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March 31, 2020

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

I am honored to submit herewith the Bank of Israel Annual Report for 2019, in accordance with Section 54 of the Bank of Israel Law, 5770–2010.

The corona crisis that is currently gripping the global economy, including the Israeli economy, broke out in China and spread to the rest of the world at the beginning of 2020. Since the outbreak of the crisis, there has been a constant discussion among medical and economic experts in order to find the balance between preventing infection and risk to life and minimizing the damage to the economy. According to most recent data and the Bank of Israel's updated forecast, the crisis is expected to have a significant impact on growth and to markedly increase unemployment, and it is important that the government and all policymakers continue to make the decisions necessary to minimize its effect.

In view of the timing of the outbreak of the virus, the economy was not affected at all in 2019—the year surveyed in this report—and the report does not relate to it. However, I would note that the picture emerging from the report regarding 2019 shows that the good state of the economy prior to the crisis put it in a relatively strong starting position from which to deal with the far-reaching economic ramifications of the crisis. This report was completed after the crisis had hit with its full force and the economy had transitioned to operating under emergency regulations. Therefore, we narrowed the report, and it mainly includes sections dealing with the current analysis of developments in 2019. The discussion of structural issues in the economy is being delayed to a later time.

In 2019, GDP grew by 3.5 percent, similar to its growth rate in the previous two years. However, net of unusual factors, growth in 2019 was lower. The improvement in terms of trade and the accommodative macroeconomic policy supported the expansion of domestic uses. The slowdown in world trade and the continued appreciation of the shekel in terms of the real effective exchange rate made it difficult for manufacturing exports. In contrast, advanced services exports continued to grow rapidly, even beyond the rapid growth of world trade in such services. Thanks to this and to the marked growth in advanced manufacturing exports, total exports continued to grow rapidly this year. This was reflected both in the contribution of exports to growth this year, and in the expansion of the surplus in the current account of the balance of payments. The improvement in the terms of trade also contributed to the growth in the surplus despite the rapid growth of imports.

In 2019, the labor market remained in a full employment environment. The unemployment rate reached its lowest level in decades, and the employment rate reached a new all-time high. However, the moderation of the pace of wage increases, the halt in the growth of labor income as a share of GDP, and additional signs indicate that the labor market did not continue to tighten. As a result of the continued moderation of the growth in the primary working age population and the full employment environment, growth in 2019 continued to rely to a large extent on the increase in the capital stock, and only to a lesser extent on growth in employment. One of the positive results of the increase in participation and the decline in unemployment in the past decade was a reduction of poverty, which was greatly influenced by the positive state of the labor market. However, in order to continue the reduction in poverty, measures are necessary to improve the human capital of groups that are characterized by a high poverty rate.

Inflation in 2019 was 0.6 percent—below the lower bound of the target rate (1–3 percent). The inflation rate in the second half of the year was lower than in the first half and in the previous year. This decline was mainly due to the marked appreciation of the shekel during the year. One-year inflation expectations also moderated in the second half of the year, to around the lower bound of the target. The Bank of Israel interest rate remained unchanged throughout 2019, at 0.25 percent. However, in view of the sharp change in the global environment during the year, the turnaround in the direction of monetary policy in many countries, and the decline in the inflation environment in Israel, the expected path of the interest rate in Israel changed from upward to downward. In view of these changes in circumstances, and as part of its continuing policy, the Bank of Israel purchased large volumes of foreign exchange in the fourth quarter of the year.

The government deficit totaled 3.7 percent of GDP in 2019—0.8 percent of GDP higher than the ceiling, and than the 2018 deficit. The growth rate of public expenditure moderated this year, but remained higher than the expenditure rule, since the government decided to raise the expenditure ceiling beyond what is set out in the rule. The increase in public expenditure, alongside the reduction in tax rates in recent years, increased the structural deficit. The public debt to GDP ratio declined by one percentage point this year, to 59.9 percent of GDP, despite the high deficit, thanks to the rapid growth of nominal GDP, the appreciation of the shekel, and the decline in the government's balances at the Bank of Israel.

Home prices resumed their increase this year, after there was a pause in the previous two years for the first time in a decade. This increase, alongside the resumption of the increase in the number of home purchase transactions, indicates an increase in demand relative to supply. The number of building starts remained high.

The private debt to GDP ratio in Israel—both regarding households and businesses—is lower than in other advanced economies. Housing debt increased at a high rate this year. The growth rate of consumer debt was similar to that of recent years, but institutional investors' and credit companies' share of such debt increased, in view of the structural changes in the credit market, and particularly in the credit card market. The composition of business credit also changed. In contrast with previous years, bank credit to large businesses increased rapidly in the past two years, while the growth rate of credit to small and medium businesses slowed.

Prof. Amir Yaron

A handwritten signature in blue ink that reads "A. Yaron". The signature is written in a cursive, flowing style.

Governor of the Bank of Israel