

**BANK OF ISRAEL**

**Policy Panel – IMF Annual Conference – Amir Yaron Speech 9/11/23**

As we are all aware, Israel is currently at war, following the October 7th inhuman brutal attack, by the terrorist organization of Hamas.

This is a crucial time for Israel's security and we thank all those who support us. Our hearts are with the innocent victims of the war and our hope is for it to end with the safe return of the hostages to their families and with peace and security.

Let me now address the issues and questions presented for this session.

An important question is to what extent can a small open economy like Israel, or for that matter any SOE, conduct its monetary policy independently, or should it rather follow the steps of the major economies. Another question is: what are the spillovers from the policy taken by the major economies to SOEs and how do those impact local conditions.

The answer to these questions depends on the development level of the economy, its specific areas of exposure to the global economy and the particular shock it might need to react to.

Generally, local monetary policy cannot be entirely disconnected from that in major economies. Yet, local circumstances justify and require setting policy that is tailored in accordance with the economy’s structure and needs. Key considerations will include interest rate differentials, FX and the effect on domestic activity, in particular exports, on inflation, and on financial markets.

As we all know, our planet has become a small village. The COVID experience demonstrated that spillovers can be a result of common shocks. Monetary policy was generally similar in many countries because the initial health shock as well as many supply-side difficulties were similar.

 Also a common monetary framework (such as inflation targeting), meant that monetary policy in different economies was predicted to act in a similar manner.

Having said that, the differential health shock and related steps, fiscal policy, and exposure to supply side effects and commodity prices, led to somewhat different policies and inflation and activity outcomes. Consequently, there was more heterogeneity in monetary policy “exiting” Covid than upon its entry.

Israel was fortunate in that sense, with a relatively small share of tourism sector and a relatively large high-tech sector, which actually benefited from the increased dependency on remote work. These circumstances led to a wedge between global monetary policy and the required domestic monetary policy.

[Slide 2 – inflation] The slide shows that for these reasons and others, inflation in Israel is in the lowest quartile of rates in the OECD. In particular, headline inflation in Israel was low because its natural gas supply and prices were shielded from global developments.

The next slide shows the swift recovery of the Israeli economy from the COVID crisis. The level of GDP exceeded its long-run trend already by end 2021, and stayed somewhat above this trend by Q3-2023.

An additional key attribute in Israel that affects the potency and effectiveness of monetary policy is the large share of mortgages that are directly tied to the Bank of Israel rate. Therefore, raising rates influences the stock of almost all home owners, not just new ones. This is another cause for possible differences between global and local monetary policy rate decisions.

The Bank of Israel was one of the first Central Banks to respond to the increase in inflation. As a first step, we shrank the unconventional tools employed during COVID (e.g. QE, FX intervention, and special funding to commercial banks). Relative to its rate of inflation, Israel has been among the first movers. [slide – reaction of rates]. This is another evidence for only partial dependence of SOEs on policy taken by major central banks.

[slide – fed, ecb, BOI rates] The policy the Bank of Israel has in fact set in recent years is consistent with this approach. We are aware of the fact that domestic monetary policy cannot deviate “too much” from global conditions but at the same time, we recognize that policy should be set according to the specific shocks to our economy, taking into account its fundamental attributes.

[slide Nasdaq-dollar] We learned over the years that there is a strong connection between the S&P and Nasdaq indices and the Shekel/Dollar exchange rate. This is because Israeli institutional investors react continuously to changes in the value of their foreign denominated portfolio. This slide shows this pattern very clearly. However, as can easily be seen, since the beginning of 2023 this strong connection has weakened. This was the time period the potential changes to the judicial system ignited a widespread civilian opposition. Similarly, the Israeli and US stock markets who tend to move together also displayed a weakened connection. According to the assessment done at the Bank, if the exchange rate were to follow the NASDAQ index according to the previous pattern, the Shekel would have been about 15% stronger relative to the actual FX rate in September 2023. Given our estimates of the FX pass-through to inflation –this amounts conservatively to additional inflation of about 1 to 1.5%. This demonstrates again the power local significant developments have on the financial markets, inflation and policy.

I want to move on and discuss current developments in relation to monetary policy spillovers.

An important part in the analysis of potential effects of spillovers are the initial conditions or the state of the economy when a shock hits the economy.

