

25 Nissan 5768

19 April 2009

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

I submit herewith the Annual Report of the Bank of Israel for 2008, in accordance with section 59 of the Bank of Israel Law, 5714–1954.

After five years of rapid growth, Israel's economy suffered a reversal in the second half of 2008, and started sliding towards recession, in the wake of the intensifying global crisis. Although GDP increased by an average of 4 percent over the year, in the fourth quarter it actually contracted.

In the first part of the year, the trends that characterized the period of rapid growth continued—economic activity continued at a high level, unemployment remained low while the current account of the balance of payments remained in surplus with a high rate of saving, the public debt/GDP ratio fell significantly, and profitability in the business sector remained strong. However, as the global crisis worsened, its effects became more acute towards the end of the year, and the economy then slid rapidly towards a recession: there were steep declines in exports and tax revenues, and private consumption also fell; employment stopped rising, the real wage fell, and unemployment started to rise. The budget deficit increased in 2008, and the rate of decline of the public debt/GDP ratio slowed, as the slowdown in activity and the falls in the capital market adversely affected tax revenues, at a time of further reductions in statutory tax rates.

The turnaround was also evident in inflation: till September it was high, reflecting the increase in global oil and commodity prices and excess demand in the local economy; then it declined sharply, in light of the fall in world prices and the moderation of excess demand.

Israel's financial system underwent considerable upheaval, but much more moderately than abroad. Prices of shares and corporate bonds fell, and spreads in the credit market widened considerably. However, the financial institutions, including the banks, exhibited resilience. The strongest impact was on the nonbank credit market, which became a key source of contraction in credit supply.

The recession in Israel, derived from the global crisis, has led to a decline in aggregate demand and is already evident through its major impact on activity, in particular on exports. It will also be reflected by significantly increased unemployment, and is likely to deteriorate further due to the shortage of credit resulting from the evaporation of the nonbank credit market. There is thus a need for a policy to mitigate the negative effects of the crisis on growth, employment and welfare, while easing the credit problem. Moreover, policy must minimize long-term harm to the economy, so that when the crisis ends, the

economy will be in a position for renewed growth. Policy will be judged not only in the light of the decisions taken, but also in light of the ability to implement them quickly and on the required scale.

The Ministry of Finance has formulated measures to deal with the crisis in the framework of its Acceleration Plan, as well as via other steps, which could reduce the severity of the recession, provided they are implemented fully and quickly. However, the scale of these measures is limited, partly because the 2009 budget has not been approved.

Monetary policy reacted to updated assessments of the severity of the global crisis and its effects on Israel, as well as to changes in world prices which affected both actual and expected inflation in Israel. In this framework, the Bank of Israel acts to support economic activity, and in particular to reduce the cost of credit. Thus the Bank cut the interest rate sharply from October 2008 to its current unprecedentedly low level of 0.5 percent. At the same time the Bank made several changes to its monetary instruments, such as narrowing the interest spread (the “corridor”) between the credit window and the deposit window for commercial banks; these measures increase liquidity for those active in the market and reduce its cost. In addition, in February 2009 the Bank started buying government bonds on the secondary market, to lower the long-term interest rate, and in March 2009 it announced that it was increasing the scale of its purchases. Since March 2008 the Bank has been buying foreign currency in the context of its plan to increase the level of the foreign exchange reserves—it started with \$25 million a day, and since July 2008 it has purchased \$100 million a day. In doing so it also supports the depreciation of the shekel, thereby helping economic activity. The Bank of Israel will continue to use all available instruments to ease the liquidity situation and credit conditions for the private sector.

In order to reduce the effects of the crisis on the economy it is important to implement additional measures to deal with the labor market, increase domestic demand, and ease the credit problem. These should be on a significant scale, simple, and capable of being implemented quickly. Steps to boost demand should be directed towards demand for labor intensive items; some measures should focus on the low-income sections of the population, with a high propensity to consume, thereby contributing to increased consumption and encouraging domestic activity. Along with the steps recommended, it is essential that the government make a definite commitment to reduce the debt/GDP ratio in the medium term, until it reaches the levels which are the norm in the advanced economies, or even lower.

Vigorous implementation of the measures formulated by the Ministry of Finance combined with policies as proposed herein will serve to increase aggregate demand and ease the credit problem in the business sector; this will help mitigate the effects of the recession and will minimize its impact on low-income families. It would also act to prevent long-term damage that could adversely affect Israel’s economic development in the future.

Beyond dealing with the crisis, policies are required to confront the basic challenges of the economy and work towards the achievement of long-term economic and social aims. This, to ensure constant improvement in the standard of living and welfare, and to create the conditions for the renewal of sustainable growth. In certain areas there has indeed

been improvement in the last few years, due to rapid growth and macroeconomic policy, but some of the improvement is only cyclical. Thus, as well as coping with the crisis, it is important to continue fiscal consolidation, to maintain price stability and financial stability, and to deal with problems in education and infrastructures and with poverty.

The performance of the basic and higher education systems should be improved, and the policy of reducing poverty should continue, focusing on the extension of employment among those segments of the population with low participation in the labor market.

The momentum of structural reforms in infrastructures should be regained—mainly in energy, water and public transport. These reforms will help increase competition and efficiency in the infrastructure, thus supporting both increased productivity in the business sector and growth.

Continued development of the financial infrastructure is important, with policies that will reduce vulnerability of the financial system while implementing the lessons of the current crisis. For this purpose, regulation should be adjusted as necessary, supervision of nonbank financial institutions should be tightened, and the structure of incentives for managers of the public's savings should be corrected, to reduce their tendency to take excessive risks. The reduction of the vulnerability of the pension savings system is of special importance.

It is important to complete legislation of the new Bank of Israel Law, similar to updated legislation in other countries that regularized the activities of their central banks. The new law must ensure the independence of the central bank, as is the norm in modern central bank laws around the world, and must clearly define its objectives. The main goal of the Bank will be defined as ensuring price stability in accordance with the target set by the government, while supporting the government's other economic aims, including growth, employment and the stability of the financial system, provided they do not conflict with price stability. The Bank will be granted full independence to use the instruments needed to achieve its aims. It is recommended that a Monetary Policy Committee be established, that will make monetary policy decisions. The Committee will be headed by the Governor, and will include appropriately qualified members from outside the Bank free of conflicts of interest. With regard to the management of the Bank, it is recommended to establish a Council that will be responsible for administrative issues and will serve as the Bank's Board of Directors. A majority of members of the Council will be from outside the Bank, and one of them will head it.

Yours sincerely,

A handwritten signature in black ink, reading "Stanley Fischer". The signature is fluid and cursive, with the first name "Stanley" and last name "Fischer" clearly distinguishable.

Stanley Fischer
Governor, Bank of Israel