24 Adar 2, 5771
March 30, 2011

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

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

Economic activity in Israel continued to expand in 2010, extending the trend that started in the second quarter of 2009 with the beginning of the recovery in Israel from the effects of the global crisis. GDP grew by 4.6 percent in 2010, with rapid increases in fixed investment, exports and private consumption; growth in the final quarter of the year was at an annual rate of more than 7 percent. Together with the growth in GDP, employment also increased, by 3.5 percent, with a rise in the rate of participation and a decline in unemployment to 6.6 percent, a low level approaching the 6.0 percent rate prior to the crisis.

The rate of inflation was 2.7 percent in 2010, within the price stability target range. A 5 percent increase in the housing component of the CPI, and increases in the prices of energy and fruit and vegetables during the year contributed to the overall price rise. Inflation in 2011 is expected to be higher than the target range in light of the increases in prices of commodities and oil and the expectation of continued rapid economic growth in Israel.

The positive developments in the domestic financial system continued during the year. The resilience of financial institutions, including the banks, strengthened, and was reflected in improvements in their capital structures. This was accompanied by supervisory requirements introduced to strengthen corporate governance and risk management in the financial institutions.

Alongside these positive developments, various risks—mainly in the global sphere but also in the domestic market—are still evident, and continued efforts are required to minimize them to reduce the negative impact on Israel's economy should they be realized. In particular, house prices continue to rise at an unsustainable rate, the volume of mortgage credit is increasing rapidly, and risk spreads on corporate bonds have declined significantly.

Economic policy encouraged the expansion of activity in 2010 and instilled an atmosphere of stability into the economy. The improvement in the global economic environment, particularly the growth of world trade, also contributed to the increase in activity.

The objective of monetary policy was to entrench inflation firmly within the target inflation range while supporting activity and maintaining financial stability. Monetary policy remained expansionary during the year, reflected by the gradual way in which the interest rate was increased—it reached 2 percent at the end of the year—and by purchases of foreign currency. The latter served to moderate the pace of appreciation of the shekel, which was affected inter alia by inflows of short-term capital, and thereby reduced the negative impact on exports. The shekel appreciated by 7 percent in terms of the nominal effective exchange rate during the year. The Bank of Israel purchased some $12 billion of foreign currency in 2010, about half of the amount it purchased in 2009.

The interest rate was adjusted gradually, because a) during the year there was great uncertainty about the rate of export growth and the sustainability of the recovery world wide, a necessary condition for export growth, and b) the advanced economies continued to keep their interest rates low, and the differential between their interest rates and Israel's increases short-term capital inflows, which tend to cause the shekel to appreciate, to the detriment of exports.

At the beginning of 2011 the Bank of Israel introduced additional measures in the foreign currency market. It imposed reporting requirements on swaps and NIS/foreign currency forwards, and on nonresidents' transactions in *makam* and short-term government bonds; the Bank also announced the imposition of a 10 percent reserve requirement on nonresidents' NIS/foreign currency swap transactions and foreign currency forwards. This was done to reduce the profitability of nonresidents' short-term capital inflow into Israel, and thereby to moderate the appreciation caused by such inflows. At the same time the Ministry of Finance announced that it intended to abolish the tax exemption of nonresidents' profits from investments in *makam* and short-term government bonds—thus bringing this taxation in line with that on Israeli residents—with the intention of making such investments less attractive.

Fiscal policy was reflected in a marked decline in the government deficit, from 5.1 percent of GDP in 2009 to 3.7 percent of GDP in 2010, 1.8 percent of GDP lower than the deficit ceiling specified in the Law. The debt/GDP ratio also fell, from 79.2 percent in 2009 to 76.2 percent in 2010. The decline in the deficit occurred despite a relatively steep 6 percent increase in public expenditure, as the increase in government revenues exceeded expectations due to the rapid growth in economic activity, and the stability (in net terms) in tax rates.