[slide-growth after wars] The Israeli economy is strong and stable. It has robust and healthy economic foundations. We are a global leader in innovation and technology. The Israeli economy has known how to function and to recover from difficult periods in the past and to return to prosperity rapidly. I have no doubt that the same will be the case this time.

 [slide debt] Importantly, over the years Israel has shown responsible fiscal position as demonstrated by the declining path of the debt-to-GDP ratio. Israel entered the war with a very solid fiscal stand. Our debt to GDP ratio is just under 60% and a budget deficit, which was expected to be around 1.5% of GDP in 2023, following a surplus in 2022.

There is no doubt the war will have fiscal implications and generate budget pressures. According to initial projections of our research department, which are of course accompanied by extreme uncertainty, and assuming the war is primarily concentrated in the southern border and lasts till the end of this year, GDP growth is likely to be reduced by about 1% in 2023 and 2024 relatively to the forecast before the war and the debt to GDP ratio is likely to rise to somewhat more than 65% by the end of 2024 as costs are larger than was initially projected

[Slide – BOI steps] As I mentioned in my opening, Israel has been in war for over a month now. Above and beyond the vast human, security and political consequences, there is no doubt this is a major shock to the economy –to households, workers, and businesses. Economic policy – fiscal and monetary, which we in the BOI lead – takes the necessary actions in order to alleviate the difficulties accompanying these challenging times.

With the outbreak of fighting, significant depreciation pressures were seen, which were reflected in early trading in foreign markets. The Bank of Israel responded rapidly. Already on October 9, before trading opened, we implemented a plan to sell up to $30 billion and to put into operation Swap transactions totaling up to $15 billion. Within the framework of the program, the Bank is acting in the market to moderate the fluctuations in the value of the shekel and to supply the liquidity required to continue the orderly activity of the markets. The initial high level of the Bank of Israel’s foreign exchange reserves, at about $200 billion, gives us ample space to act to achieve this target. In addition, the Bank also put into operation a shekel Repo transaction plan, and a monetary program focused on small businesses.

In parallel, from the beginning of the war, the Bank of Israel rapidly formulated a uniform and agreed-upon framework that was adopted by the commercial banks and was expanded to credit card companies as well. The framework is focused on those serving in the army reserves, the population on the borders, and the families of the victims and hostages. These populations will be able to defer for three months payments on mortgages, consumer credit, and small business credit without costs.

Many of the banks have extended these steps-- a very welcomed outcome, as they are stable, resilient and have ample capital buffers.

In our interest rate meeting, on October 23rd, we kept the policy rate at 4.75%. This is consistent with the Bank’s FX activities and inflation endeavors.

This array of policy steps that were taken by the Bank of Israel in the last month reveals the sufficient and necessary independence that the Bank enjoys, and that it has an adequate set of monetary tools that can ensure financial stability. Avoiding a reduction in the rates is in line with operating in the FX market to moderate large depreciation fluctuations. Moreover, the steps taken by the Bank vis-à-vis the banking sector, allow in practice some monetary easing, but targeted at those who need it most, without compromising the need to deal with increased risk premia in financial markets.

One month in, we can cautiously say that the policy mix we applied contributed to the stability not only of the FX market but also had positive spillovers for the stability of local financial markets.

[slide – inflation expectations] The developments in the markets also indicate that the public understands that the BOI enjoys the required independence in order to take the necessary steps at these times. Inflation expectations for the short term and long term have remained substantially stable. [slide – long term expectations] [slide – fx rate] The exchange rate has depreciated, but by now is back to the level prior to the war.

Fiscal policy is of course central and crucial for the ability of the economy to overcome this crisis and resume growth in the medium and long term. The Government is working on various fiscal support plans which the Bank is playing a key role in advising, in its role as the economic advisor to the government. The Bank has stated the importance of finding a responsible balance between supporting the economy and maintaining a sound fiscal position. While it is clear that overall fiscal needs will increase, the Bank advice was to utilize the 2023 budget, yet demonstrate fiscal responsibility by introducing several important adjustments and cuts in less necessary activities in the 2023 and 2024 budget.

I have no doubt that, as always, Israel will prevail and has the right ingredients to spring-back to its great economic potential. We all hope for calmer and more tranquil times.