exports. The rapid growth was also reflected in the tight labor market, where the employment rate increased, the unemployment rate decreased, and both returned to their precrisis levels.

Inflation totaled 5.3 percent in 2022, exceeding the upper bound of the target range for the first time in the past decade. The acceleration of inflation began in 2021, following many years in which it was very low. Similar to what is taking place in many countries, the acceleration of inflation was influenced at first mainly by global supply constraints in view of the exit from the COVID-19 crisis. Those supply constraints were exacerbated during the year in view of the war in Ukraine, the effects of which were mainly felt in energy and food prices. During the year, the contribution of robust domestic demand to inflation also increased. However, inflation in Israel this year was lower than in most advanced economies—largely due to Israel's reliance on its own natural gas reserves, the prices of which are fixed in long-term contracts. Following a prolonged appreciation, the shekel depreciated by 4 percent during the year in terms of the nominal effective exchange rate—a process that has continued at the beginning of 2023.

With the exit from the COVID-19 crisis and the appearance of inflationary pressures, the Bank of Israel was among the first central banks in the world to taper its monetary accommodation in 2021, by halting the use of the special monetary tools that were applied during the crisis. At the beginning of the year, the interest rate was still kept low in view of the broad morbidity of the Omicron wave and the uncertainty surrounding the decline of the COVID-19 pandemic, and in order to support the economy's recovery from it. It quickly became clear that economic activity was recovering at an accelerated pace, and that inflation was accelerating—increasingly due to demand pressures. Global inflation further accelerated when the war in Ukraine broke out in February, leading to a shortage of raw materials and a sharp increase in global commodity prices. The Monetary Committee therefore announced as early as February its assessment that the conditions would soon be ripe for a gradual increase in the interest rate. In April, the Committee began a rapid process of increasing the interest rate, from 0.1 percent to 3.25 percent at the end of the year—its highest level since 2010. The Committee has continued increasing the rate at the beginning of 2023. The rapid and determined increase in the interest rate, also similar to other countries, is intended to prevent the entrenchment of inflation at a high level.

The effect of the change in monetary policy has been noticeable in the financial markets. The interest rate on bank credit, both to business and to households (housing and nonhousing), increased during the year as the Bank of Israel interest rate increased. Over the course of the year, total credit in the economy increased rapidly, but while the sharp increase in credit continued in the first half of the year, the pace of that increase slowed in the second half. In the Israeli financial markets, asset prices declined this year, influenced both by the interest rate increases in Israel and by the interest rate increases and financial market declines abroad. The declines in the Israeli financial markets continued at the beginning of 2023, and were sharper than those recorded in most markets abroad. The capital raised by high-tech companies declined during the year from the peak levels of 2021, reaching levels at the end of 2022 that were similar to those from before COVID-19. However, the share of those employed in the high-tech sector continued to increase in 2022, and wages in the sector increased by a higher rate than in the rest of the business sector.

The end of the COVID-19 crisis and the increased economic activity led to a sharp improvement in the fiscal aggregates. There was a government budget surplus of 0.6 percent of GDP (compared to a deficit of 4.4 percent of GDP in 2021), and public debt declined to 60.7 percent of GDP, just slightly higher than its pre-COVID-19 level. The halt in support payments that were required during the crisis led to a sharp decline in public expenditure as a share of GDP, and public revenue grew, mainly thanks to a sharp increase in direct tax revenue. The moderation of the increase in public expenditure (excluding COVID-19 expenditures) in recent years was due in part to the delay in signing new public sector wage agreements. In addition to rapid economic growth, the rapid increase of tax revenues also reflected one-off factors such as increased cash flow to the high-tech sector and strong real estate activity.

As stated, the high level of investment in residential construction contributed to rapid economic growth this year. Despite the expansion of the supply of dwellings and the high level of building starts in the past two years, home prices continued to increase rapidly throughout most of the year. However, toward the end of the year, the price increases moderated, and there were even declines in the prices of new homes. The moderation of the increase in home prices was also affected by the decline in transactions, which took place partly against the background of more expensive mortgages.

The growth of labor productivity in Israel, which is essential to ensure sustainable economic growth, accelerated in the past decade, and the gap relative to other OECD countries has started to narrow. However, labor productivity in Israel remains low compared to those countries, and increasing it is one of the main challenges faced by the economy. To do so, we must act along a number of strategic paths, including the development of human capital, investment in physical infrastructure—mainly for public transit—and in digital infrastructure, promotion of the use of digital tools in the government's work, and advancement of competition and innovation in the financial system, while continuing to maintain its stability. The program that the Bank of Israel presented to the incoming government upon its establishment discusses these issues in detail, and also relates to dealing with other main challenges such as housing and the energy and climate issue.

The Bank of Israel Annual Report by its very nature surveys the year that has passed. At the same time, I find it proper to briefly refer to the developments in recent months. The current period, in which global and domestic economic conditions are changing, requires particularly responsible management of fiscal policy. As a matter of fact, at the end of February, the government approved a State budget proposal that is consistent with the tightening monetary policy during this period. The public sector wage agreements that were recently signed are also consistent with restraining inflation and returning it to the target range. At the same time, the government is advancing legislative amendments concerning the judicial system in Israel. The existence of strong and independent institutions is essential for the stability and prosperity of the economy over time, which is also shown by economic research literature. Those institutions become even more important in an era of globalization and in light of the characteristics of the Israeli economy. A number of developments in the financial markets, and the discussion by international economic entities of the legislative processes currently being debated in Israel underline the need to ensure the independence and professionalism of Israeli institutions, as well as the need for significant changes to be made by broad agreement.

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Governor of the Bank of Israel