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

I am honored to hereby present the Bank of Israel Annual Report for 2020, pursuant to Section 54 of the Bank of Israel Law, 5770–2010.

The COVID-19 pandemic that upended the world in 2020 also had a major impact on Israel. Apart from the widespread morbidity and mortality, it had an impact on both economic activity and various aspects of society and welfare. The government imposed severe restrictions on activity, which peaked during three lockdowns, and which were intended to moderate the rate of infection. These restrictions were focused on creating physical distancing, and their impact was therefore focused primarily on industries and activity that involve physical proximity. The harm to the rest of the economy was limited. The fluctuations in the severity of the restrictions were also manifest in volatility in the level of economic activity over the course of the year, particularly the sharp drop during the first lockdown.

Israel was in a healthy economic situation in many respects when the pandemic began. Nevertheless, the pandemic had major consequences for the economy, with GDP falling by 2.5 percent. The decline in GDP was led by an exceptionally large drop of 9.5 percent in private consumption, which was also manifest in a sharp increase in the savings rate. In contrast, exports played an important role in moderating the damage to the economy, primarily thanks to the sustained and rapid growth in the export of high-tech services. The positive performance in exports alongside the sharp drop in imports led to a significant expansion of the current account surplus. The inflation rate this year was -0.7 percent, which is significantly less than in previous years. The crisis's effect on domestic economic activity and on global prices of fuel and food contributed to the decline in inflation, as did the appreciation of the shekel.

The effect on employment was even larger than the effect on GDP. Many workers were furloughed and the broad unemployment rate shot up to an average of 15.7 percent over the course of the year. The effect on the employment of low-wage earners was particularly severe since a large number of them are employed in industries that suffered the largest decline in economic activity. The situation in these industries also had a widespread effect on the self-employed and on small businesses. Small businesses found it hard to obtain credit, particularly prior to the activation of the State-guaranteed funds.

Fiscal policy responded vigorously, primarily by means of transfer payments that were meant to assist households and businesses. Among other measures, these included generous assistance to the unemployed and grants to the self-employed and businesses. The government also provided guarantees for the provision of loans to businesses, particularly small businesses that were severely affected by the crisis, and it took additional steps to support businesses, including a discount on municipal taxes and early tax rebates. The increase in transfer payments was the main factor in the growth of the government deficit to 11.6 percent and the increase in the debt-to-GDP ratio from 60 percent to 72.6 percent. In the absence of an approved State budget, policy was implemented as part of a continuation budget. The approval of the one-time budget increases ("COVID-19 boxes") allowed the government to significantly increase its expenditures in order to mitigate the crisis.

Monetary policy also responded vigorously. The Bank of Israel interest rate was lowered by 0.15 percentage points to 0.1 percent. Monetary policy at first focused on stabilizing the financial markets, and later employed a variety of tools to ease financing terms. The most prominent of these in terms of scope was the purchase of government bonds in the secondary market. The Bank of Israel used other tools as well, some of them for the first time in Israel, such as the purchase of corporate bonds and loans to the banks at particularly low interest rates conditional on the channeling of credit to small businesses. Later on, the Bank of Israel also announced that it would provide these loans at a negative interest rate (-0.1 percent) and set a ceiling on the interest that the banks could collect from businesses in this context. In addition, the Bank of Israel purchased foreign currency in large quantities in order to moderate the appreciation of the shekel and its adverse effect on economic activity.

Alongside the steps employing monetary tools, the Bank of Israel worked to increase the quantity of bank credit by easing the regulation of the banks. Similarly, and as part of the programs for deferring loan payments initiated by the Bank of Israel, payments were deferred on a significant scale, primarily those on housing loans, but also on credit to small and micro businesses.

At the end of 2020, Israel initiated a large-scale vaccination program. Its effect on morbidity was already noticeable during the first quarter of 2021, which is beyond the period analyzed in this report, in view of which the government significantly eased the restrictions on activity.

As Israel emerges from the crisis, fiscal policy will need to be adjusted in order to ensure that the public debt to GDP ratio is on a downward path. The contraction of the special expenditures having to do with the crisis will not suffice. The large and expanding structural deficit prior to the crisis shows that additional adjustments will be necessary. Moreover, there must be a return to conducting fiscal policy within formalized frameworks and in accordance with long-term fiscal rules in order to maintain its credibility over time and support the processes of setting priorities. Passing the 2021 budget is an essential step in this direction.

It is important to prepare to deal with the potential long-term implications of the crisis, such as persistent unemployment, structural changes in the economy, and the cumulative effect on the scholastic achievements of some pupils. Furthermore, once the crisis is over, it will again become necessary to focus on the fundamental problems of the economy, chiefly low productivity, disparities in productivity between segments of the population and sectors of the economy, and inequality. Some of these problems were exacerbated during the crisis, such as those due to the differential effect on more highly educated workers and those with lower education and wage levels, and in view of the importance of education and skills for online activity. These all underscore the importance of improving the education system and reducing educational gaps. Increasing investment in the economy, particularly in public transit, communication and energy infrastructure, is also necessary in order to increase productivity in Israel. In addition, and as a lesson from the crisis, it is important to upgrade the information infrastructure used to formulate and implement government policy. The crisis has emphasized the possibilities for the assimilation of advanced technologies in order to improve government activity and service to the citizen, and it is worthwhile broadening these processes.

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