In 2010 a new fiscal rule was adopted based on a higher expenditure ceiling than in the previous rule, and a downward deficit path for the next few years. The rule is consistent with the convergence of the debt/GDP ratio to about 60 percent in 2020, a long-term target appropriate to Israel's economy. However, whereas the achievement of the deficit in the next two year is consistent with the 2011–2012 two-year budget, the reduction of the debt/GDP ratio to 60 percent in 2020 as planned will occur only if the economy grows at more than 5 percent per annum. At lower growth rates, the deficit will be below the ceiling only if the government postpones the continued implementation of planned tax reductions, or if it suspends some of the increases in expenditure permitted under the new fiscal rule.

The budget allocates more resources to all levels of the educational system and also to measures to encourage participation in the labor market. These policy changes are intended to integrate weaker sections of the population into economic activity, thereby helping to increase their incomes, spur growth, and reduce economic inequality in Israel. They are of significant importance, and should be implemented.

Prices of real and financial assets increased rapidly in 2010 in the low interest environment. Share prices increased by 13 percent, in line with global trends. Corporate bond yields fell, due mainly to a reduction in their risk premia, and to a lesser extent due to the decline in government bond yields. Alongside the decline in yields there was an increase in bond issues of companies with low ratings and unrated companies, and particularly real estate companies.

House prices continued to increase at a relatively fast pace in 2010, about 16 percent, and since their low point at the beginning of 2008 they have risen by 39 percent in real terms. These developments led to concern over the creation of a bubble in the housing market, and resulted in the introduction of steps by the Bank of Israel and the government to slow the pace of prices increases and to maintain the stability of the financial system.

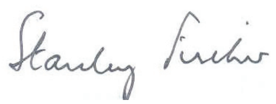
The Bank Supervision Department acted during the year to reduce the risks to the stability of the banking system that could derive from the rapid increase in the volume of mortgage financing. Restrictions were imposed on the activity of housing project purchasing groups, and additional capital allocation was required for loans with relatively high loan-to-value ratios.

As part of the increase in house prices can be explained by the cumulative supply shortage of houses relative to the expansion in the number of households, the preferred solution to increased housing prices in the long run is an increase in supply. The government therefore took several steps during the year to increase the supply of land available for building, and to reduce barriers in the processes of land sales and making it suitable for building. Nevertheless, since part of the demand for houses is temporary and is related to the relatively low rate of interest, it is important to ensure that the increase in supply matches the long-term demand surplus.

The discovery of two very large gas fields off Israel's coast in the last two years constitutes a significant development—the Tamar field, which is currently being developed, is expected to supply Israel's gas requirements for about thirty years, and the even larger Leviathan field which is next in line, has a quantity of gas that will enable Israel to become a gas exporter. These discoveries have significant economic implications that will be felt gradually over the coming decade. They are expected to have a marked effect on the balance of payments and the exchange rate only if there will be significant gas exports (which in any event are not expected to occur before the end of this decade). The potential negative effects of these discoveries on the domestic economy—the so-called Dutch disease—can be offset by the creation of a Sovereign Wealth Fund, which would invest only abroad. Properly managed, that would help also in the intergenerational distribution of the benefits from the gas discoveries.

In 2010 the process of Israel's accession to the OECD was completed, and Israel became a member. Israel's joining the OECD is evidence of the country's standing as a developed country, but is also presents it with a challenge to continue to advance in several spheres, including the degree of competitiveness, the quality of education, and the quality of the environment.

In March 2010 the Knesset passed the new Bank of Israel Law. The Law defines the maintenance of price stability as the Bank's central goal. Additional goals include supporting other objectives of the government's economic policy, especially growth, employment, and reducing social gaps, and supporting financial stability, provided that in the opinion of the Monetary Committee this support will not prejudice the attainment of price stability over the course of time. The implementation of the new Bank of Israel Law—which clearly specifies the Bank's objectives and provides it with the required tools to achieve the objectives and the independence to operate them—and redefines its decision making methods, is expected to strengthen the Bank's capacity to perform its functions and thus support the continued prosperity of Israel and the welfare of its citizens.



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